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United States Economic Policy Toward Asia

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Abstract

The relationship between the US and Asia will be the single biggest determinant in the evolution of the global economic system. In the absence of adequate reform at the global level, the alternative could be further fragmentation into competing regional blocs. Asia holds the key, combining both dissatisfaction with existing global arrangements with the resources to reconstitute, at least at the regional level, an alternative set of institutions and practices. How Asia responds will partly depend on the policies of the dominant global power, the United States.

The Obama Administration faces two specific challenges in organizing American economic diplomacy toward Asia. The global financial crisis is probably the worst since the Great Depression and the domestic political environment which makes it increasingly difficult to formulate a constructive trade policy. Addressing the financial crisis is the top priority. In the trade arena, three issues require prompt attention: the re-establishment of fast-track negotiating authority for the President, the resolution of the Doha Round impasse, and the passage of the KORUS FTA. Finally, in the area of least immediate domestic political sensitivity, the Administration will have to formulate a coherent strategy for responding to the emerging regional and sub-regional policy initiatives within Asia in both the financial and trade spheres.
That the US and Asia have an enormous stake in their shared prosperity should go without saying: Asia accounts for over one-quarter of US trade and roughly one-sixth of US outbound private foreign direct investment. Asia includes the world’s second and sixth largest national economies (Japan and China), the largest recipient of foreign direct investment, China, and another emerging powerhouse in India. Reciprocally, from an Asian perspective, the US is an important partner: roughly 13 percent of Asian trade is with the US (with a much larger share of final demand for finished products), and the US absorbs a similar share of outbound Asian FDI. The American importance to Asia goes beyond these figures: the US is the leader in the emerging sectors of the post-industrial economy, and it is becoming a more important partner with Asia in areas such as trade in services and technology transfer. More broadly, US leadership for more than one half century has supported the maintenance of a liberal global trade and financial system, the enabling framework in which Asia has experienced its spectacular development.

Looking forward, however, the relationship faces major challenges. The global financial crisis, with its epicenter in the US, may provide an enormous impetus to a shift in global power toward Asia, through direct trade and financial channels, as well as through induced policy changes in the US, regionally, and globally. These developments in turn feed into the increasingly difficult long-term challenges of managing globalization and maintaining the open international economic order which has served American and Asian interests. These challenges are made more difficult by a diplomatic environment in which public disfavor in many countries with US foreign policies including the wars in Iraq and Afghanistan have damaged America’s capacity to lead (Pew Global Attitudes

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1 In purchasing power-adjusted terms, Asia accounts for one-third of world output, and China replaces Japan as the world’s second largest economy.
Project 2008), though the election of Barack Obama, who if anything appears more popular with foreigners than his own countrymen, may provide renewed opportunities (Kull 2007, BBC 2008, Harris Interactive 2008).

Asia, with a large number of economies of widely varying sizes and income levels, encompasses enormous diversity. One implication is that while the process of growing regional trade and investment ties are forging a stronger regional identity than existed in the past, the national interests of Asian countries diverge on many specific policy issues, creating some paradoxical challenges for American policymakers: Asia’s heterogeneity militates against defining US economic policy in regional terms, yet the emergence in Asia of regional institutions and initiatives requires a US policy response. The US will host the Asia Pacific Economic Cooperation (APEC) forum in 2011, forcing Asian regional issues onto the agenda of the current Administration.

For the most part, the US policy agenda toward Asia does not revolve around regional issues, but rather is derivative of American global economic concerns. Likewise, from the standpoint of most Asian governments, the issues of greatest salience in their relationship with the US are either bilateral in nature, or are the bilateral manifestation of issues of global concern. Some of the critical items on the US economic agenda with Asia—establishing a viable policy on sovereign wealth funds, the Korea-US Free Trade Agreement (KORUS), and the future of the Doha Development Round of multilateral trade negotiations under the auspices of the World Trade Organization, to name three—may or may not be specifically “Asian” per se.

The ability of the US and Asia to work together to sustain an open system of international economic relations face challenges at both the inter-state diplomatic level
and at the domestic political level. In the US, the Obama Administration faces two specific challenges in organizing American economic diplomacy toward Asia. The first is the financial crisis, probably the worst global financial crisis since the Great Depression, which risks substantial negative impact on both the US and the global economy. The second is a domestic political environment which makes it increasingly difficult to formulate a constructive trade policy. The paper begins with a brief review of the financial crisis and some of the channels through which it will affect relations between the US and Asia. It then considers the longer-run challenges to the preservation of a liberal system of international economic relations, first examining concerns at the level of inter-state diplomacy, and then addressing the problems of maintaining domestic political support for openness. Finally, the paper considers prognosis. The main conclusion is that the relationship between the US and Asia will be the single biggest determinant in the evolution of the global economic system. Accelerated fragmentation of the global economy is a distinct possibility. Asia is key, combining both dissatisfaction with existing global arrangements with the resources to reconstitute, at least at the regional level, an alternative set of institutions and practices. How Asia handles this situation, acting to strengthen reformed global institutions or undermine them in favor of regional alternatives, will partly turn on the policies of the dominant global power, the United States.
The Global Financial Crisis

The International Monetary Fund (IMF) predicts that global financial output will fall by 1.3 percent in 2009, making it the worst year since the Great Depression (IMF 2009a). The origins of the current financial crisis reside primarily in developments in the US housing market. The “originate and distribute” banking model and the associated practice of securitization—the bundling and reselling of mortgages—reduced the incentives of mortgage originators to exercise due diligence with respect to borrowers and loan quality predictably declined.

In parallel, the process of financial innovation, made possible by deregulatory moves begun in the late 1970s, gave rise to instruments of increasing complexity, a characteristic that made developments in the mortgage market more hazardous, by impeding the ability of financial firms to assess both portfolio and counterparty risk.

These developments were abetted by unusually low interest rates due to a variety of factors including the Asian savings glut, and a bias toward monetary ease under the Greenspan Fed, which both facilitated borrowing in the first instance or primary sense, as well as encouraging excessive leverage among secondary market participants (Taylor 2009).

