# U.S. ECONOMIC POLICY TOWARD ASIA FOR THE INCOMING ADMINISTRATION

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**Issue:** A new U.S. administration will be under pressure to quickly determine its position on a host of trade, investment, and financial issues, including: a) bilateral and/or multilateral free trade agreements as policy instruments; b) the completion of the Doha Development Round; c) exchange rate questions, including the weakening U.S. dollar; and d) trade imbalances. Is there a coherent integrated strategy that can address these multiple issues? Can these issues be addressed simultaneously, and, if not, how should they be prioritized? Can remedial solutions be found without undertaking corresponding domestic economic and financial measures?

## Introduction

Economically, Asia is a region of considerable diversity: some of its economies include major international investors and technological innovators, while others continue to employ large parts of their workforces in agriculture and receive concessional assistance from the international community. For the most part, the U.S. policy agenda toward Asia does not revolve around regional issues. Instead, U.S. economic policy toward Asia is largely derived from its global economic policies. From the standpoint of Asian governments, the issues of greatest salience in their relationship with the United States are either bilateral in nature, or are the bilateral manifestation of issues of global concern.

With that said, increasing intra-regional trade and investment are forging a stronger Asian regional identity than existed in the past. This creates some paradoxical challenges for American policymakers. Regional diversity militates against defining U.S. policy in regional terms, and the national interests of Asian countries diverge on many policy issues – yet the emergence in Asia of regional institutions and initiatives requires a U.S. response. The United States will host the Asia Pacific Economic Cooperation (APEC) forum in 2011, forcing Asian regional issues onto the agenda of the next administration.

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Unlike many of the more traditional diplomatic issues discussed in other contributions to this volume, where the administration acts with relative autonomy, U.S. economic diplomacy is significantly affected by both market developments and U.S. domestic politics. The incoming administration will face two specific challenges in organizing American economic diplomacy toward Asia. First, there is a risk that the financial market turmoil will have a substantial negative impact on both the United States and global economy. Second, there is a domestic political environment that makes it increasingly difficult to formulate a constructive trade policy. Some of the critical items on the U.S. economic agenda with Asia — establishing a viable policy on sovereign wealth funds, the Korea-U.S. Free Trade Agreement (KORUS), and the Doha Development

Round of multilateral trade negotiations under the auspices of the World Trade Organization, to name three — may require immediate attention, and may or may not be specifically "Asian" per se.

## Macroeconomic and Financial Context

The next administration will likely have to confront the largest global financial crisis since the Asian crisis of 1997-98. Estimated losses among banks, insurance firms, and other institutions currently approximate $1 trillion. This episode could amount to a watershed event. Depending on the specifics of the unfolding crisis and the outcome of the November 2008 elections, the United States could reverse the trend toward financial market deregulation begun during the Carter administration. A key question is whether such reregulation would adversely affect U.S. economic performance, possibly contributing to a decline in the relative importance of the United States in the global economy and reducing American diplomatic relevance.

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Reregulation would also change the ideological context of international policy formation. Less pressure on Asian countries for financial market liberalization would emanate from multilateral organizations such as the International Monetary Fund (IMF), World Bank, and Asian Development Bank (ADB). Such a lag would presumably be reflected in the U.S. trade negotiation agenda — with less confidence in unfettered financial market operation, and U.S. policy swinging back toward regulation, U.S. demands for Asian countries to liberalize their financial markets and grant U.S. service providers greater access would eventually attenuate or become less effective.

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 and the Organisation for Economic Co-operation and Development (OECD) is running a counterpart operation for SWF investment recipient countries. In March, the United States, United Arab Emirates, and Singapore — home to some of the oldest SWFs — announced a code of conduct, which they hope will gain adherents and form the basis for a global standard.

Some Asian countries have benefitted substantially from the rapid growth of consumption in the United States since 1994, and there has been some talk of "de-coupling": the hope that rapid growth elsewhere, particularly in China, might cushion the blow as the U.S. economy slows or enters recession. However, rather than "de-coupling," Asia may well experience "reverse coupling," as a combination of slowdown in the United States and depreciation of the U.S. dollar leads to a substantial, sustained increase in U.S. net exports.

The bilateral trade imbalance with China ballooned to $252 billion in 2007, accounting for more than one-third of America's global trade deficit of over $700 billion. China's exchange rate policy will also be a source of ongoing concern. In the long run, China will experience significant real appreciation generated by its rising productivity in its traded goods sector, and exchange rate policy will move toward a more genuine float. But getting to this outcome will be politically contentious, and the next administration will face congressional pressure on the Chinese currency issue.

## Regional Macroeconomic Cooperation

In the decade since the 1997-98 crisis, Asian disappointment with Washington writ large has encouraged a push for both greater influence in global institutions such as the IMF, as well as more robust regional institutions and arrangements.

At the IMF, quota allocations (in principle reflecting the importance of individual countries in the world economy) determine the amount of foreign exchange countries make available for IMF use, board representation, and notionally the level of IMF borrowing for which a member is eligible. Asia remains underweighted despite recent quota reallocations. More radical recalibrations have been blocked by Western Europe, which is over-weighted. 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 underrepresented areas the remaining freed quota. 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 allowed the United States to duck this conundrum. As for Asia, there is no single dominant economy equivalent to the United

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Instead, the Asians have increasingly focused on regional initiatives. In the financial sphere the most prominent of these initiatives 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. Sixteen bilateral swap agreements amounting to as much as US$83 billion have been concluded, with further growth expected. The Asians are also pursuing other regional initiatives, such as the promotion of a regional bond market and the adoption of a common basket currency peg, with the Japanese-led ADB effectively serving as the secretariat.