Finally, the ratings agencies and regulators were asleep at the switch. In particular, the regulatory system of the US was revealed to be fragmented and inadequate, particularly with respect to the so-called “second banking system” comprised of non-bank financial institutions such as hedge funds. Abundant liquidity and regulatory lassitude enabled criminal frauds on a grand scale, of which the Madoff and Stanford...
scandals are the leading indicators. Similar developments occurred in parallel elsewhere around the globe, particularly in the UK.

The crisis was propagated internationally through open capital markets exposing pre-existing weaknesses in financial sectors and participants outside the US, for example the lack of capital adequacy of some European banks, real estate bubbles in parts of Europe, and reliance on foreign borrowing and potential currency and term mismatches among some Korean banks. Once the crisis got underway, rising interest rates exposed weaknesses in other parts of the financial sector, such as consumer lending and commercial real estate in the US. Crisis response in the US has been forceful (at least as measured by expenditures), but inconsistent and ad hoc, complicated by the electoral calendar in the US and the political transition from the Bush Administration to the Obama Administration.

Benchmarking against past banking crises, US economy could continue shrinking into 2010, followed by slow recovery, and eventual increases in asset prices and employment, with housing prices taking the longest time to recover (Reinhart and Rogoff 2008), though others have predicted a more rapid recovery (Mussa 2009, Bernanke 2009). While trying to calculate losses ex ante in the midst of a crisis is a mug’s game, the IMF estimates that current gross financial losses are $4.1 trillion, with losses on US assets $2.2 trillion or 15 percent of current GDP. Estimates have risen as the crisis has unfolded (IMF 2009), putting them into the same league as those experienced by Japan, Korea, and Taiwan during their crises during the 1990s. Boone and Johnson (2009) have ventured that ultimate taxpayer costs will be on the order of $1 trillion. There is some thought that the crisis will actually prove more severe and protracted in Europe.
Some Asian countries have benefitted substantially from the rapid growth of consumption in the US since 1994, which coincided with their interests in running current account surpluses and accumulating reserves as a form of self-insurance following the 1997-98 Asian Financial Crisis. In 2007, China’s current account surplus as a share of GDP reached a historically unprecedented 11 percent, and is forecast to remain an extraordinary 10 percent through 2009 (IMF 2009). During the early stages of the current episode, there was wishful thinking about “decoupling,” the notion that Asia would be able to maintain its growth rates, even as the US and Europe slowed. The fourth quarter of 2008 laid this notion to rest: growth rates were marked down throughout the region, with the Japanese economy contracting at an astonishing annualized rate of more than 12 percent, followed by a 15 percent year on year decline in the first quarter of 2009. By spring 2009, its stock market stood at its lowest level since 1982.

Rather than “decoupling,” Asia appears to be experiencing “re-coupling” or “reverse coupling” with a vengeance. There are multiple channels through which this is occurring. The most obvious is through the “real” channel, as a combination of slowdown in the US and Europe and depreciation of the US dollar leads to a substantial, sustained increase in US net exports. This adjustment is already beginning to occur, and is happening much more abruptly than people expected—witness for example, the collapse of Taiwan’s exports, falling nearly 45 percent January 2008- January 2009. One upside for most of Asia associated with this weakening of global growth has been the fall in commodity prices, the price of oil in particular, and the improvement in the terms of trade has acted as a kind of automatic stabilizer, cushioning the external shock. But it is unlikely that the US will be able to continue as the “consumer of last resort” and the IMF
predicts that the region will not experience a sustained recovery until mid-2010 and that it cannot rely on China to pull it out of its slump (Burton 2009). To revive growth Asian countries will have to increase domestic demand in the context of an unwinding of the massive global imbalances.

Beyond the real effects, Asian economies will suffer losses based on their degree of exposure to troubled markets, as well as some specific financial sector challenges such as among Korean banks. Shocks felt through this financial channel may have secondary real side implications as well. The re-equilibration of financial flows has resulted in exchange rate adjustments, including an appreciation of the Japanese yen, associated with a reversal of the carry-trade. Over the course of 2008, the Korean won depreciated more than 40 percent against the Japanese yen, for example. This shift in competitiveness could have additional knock-on implications; it is conceivable that Korean auto firms could experience an increase in market share at the expense of Japanese assemblers in the shrinking US market, complicating the passage of the KORUS FTA, for example.

A key issue is how China will contribute to greater stability in international economic relations. Chinese officials have become more assertive in their pronouncements on international economics issues: Premier Wen Jiaobao has criticized US economic policies, and People’s Bank Governor Zhou Xiaochun has called for a new reserve currency based on the IMF’s Special Drawing Rights (SDRs). (When the latter statement roiled currency markets, Chinese authorities quickly indicated that it was a long-run, not immediate, aspiration.) Whatever the reserve currency, an outstanding issue is whether and how China will increase the flexibility of exchange rate determination and how this might affect the movements of other Asian currencies against the yuan. The
bilateral trade imbalance between the US and China ballooned to $266 billion in 2008, accounting for one-third of America’s global trade deficit of nearly $800 billion. In the long-run, China will experience significant real appreciation generated by its rising productivity in its traded goods sector, the current account surplus will diminish, and exchange rate policy will move toward a more genuine float. But getting to this outcome will be politically contentious, and the Obama Administration will face Congressional pressure on the Chinese currency issue.

The crisis is likely to prove to be a watershed event and have a longer term effect on Asia through what might be called the policy channel. In response to the crisis, the US is currently re-regulating its financial sector on an ad hoc basis, reversing the trend toward financial market deregulation begun during the Carter Administration in the 1970s. The government takeover of mortgage giants Fannie Mae and Freddie Mac has effectively nationalized roughly half of the US mortgage market; the US effectively nationalized AIG, a major insurer, and the nationalization of the banking sector remains a possibility. A key issue is whether such interventions would adversely affect US economic performance, possibly contributing to a decline in the relative importance of the US in the global economy and reducing American diplomatic relevance.

At some point, US authorities will attempt to move beyond improvisation and undertake a concerted regulatory overhaul. If inexpertly done, this move could both impair the competitiveness of the US economy as well as reduce the attractiveness of the US financial sector. Both developments would be bad for Asia.

Re-regulation would also change the ideological context of international policy formation both bilaterally and through multilateral institutions for financial sector
liberalization generally, and external liberalization specifically. Less pressure for financial market liberalization on Asian countries would emanate from multilateral organizations such as the International Monetary Fund (IMF), World Bank, and Asian Development Bank (ADB). With a lag, this shift would presumably be reflected in the US trade negotiation agenda: with less confidence in unfettered financial market operation, and US policy swinging back toward regulation, US demands for Asian countries to liberalize their financial markets and grant US service providers greater access would eventually attenuate or become less effective. This tendency is already manifest in the April 2009 G-20 Leaders’ Statement which made “strengthening financial supervision and regulation” a key component of their recovery and reform plan (Leaders of the Group of Twenty 2009).

Heightened interest in the regulation of sovereign wealth funds (SWFs) will be of immediate relevance to Asian sovereign investors. The IMF is facilitating a dialogue on identifying best practices for SWFs; the OECD is running a counterpart operation for SWF investment recipient countries. In March 2008, the US, United Arab Emirates, and Singapore, homes of some of the oldest SWFs, announced a code of conduct, which they hope will gain adherents and form the basis for a global standard. The IMF’s International Working Group (which includes Australia, China, Korea, New Zealand, Singapore and the US among its members) issued a set of voluntary principles in October 2008.
Longer-term Challenges

Globalization is built on the twin supports of technological innovations and supportive institutions that facilitate the global diffusion of those technological innovations. Following two world wars and the Great Depression, which brought an earlier “Golden Age” of globalization to a close, the non-communist world, led by the United States, began to reassemble the pieces of a liberal trading order: a key currency system based on the US dollar and supportive multilateral institutions, including the General Agreement on Tariffs and Trade (GATT) and its eventual successor, the World Trade Organization (WTO), as well as other multilateral institutions, such as the World Bank and the International Monetary Fund (IMF) in the financial sphere. The result was a rising volume of international trade and investment made possible by falling transaction costs and relative international stability (admittedly in the context of the Cold War). The subsequent transformation of the Chinese economy from a closed, centrally planned system to a more open, market-oriented one, and the eventual end of the Cold War and the collapse of the Eastern Bloc and the concomitant spread of capitalism, gave further impetus to this second “Golden Age” of globalization.

This order’s sustainability is in doubt, however. Presumably technological advances will continue to drive down cross-border transaction costs. Indeed, with greater and greater numbers of human beings achieving advanced education, if anything, one would expect the rate of technological advance to accelerate. The weakness, rather, is in the supportive institutions.

Globalization creates winners and losers, begetting social tensions that must be managed at both the national and international levels. At the national level, for example,
in the US, the public is split largely along educational lines—those with only a high school education or less fear globalization, while those with some post–high school education tend to view it benignly (Blonigen 2008). While it is possible that this difference in outlook is due to the ignorance of less educated people, their assessment may also reflect a rational appraisal of the impact of globalization on their earnings and relative status. In the US, it appears that married females, who for social reasons have less geographical mobility, experience particularly large lifetime earnings losses associated with trade-related job displacement (Kletzer 2001). Perhaps it is not surprising that they formed an important constituency in the presidential bid of Hillary Clinton, the most protectionist of the major candidates in the 2008 presidential primaries. Similar political tendencies are evident in Asia.²

One concern is that the major international institutions, such as the IMF and WTO, do not adequately reflect the interests of either poor countries or emergent powerhouses. The situation is further complicated by the fact that globalization may be conflated with American hegemony. While the US is truly becoming globalized—no single country or region is predominant in the rapid increase in the international integration of American goods, capital, and labor markets—this is often not the case for other countries. The centripetal pull of the US economy and US political and cultural

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² In Asia, polling conducted between November 2008 and February 2009 suggests a growing dissatisfaction with the status quo, both with respect to international and national economic systems (BBC 2009). The poll was conducted in six Asian countries: Australia, China, India, Indonesia, Japan, and the Philippines. Dissatisfaction with the international system was the highest in the Philippines (88 percent), with majorities supporting major changes in the international system in Australia (76 percent), China (75 percent), and Indonesia (62 percent). Majorities in the Philippines (92 percent), Indonesia (73 percent), and China (59 percent) also supported significant change in their domestic economic systems. Japan was the only country in the 24 country global sample in which majorities did not support major or minor changes in the international system and a majority only supported minor change at the domestic level.
influence is such that in many parts of the world globalization occurs with an American accent. The US itself becomes quite naturally the focal point of apprehensions regarding globalization. Key elements of US foreign policy, including military activities in both Afghanistan and Iraq, have exacerbated such tendencies in many corners of the world (Pew Global Attitudes Project 2008).

Hence the status quo faces at least two sources of potential vulnerability. The first challenge is at the diplomatic level. Globalization thrives on order. The issue today is that the objections to globalization on current terms by a growing number of systemically important participants may degrade the existing commercial regime significantly without constituting a consensus sufficient either to reform the existing system or construct a coherent alternative.

In this respect Asia is key; in the decade since the 1997-98 crisis, Asian disappointment with “Washington”—both the US government and the Washington-based World Bank and IMF—has encouraged a push for both greater influence within these institutions as well as more robust regional institutions and arrangements. Rightly or wrongly many Asians regard the Fund’s performance during this episode as incompetent if not malicious. (In Korea, the crisis is referred to as “the IMF crisis.”) In the aftermath of the crisis, the Asians in effect said “never again,” building up colossal foreign exchange reserves as a form of self-insurance while exploring reinvigorated Asian regional financial initiatives. Privately Asian policymakers indicate that any government today that went back to the Fund would be stigmatized if not turned out of office. What sets Asia apart from other regions of the world such as Latin America or Africa where governments may have similar dissatisfaction with the existing order, is that with roughly
$4 trillion in official reserves, Asia has the financial resources to alter, reinforce, or undermine the existing order if the political will is there. The financial crisis emanating from the US has further stimulated interest in regional cooperation.

The second vulnerability is that systemically important governments will be unable to sustain an internal political consensus supportive of an open system. Of course these two challenges are interrelated—changes to rules may be politically controversial and acceptable in one polity but not another, so the sustainability of globalization at its current level will reflect both the interplay of inter-state diplomacy and domestic politics. Management of these challenges is likely to be made more acute by the global financial crisis and the political stresses entailed, at least in the short-run. Trade volumes declined in the second half of 2008, and the World Bank is predicting that trade will shrink in 2009, falling for the first time since 1982, and exhibiting its weakest performance since the Bank began keeping records in 1970 (World Bank 2009).