To some observers, the CMI appears to be an embryonic Asian Monetary Fund (AMF). The key issue for the United States is the degree of coordination of lending conditionality between the IMF and a potential AMF. If the AMF 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. Currently, only 20 percent of CMI funds can be drawn before triggering IMF linkage. Nevertheless, theoretically this means that the financing that some Asian countries can now access through the CMI mechanism exceeds their IMF quota. Today, the CMI appears to be consistent with the existing global financial architecture. But Asian countries possess roughly $3 trillion in official reserves, around 50 percent of the world total. If the political will is there, Asia has the financial wherewithal to go its own way. Whether it will depends significantly on the capacity of Japan and China to act cooperatively.

## Trade Issues

Similar tensions between global and regional institutions exist with respect to trade policy. As in the macroeconomic sphere, the United States faces the challenge of prioritizing its efforts between multilateral, regional, and bilateral initiatives; and evaluating its interests vis-à-vis Asian regional initiatives.

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The World Trade Organization (WTO) is the centerpiece of U.S. trade policy. All major Asian countries are members. The organization's ongoing negotiations, the Doha Development Round, has stalled for a variety of reasons: a complex negotiating agenda; the increasing assertiveness of a number of middle powers; and political weakness among 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, have some of the world's most inefficient and protected agricultural sectors; while others such as Thailand, Indonesia, and the Philippines are members of the Cairns Group of self-identified, non-subsidizing agricultural exporters.

The prospects for successfully concluding the round have been dimmed even further by the expiration of "fast-track" negotiating authority for the president. (The "fast-track" procedure pre-commits Congress to a simple up/down vote without amendment within a specified time frame, without which successful negotiation of a global trade accord would probably be impossible.) The next administration will need to approach Congress immediately to secure fast-track authority to attempt to salvage Doha. Yet, U.S. 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 Colombian Free Trade Agreement. Some in Congress argue that the Colombian case is unique and should not set a precedent for other fast track cases (including KORUS); but what matters in this context is not attitudes on Capitol Hill, but rather the reactions of foreign governments — as they will be the ultimate arbiters of how badly Congress has damaged U.S. negotiating credibility.

Stasis at the WTO has encouraged preferential trade initiatives. APEC is the most prominent such scheme 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 into more of a consultative organization to encourage trade and investment facilitation, and an annual opportunity for heads of government to meet.

As trade liberalization has stalled at the global and regional levels, action has naturally shifted toward more limited sub-regional and bilateral initiatives. The Association of Southeast Asian Nations or ASEAN has led the way, rhetorically at least, in trying to place its own sub-regional ASEAN FTA (AFTA), as the center of a hub-and-spoke system. The United States successfully concluded a free trade agreement with Singapore, but negotiations with several other Asian countries have stalled.

In light of the deteriorating political environment in the United States, it is unclear whether KORUS will ever be ratified. Confronting this situation will be at the top of the agenda of the incoming administration. The U.S. Congress has never failed to ratify a bilateral trade pact and failure to implement KORUS would be a terrible blow to U.S.-Korea relations, U.S. standing in Asia, and the U.S. role in global trade policy.

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As a post-industrial economy, the United States 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 U.S. 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.

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 U.S. Congress, forcing the United States to reassess its stance and adopt a more forthcoming posture. Korea, for example, is in the midst of an FTA negotiation with the European Union.

The most constructive course 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 United States has the political capacity to liberalize trade.

## Aid

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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 non-favored recipients and 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, the U.S. approach is embodied in the Millennium Challenge Account (MCA), administered by a government corporation, the Millennium Challenge Corporation. Five Asian countries – Indonesia, Mongolia, the Philippines, Timor-Leste, and Vanuatu – are currently MCA eligible. Some Asian countries (such as Vietnam) meet the MCA income level criterion, but fail on 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 U.S. foreign assistance.

Lastly, food issues, a staple of development policy a generation or two ago, had in large part dropped off the development agenda until the explosion in world prices in 2007-08. American policies and leadership in this arena will have a significant impact on a number of the poorer countries in Asia.

## Recommendations and Conclusions

The economic policy agenda of the incoming administration will be shaped by financial market and macroeconomic developments that are by definition unknowable at present. Its ability to respond constructively to some of these challenges, particularly in the trade sphere, will depend to a large extent on electoral outcomes in November 2008.

In the trade arena, three issues will require immediate attention: the re-establishment of fast-track negotiating authority for the president, the completion of the Doha Round, 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.

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 United States; regulation of foreign investment in the U.S. (particularly by SWFs); and the multifaceted (macroeconomic, financial, and trade and investment) economic engagement with China, which will be the most politically sensitive bilateral relationship over the next four years.

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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. 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 U.S. policy agenda through institutions such as the ADB. Analogously, in the trade arena the emphasis should be on shaping the development of preferential schemes in ways that are compatible with broader global rules, and dealing with — by pre-emption, emulation, or countermeasures — preferential schemes that would harm U.S. interests.