**Inter-state Issues: Complexity, Pluralism, and Legitimacy**

Over the past 30 years the United States has undergone a remarkable process of globalization. The share of merchandise trade in national income has nearly doubled to 23 percent, making the United States a more open economy than other large industrial countries such as Japan or Germany (excluding intra-EU transactions). The United States faces issues of how to prioritize its own efforts among multilateral, regional, and bilateral initiatives, and how to evaluate its interests vis-à-vis Asian regional initiatives.
Trade

The WTO is the centerpiece of US trade policy. All major Asian countries are members. The Doha Development Round, the organization’s ongoing negotiations, has stalled for a variety of reasons: a complex negotiating agenda; the increasing assertiveness of a number of participants, notably China and India; political weakness in the traditional major powers which has made compromise, particularly on the central issue of agriculture, more difficult. On agriculture, Asia has no coherent regional interest. Some Asian countries such as Japan and South Korea number among the world’s most inefficient and protected agricultural producers, while Australia, Indonesia, Malaysia, New Zealand, Pakistan, the Philippines and Thailand are members of the Cairns Group of self-identified, non-subsidizing agricultural exporters.

When the liberal international trade system was being reconstructed following the Second World War, participants concentrated on dismantling wartime restrictions on cross-border trade and reducing border barriers that had grown since the 1920s. Multiple “rounds” of multilateral trade negotiations under the GATT focused on the elimination of quantitative restrictions and the reduction in tariffs on trade in industrial goods, with the universally politically sensitive agricultural sector largely excluded from this liberalization process. Two developments over the last quarter century greatly complicated this process.

The first is that the successful conclusion of trade negotiations has been made more difficult as the substantive agenda has broadened and grown more complex. Changes in the underlying economy, including the rise of multinational firms with global production and sales operations, the shift in the developed countries toward a “post-
industrial economy,” and the growth of tradable services, all contributed to a shift away from the old tariff-cutting paradigm of trade negotiations. As difficult as agreeing on tariff-cutting formulas may have seemed to the negotiators of the Kennedy or Tokyo Rounds, the conceptual complexity and political sensitivity of these efforts paled beside the emerging “behind the border” issues such as competition policy and intellectual property rights (IPR) protection, to say nothing of the hot-button “social agenda” of labor and environmental standards. The climate change–trade linkage is likely to rise in importance in coming years, further increasing political salience and complexity. The length of time needed to complete a round has steadily lengthened, with the Uruguay Round, which greatly broadened disciplines on services protection, introduced IPR obligations into the system, and established the WTO and its strengthened dispute settlement system, taking from 1986 to 1994 to conclude. Its successor, the Doha Development Round, launched in 2001, remains in suspended animation. (Ironically, the specific trigger for the most recent collapse of negotiations was a dispute over the very traditional issue of agricultural tariffs.) There are already calls to shift the negotiating agenda toward more uncharted territory or to deemphasize multilateral negotiations through the WTO (Crook 2008, Mattoo and Subramanian 2009).

At the same time that the trade agenda was expanding and impinging more on what had been purely domestic policy concerns, the number of negotiating parties was growing in both nominal and real terms, so to speak. The GATT had effectively been a US-European Union (EU) condominium. Ironically the very successes of the Uruguay Round—the extended obligations, single undertaking, and strengthened dispute settlement—contained the seeds of the old paradigm’s destruction. In the past, practices
such as “special and differential” treatment, which effectively absolved developing countries from most obligations, and the use of opt-in “codes” on issues such as government procurement, which allowed countries to take on differing levels of obligations, created automatic political safety valves for developing-country participants.

The Uruguay Round’s single undertaking at once enhanced the obligations embodied in the system and their enforceability. At the same time, the technical and financial aid promised to developing countries to support taking on these heightened obligations was largely not forthcoming.

This experience left many developing-country governments embittered and skeptical of entering into new obligations through the WTO system. By the time of the Doha Development Round, launched in 2001, India, China, and other “new” players were demanding far greater influence on the negotiations than they had been accorded in the past. And while this did not represent a recrudescence of the 1970s North-South split, some of the growing chorus brought with them distinct viewpoints on the role of international trade and the appropriate rules and procedures for its governance.

The naming of the round itself was a mistake both conceptually and politically. Trade negotiations can contribute to development, but they are not fundamentally about development—they are about reciprocal trade liberalization. Politically the elevation of “development” raised expectations among developing countries without addressing the reality that the US and EU would have to be onboard for the round to reach a successful conclusion—which required that their core trade objectives be met. Thus increasing complexity and political sensitivity coincided with growing pluralism present an obvious, and possibly insurmountable, challenge for policy management.
In the WTO, in principle, each member state has an equal voice. But in reality, many smaller and poorer states, including some in Asia, have inadequate resources to support permanent teams in Geneva. Moreover, with more than 150 members, a negotiation in which representatives of all the members literally sat around a table and hashed out text is effectively impossible. What has developed instead is a process in which a subset of informally selected major countries engages in negotiations and then in effect presents the rest of the membership with a fait accompli. The current practice of the agreement consisting of a “single undertaking,” in which reservations or opt-outs are not permitted, means that some democratically elected governments are being asked to sign on to agreements that they had no say in formulating—and then to deal with the domestic consequences—underscoring not only the democratic deficit embodied in the decision-making of the WTO, but the problematic legitimacy of agreements reached in this fashion. After the July 2008 WTO ministerial bust-up in Geneva, whether the comatose negotiation can be revived is an open question.

Finance

The international financial institutions (IFIs) face interrelated challenges involving resources and governance. At the IMF, governance more closely reflects the political realities of the mid-20th century than of the 21st. Board representation is a function of quota allocations, in principle reflecting the importance of individual countries in the world economy, which set the amount of foreign exchange countries make available for Fund use and notionally determine the level of borrowing for which a country is eligible. The United States, with a quota share of 17 percent, is the only
member that can exercise sole veto power over Executive Board decisions under the 85 percent qualified-majority voting system. Over the past several years, the IMF Board has authorized two quota reallocations, which have increased the influence of countries such as China, Mexico, Turkey, and South Korea.

Yet Asia remains underweighted. (China’s quota is less than that of France or the Benelux countries.) The trouble is that there is a zero-sum element to Board representation, and the two over-weighted regions, Western Europe and Africa, are reluctant to see a diminution of their representation. The case of Africa is particularly problematic—given the ubiquity of Bank and Fund programs in Africa, the region’s overburdened Executive Directors already have difficulty adequately representing the interests of their client governments. In light of the influence that the Bretton Woods institutions wield in Africa, many would regard any reduction in Africa’s modest influence within these institutions as fundamentally unfair and illegitimate, and in any event African quotas are really too small to matter in terms of rebalancing. More radical recalibrations have been blocked by Western Europe. The United States, with a quota share of 17 percent, has allowed its own quota to decline (though not enough to imperil its sole veto power over Executive Board decisions under the 85 percent qualified majority voting system). To satisfy Asian desires, it might be possible to combine Western Europe into a single European Union, or Eurozone, quota and reallocate to Asia and other under-represented areas the remaining quota freed by the aggregation of Europe into a single voting entity. Yet to accomplish this, Western European governments would have to be willing to sacrifice national prerogatives, and the United States might have to surrender its veto monopoly. Thus far, European intransigence has freed the US from the
necessity of confronting this challenge though influential voices within Europe recognize the inevitability of change (de Larosière et al. 2009). As for Asia, there is no single dominant economy equivalent to the US, nor the degree of formal regional integration like the EU or Eurozone, which could make accumulation into a single regional voice possible.3

The growing importance of countries beyond the small group of traditional powers was evident in the November 2008 meeting of the G-20 hosted by the US government in response to the global financial crisis. While the meeting accomplished little, it at least signaled the recognition that the “steering committee” for the world economy would have to be broadened beyond the G-7, including such Asia-Pacific countries as Australia, China, India, Indonesia, and Korea which are not G-7 members. The organization has formed four working groups: domestic financial regulation, international cooperation overseeing financial markets, the IMF, and the multilateral development banks. The Financial Stability Forum (upgraded at the April G-20 meeting to the Financial Stability Board) has been broadened to include China, India, Korea, and Indonesia. Likewise the Basel Committee on Banking Supervision was recently expanded to include Australia, Japan, Korea, China, and India.

The challenges for the international financial system go beyond the “chairs and shares” issue; given the magnitude of challenges confronting the global economy, the IFIs appear to be under-resourced (Truman 2009). At the April 2009 G-20 Leaders

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3 Governance problems are evident with respect to the selection of senior leadership as well. By tradition the president of the World Bank is an American, the managing director of the IMF a European, and the head of the Asian Development Bank (ADB) Japanese, reflecting the political legacies of 1944 and, in the case of the ADB, the power of the purse. And despite some problematic choices, none of the incumbents appear willing to acquiesce to a reform of this anachronistic system, though the April 2009 G-20 Leaders’ Statement contains encouraging language.
meeting, among other commitments, the group pledged to treble resources available to
the IMF to $750 billion, to support a new SDR allocation of $250 billion, to support at
least $100 billion of additional lending by the MDBs, and to ensure $250 billion of
support for trade finance. Individual countries made individual commitments, following
the leadership of Japan which had stepped forward in February 2009, signing an
agreement with the Fund to offer up to $100 billion in borrowing rights to temporarily
supplement the Fund’s resources. Goldstein (2009) recommends a “grand bargain”
between industrial and emerging market economies which would trade enhanced
insurance (obviating the need to run undervalued exchange rates to build reserves for
self-insurance) for greater exchange rate surveillance.

Given this history, over the past decade, the Asians have focused on regional
initiatives, though there is thought in some quarters, at least, that at the present juncture
the regional initiatives may be distracting from more urgent tasks at the global level
(Drysdale 2009, Soesastro 2009). In the financial sphere the most prominent of these
regional efforts has been the Chiang Mai Initiative (CMI), a three-part cooperation
framework instituting a network of bilateral medium-term foreign exchange credit
arrangements among the central banks, undertaking regional macroeconomic
surveillance, and committing to technical assistance, with the Japanese-led ADB
effectively serving as the secretariat. In May 2009, ASEAN+3 Finance Ministers agreed
to multilateralize the existing network of bilateral swap agreements and expand
commitments to the level of $120 billion, with the ASEAN and non-ASEAN shares set at
20 percent and 80 percent respectively, and Japan and China (inclusive of Hong Kong)
each committing $38.4 billion. Originally full use of CMI funds had been conditioned on
the borrower successfully concluding an agreement with the IMF, but the May 2009 finance ministers announcement did not mention any such linkage. The finance ministers also endorsed the existing Asian Bonds Market Initiative and the establishment of a regional Credit Guarantee and Investment Mechanism.

The concern of some outside observers is that the CMI were to lend under loose or absent conditionality, the large pool of public money could fuel moral hazard and eventually contribute to the collapse of the globally oriented IMF. Indeed, under current arrangements the finance some Asian countries could access through the CMI mechanism now exceeds their IMF quota. Yet with the Fund itself effectively abandoning conditionality with its Short-Term Liquidity Facility and new Flexible Credit Line, it is likely that this linkage to the IMF in the use of CMI funds eventually will be abandoned altogether as intimated in the finance ministers May 2009 statement. Asian countries possess roughly $4 trillion in official reserves, more than 50 percent of the world total. If the political will is there, Asia has the financial wherewithal to go its own way. The May 2009 announcement, specifying equal shares in the CMI Multilaterization (CMIM) for China and Japan represents a step forward. In 1998, the US opposed the creation of an Asian Monetary Fund; in 2009 the US has taken a hands-off stance, and frankly, is not in much of a position to do otherwise.
While commercial relations form the core of US economic engagement with Asia, development assistance will continue to be an important aspect of diplomacy toward lower income Asian countries.

Within the multilateral development banks, the United States has advocated re-focusing assistance toward the lowest income countries and away from middle income countries as well as urging programmatic and procedural changes. Unsurprisingly, these ideas have not been received with particular enthusiasm by either non-favored recipients or some other donors. One issue is how to “graduate” China from eligibility. It is a poor country, yet it also includes pockets of considerable wealth, has launched a manned rocket into orbit, and demonstrates ample ability to attract private capital.

At the bilateral level, a Bush Administration initiative, the Millennium Challenge Account (MCA), marked a significant departure for US bilateral assistance policy, emphasizing targeted grant assistance to a select group of low-income countries chosen according to quantitative performance criteria relating to “ruling justly,” “encouraging economic freedom,” and “investing in people,” and is administered by a new government corporation, the Millennium Challenge Corporation. Five Asian countries—Indonesia, Mongolia, Philippines, Timor-Leste, and Vanuatu—are currently MCA eligible. Whether the Obama Administration will continue along this track, revert to more traditional approaches, or do something altogether different is unclear at this point.

Some Asian countries such as Vietnam meet the MCA income level criterion, but fail on the other criteria (typically regarding governance). Countries that do not qualify for the MCA will remain eligible for other sorts of bilateral assistance; HIV-AIDS and
public health programs, as well as pollution control and “green” assistance, which are not subject to MCA strictures, will probably account for a growing share of future US foreign assistance.

**Domestic Politics: Waning Mass and Elite Support**

The difficulties of managing globalization at the international level are mirrored at the level of national politics, where there is evidence of waning support for globalization at both the mass and elite levels. In the late 1990s, high-level multilateral economic conclaves such as the annual G-7 heads of government meetings, the joint World Bank–IMF annual meetings, and WTO ministerials were increasingly accompanied by mass, and sometimes even violent, protests culminating in the infamous 1999 “Battle of Seattle” WTO ministerial. The 9/11 terrorist attack and the subsequent public response at least temporarily cowed the anti-globalists, but as the world converges back to some kind of normalcy, it would not be surprising if the globalization issue heated up again at the mass level, particularly in the context of a global recession. Large, and at times violent, street demonstrations occurred at the London G-20 Leaders meeting.

Public opinion survey data suggest that support for free markets is relatively ubiquitous, though there is some variation by region in the degree of enthusiasm for markets. Table 1 reports cross-national data on attitudes towards free markets, international economic organizations such as the WTO and the IFIs, and globalization taken from two surveys conducted by the Pew Global Attitudes Project (2003, 2008). In the first survey, the US and East Asia (with the exception of Japan) are relatively supportive of markets, South Asia less so. Support declines, however, when respondents
are asked about globalization or specific manifestations of globalization such as the multilateral economic organizations discussed in the preceding section. Support for globalization declines even further when one moves from economics to cultural issues. In short, the survey shows general comfort with markets, less comfort with international exchange, and discomfort with the social and cultural impact of globalization. Only the “market” and “not protect against foreign influences” questions were asked in the follow-up survey and while support declines across the board, the US and East Asia exhibit relatively positive attitudes. If the lesson to be learned from the lack of Japanese support and the subsequent across-the-board fall in support for globalization is that poor economic performance makes people less tolerant and secure, then the current crisis does not auger well for the future.

The decline in support in the US for globalization is confirmed by more specific polling data on trade agreements. The intrusion of international competition into a wider range of activities, and through the process of offshoring the introduction of international competition into previously sheltered, computer-savvy, middle class occupations in what were historically considered “non-tradable” activities, has raised the political salience of trade issues in the US. A 2008 poll by the Pew Center for the People and the Press concluded that “Americans express increasingly negative opinions toward the World Trade Organization (WTO) and free trade agreements (FTAs) such as the North American Free Trade Agreement (NAFTA). In the current survey, a 48% plurality says that free trade agreements are a bad thing for the country, compared with 35% of the public who call them a good thing. Last November [i.e. 2007], opinion about free trade’s impact on the country was evenly split; for the previous decade, modest pluralities said
that free trade agreements were good for the country…There is now a broad agreement that free trade negatively affects wages, jobs, and economic growth in America” (Pew Center for People and the Press 2008, section 4). The “Buy American” proposals considered as part of the stimulus package have broad bipartisan support: “Two thirds of Americans think such a requirement is a good idea because it keeps jobs in America, while just 24% see it as a bad idea because other countries might retaliate by not buying American products and services. Wide majorities of Democrats (70%), Republicans (66%) and independents (63%) all agree that it would be a good idea for the plan to require that spending be limited to U.S.-made goods and services” (Pew Center for People and the Press 2009 p2).

The Pew Center results of deteriorating popular support for trade are generally reinforced by the limited amount of time-series polling on the topic (figure 1). It is possible that this decline in support for trade represents a temporary dip rather than a permanent shift in attitudes; there is some evidence to suggest similar trade skepticism during the 1992 recession, which was followed by the congressional passage of NAFTA and the Uruguay Round agreement.

Given this popular skepticism, it is not surprising that political decision-makers have evinced trepidation. Trade policy has become increasingly partisan in the United States, and while trade concerns were probably a minor contributor, the Democratic Party, the more trade-skeptical of the two major US political parties, won the White House in the 2008 elections with the election of Senator Barack Obama as president and


increased its majority in both houses of the US Congress as well. The 2008 Democratic Party statement on trade reaffirms the party’s commitment to achieving a successful completion of the Doha Round and strengthening the rules-based multilateral system. But the document says very little about liberalization per se; instead, its focus is on emphasizing enforcement of foreign government obligations of existing agreements, including provisions on labor, environment, and safety standards in trade agreements, and combating currency manipulation. It says nothing about either FTAs that have been signed but await congressional ratification (Colombia, Korea, and Panama) or other potential regional initiatives with Asia and Latin America.

The early days of the Obama Administration have not been entirely reassuring in this regard. Although the Administration appears to be backing away from some problematic positions (such as the pledge to renegotiate NAFTA), its relatively supine response to backdoor protection via “Buy American” initiatives, and the lack of any positive agenda with respect to the FTAs pending ratification are troubling. One bright spot has been the signal that the US is prepared to sign the ASEAN-sponsored Treaty of Amity and Cooperation, and there is evidence of some modest improvement in world public opinion toward the US, and Barack Obama, who seems to have captivated non-

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6 Democrats are considerably more trade-skeptical than Republicans, with solid majorities holding negative views. Republicans are essentially evenly split, 43 percent v. 42 percent in support of free trade agreements (Pew Center for the People and the Press 2008). Statistical modeling suggests that Democratic House members systematically are less inclined to vote for FTAs than their Republican counterparts (Im and Sung 2008). However, the sample period 2003-2006 was one in which the President was a Republican, and there is some evidence that the pattern of partisanship shifted on close votes, suggesting that Republican leaders may have been calibrating marginal votes carefully (all FTAs were passed). Whether this pattern of calibrating marginal votes will continue under a Democrat President and Congress remains to be seen. A recent attempt to remove the “Buy American” provision of the stimulus bill was defeated in the Senate 65-31 without a single Democrat voting in favor.
Americans even more than his fellow countrymen, may enjoy a “honeymoon” giving the US additional room to maneuver (Kull 2007, BBC 2008, Harris Interactive 2008).

Operationally, the near-term prospects for US trade liberalization at either the global or regional level have been dimmed by the expiration of “fast-track” negotiating authority. The “fast-track” procedure pre-commits the Congress to a simple up/down vote on implementing legislation—without amendment and within a specified time frame. Given increasingly fractious US trade politics, it is highly unlikely that—in the absence of such expedited procedures—trade accords with major partners could be successfully concluded and enacted. Nonetheless, if the Obama Administration wants to have a significant proactive trade policy, it will need to persuade the Congress to renew fast-track authority at least for the WTO negotiations, so that it can attempt to salvage the Doha Round. It will not be easy. US credibility was dealt a potentially fatal blow in April 2008 by the congressional decision to alter the fast-track rules ex post in the case of the US-Colombia FTA (Bergsten 2008). Some in Congress argue that the Colombian case is unique and should not set a precedent for other fast-track cases, including pending consideration of the KORUS FTA. However, what matters in this context is not attitudes on Capitol Hill, but rather whether foreign governments will hold back in trade negotiations with the United States for fear that the negotiated deal will be reopened before a congressional ratification vote. In other words, US trading partners will be the ultimate arbiters of how badly the Congress has damaged US negotiating credibility.

It is by no means assured that the US political system embodies enough flexibility after the November 2008 elections to actually deliver trade liberalization. In light of the deterioration in the trade policy environment in the United States, it is unclear when the
pending FTAs will be ratified, or even if they will come to a vote. In fairness, it should be added that the US Congress has never failed to ratify a bilateral trade pact, however.

Similar tales of policy drift could be told with respect to Asian players such as Japan.\textsuperscript{7}

**Prognosis: Fragmentation?**

At the November 2008 and April 2009 G-20 meetings on 15 November 2008 and 2 April 2009 (as well as at the November 2008 Asia-Pacific Economic Cooperation (APEC) forum summit), participants committed to a loose standstill, abjuring the introduction of new protections or derogations from existing liberalization commitments. A number of countries appear to be honoring the commitment in the breach, however: Director-General of the WTO reported that since the start of 2009 there has been “significant slippage” including the introduction of new tariff and non-tariff barriers, as well as increased use of trade-remedy actions (Lamy 2009 p1). An analysis by the World Bank came to similarly worrying conclusions (Gambaroni and Newfarmer 2009). The fact that “eyes are watching” may inhibit the willingness for governments to reach for protectionist solutions; Elek (2009) reviews some “naming and shaming” options.

Apart from the resort to protection in the face of shrinking aggregate demand à la the 1930s, the longer-run issue is whether the WTO system has simply become too unwieldy to deliver much in terms of liberalization. The weaknesses of both the

\textsuperscript{7} The country appears to be stuck in a kind of long-term domestic political stalemate. A poll conducted in January and February 2009 found the Japanese public split 45-45 on whether the international system needed major or minor reform, and a bare majority (51 percent) supported minor change at the domestic level (BBC 2009). The current economic downturn could provoke a tectonic shift in Japanese politics that could break the logjam with unpredictable result, however. At present, due to the influence of the agricultural lobby, Japan appears to be more or less incapable of entering into any trade agreement that involves significant agricultural liberalization though.
multilateral trade and financial institutions have provided impetus for regional and
plurilateral initiatives in both the trade and financial fields. Accelerated fragmentation is
a distinctly possible outcome.

Stasis at the WTO has encouraged preferential trade initiatives. APEC is the most
prominent of such schemes in Asia. Its membership established the goal of free trade in
the region by 2020, with the developed countries of the group completely freeing their
trade by 2010, but this commitment has foundered for a variety of reasons, including the
lack of any enforcement mechanism. As a consequence, APEC has devolved more into a
consultative organization to encourage trade and investment facilitation, and an
opportunity for annual heads of government meetings.

As trade liberalization has stalled at the global and regional levels, action has
naturally shifted toward more limited sub-regional and bilateral initiatives. The US
successfully concluded a free trade agreement with Singapore, but negotiations with
several other Asian countries including Malaysia, Sri Lanka, and Thailand, have derailed.
The United States, as a post-industrial economy, strongly emphasizes trans-border issues
such as investment and services, which are more difficult to negotiate than more
traditional bilateral measures such as tariffs, which are the focus of intra-Asian deals. The
US penchant for loading labor standards and environmental concerns into these
agreements creates a situation in which negotiating an FTA with the United States is
more challenging than with other potential partners, particularly China.

It is unclear whether KORUS will ever be ratified. The US Congress has never
failed to ratify a bilateral trade pact and failure to implement KORUS would be a terrible
blow to US-Korea relations, US standing in Asia, and the US role in global trade policy.
But despite President Obama’s reassuring words to President Lee at the April 2009 G-20 meeting, confronting this situation is not at the top of the Obama Administration’s agenda.

Preferential trade pacts among Asian countries have proliferated. ASEAN has positioned its own ASEAN free trade agreement (AFTA) as the center of a hub-and-spoke system of Asian regionalism, creating a network of broadly comparable “10 + 1” agreements. From the standpoint of the US, it faces growing numbers of potentially trade-diverting pacts in its fastest growing export markets.

Researchers are just beginning to get a handle on how comprehensive are their provisions and how widely these preferences actually are used by firms engaged in cross-border trade and investment (Kawai and Wignaraja 2009). One simulation model found that the United States could lose as much as $25 billion of annual exports solely from the static discriminatory effects of an East Asian Free Trade Area (Scollay and Gilbert 2001) while other dynamic models concluded that real welfare loss would be lower (Jiang and McKibbin 2008; Lee, Owen, and van der Mensbrugghe 2009).

It is important to embed regional economic initiatives in broader geographic contexts lest they subsequently turn inward and become closed blocs. The European Union (EU), the most significant preferential agreement of the modern era, has been nested within a web of global and trans-Atlantic institutions, such as the GATT/WTO, the North Atlantic Treaty Organization (NATO), and the Organization for Economic Cooperation and Development (OECD) which have encouraged engagement with

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8 Petri (2008) provides a more optimistic interpretation, albeit one which ignores the practical difficulties of knitting together multiple, inconsistent arrangements.
outsiders, even as an unprecedented degree of regional integration was unfolding in Europe.

In this light, the results of a poll of “600 Asian opinion leaders” conducted by the Asian Development Bank, which appears to document a mild preference for the relatively narrow ASEAN+3 concept, is a little disturbing, though several aspects of the poll raise unresolved methodological questions (Asian Development Bank 2008, box 1.1). A more recent (and much better documented) survey of 262 Asian “strategic elites” generated an intriguing and nuanced set of results (Gill et al. 2009). There was widespread support for an “East Asian Community,” but less consensus on which countries should form that community. Among respondents from ASEAN+3 countries, significant majorities supported the inclusion of India (80 percent), the US (79 percent), and Australia (74 percent), while New Zealand and the EU failed to garner majority support. Yet despite their enthusiasm for community-building, the respondents expected unilateral, bilateral, and global arrangements to play a more important role in addressing a variety of challenges over the ensuing decade.

The Bush Administration responded to these developments by pushing the idea of the Free Trade Area of the Asia-Pacific, as well as the Px, a kind of coalition of the willing among APEC’s more liberal members. However the Obama Administration has suspended US participation in the Px talks. Were it to be made politically practical, the APEC-wide Free Trade Area for the Asia-Pacific would dominate the intra-Asia alternatives both diplomatically and economically, avoiding “drawing a line down the middle of the Pacific” and delivering greater increases in economic welfare.
Through the process of diverting trade from globally efficient producers to less
efficient – though preferentially favored – producers in signatory countries, preferential
agreements can potentially harm both signatories and third parties alike. The prospect of
being adversely affected by discriminatory deals in Asia (especially those involving the
large economies of Northeast Asia) might possibly constitute a “wake-up call” for the US
Congress, forcing the United States to reassess its stance and adopt a more forthcoming
posture. Korea, for example, has reached a tentative FTA deal with the EU.

Conclusions

The US and Asia have an enormous stake in each others’ continuing prosperity.
This outcome is in turn linked to the preservation of the open international economic
order. Yet the sustainability of this regime is by no means assured. While technological
advances will presumably continue to reduce the costs of moving labor, capital, and
goods across borders, the political prerequisites may not survive, victim of both inter-
state and domestic politics. A global economic downturn is fueling a backlash against the
Washington Consensus, the Anglo-American model of capitalism, and the multilateral
institutions of economic integration. In this context American leadership is problematic,
discredited by its role as the epicenter of the global financial crisis. An absence of
constructive leadership may contribute to an erosion of adherence to systemic norms
reminiscent of the system-fraying observed in the first decade of the 20th century as the
first Golden Age of globalization came to a close.

US policy toward Asia is largely derivative of global issues and specific bilateral
concerns. The specifically regional component in both the trade and financial fields could
increase or decrease in importance depending on the evolution of institutions at the global level.

Addressing current macroeconomic and financial sector challenges are the top priority. Management of the international aspects of these issues appears to be shifting toward the G-20 which means enhanced influence for Asian countries, which, with the exception of Japan, were excluded from the G-7. The April 2009 G-20 meeting appeared to signal a broad consensus with respect to greater regulation of financial markets and institutions, increasing resources available to the international financial institutions, and improved governance of those institutions. An overarching challenge is how to achieve an economically and diplomatically sustainable consensus behind a set of institutions and practices which allow the unwinding of massive international imbalances, in effect a “grand bargain” which would reduce the need for self-insurance which politically can be interpreted as mercantilism. China is central to resolving this issue.

In the trade arena, three issues require prompt attention: the re-establishment of fast-track negotiating authority for the President, the resolution of the Doha Round impasse, and the passage of the KORUS FTA. The highest priority should be placed on passing KORUS, if only because the cost of failure to do so, in both economic and broader diplomatic terms, is so large. To make this trade policy agenda politically palatable, it will probably need to be coupled with a broader set of social safety net and education policies—desirable in their own right—to alleviate the American public’s anxieties about global competition.

The Administration will also face a series of ongoing issues where the risks are longer-term in nature, and the common recommendation is “first, do no harm.” This
applies to regulation of financial markets in the US, regulation of foreign investment in the US, particularly by SWFs, and the multifaceted economic engagement with China, in its macroeconomic, financial, and trade and investment dimensions, which will be the most politically sensitive bilateral relationship for the foreseeable future.

Finally, in the area of least immediate domestic political sensitivity, the Administration will have to formulate a coherent strategy for responding to the emerging regional and sub-regional policy initiatives within Asia in both the financial and trade spheres. The evolution of these initiatives in turn will be affected by developments at the global level. With respect to finance, first priority should be on ensuring that the expanding regional initiatives are compatible with the broader global financial architecture, and secondly, on pursuing the specifics of the US policy agenda through institutions such as the ADB and the G-20. Analogously, in the trade area the emphasis should be on shaping the development of preferential schemes in ways that are compatible with broader global rules, and responding—by pre-emption, emulation, or countermeasures—preferential schemes that would harm US interests.

In the absence of adequate reform at the global level, the alternative could be further fragmentation into competing regional blocs. Asia holds the key, combining both dissatisfaction with existing global arrangements with the resources to reconstitute, at least at the regional level, an alternative set of institutions and practices. How Asia responds, acting to strengthen reformed global institutions or undermine them in favor of regional alternatives, will partly depend on the policies of the dominant global power, the United States. The most constructive course for the US would be to re-emphasize global liberalization through the WTO and thereby reduce the value of preferential deals.
Alternatively the United States could play tit-for-tat: either by trying to match or join the
Asian initiatives, or by further expanding its own web of preferential agreements. Either
option assumes that the US has the political capacity to liberalize trade.

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Figure 1. Opinions on Impact of Free Trade Agreements on the Country

Source: May 2008 Pew Research Center
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