U.S. Economic Policy Toward the Asia-Pacific Region

A Statement by the Research and Policy Committee of the Committee for Economic Development
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The Committee for Economic Development is an independent research and policy organization of some 250 business leaders and educators. CED is nonprofit, nonpartisan, and nonpolitical. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all.

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Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

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The United States needs a coherent and sustained economic policy toward Asia. Economic and political developments in Asia are having an extensive and increasing impact on global prospects for peace and prosperity as well as on the economic future of American workers and businesses.

A substantive policy contribution from the private sector should be a critical element of U.S. strategy. There has been little business-to-business dialogue about trade and investment issues in conjunction with the increasing prominence of Asian economies. In spite of its day-to-day involvement, business has been insufficiently involved in representing long-term U.S. interests to policy makers.

This policy statement is a major component in a multi-year CED Asia Initiative designed to provide a voice for U.S. business in shaping U.S. policy toward the Asia-Pacific region.

Another important goal of this project is to connect U.S. business to a network of private business organizations representing the current and future economic powers of the Pacific Rim. This is designed to expand CED’s nearly three decades of experience in sharing ideas with a global network of counterpart organizations. These relationships with organizations in Europe, Japan, and Australia have given CED the opportunity to issue joint statements on issues of common concern, to share research, and to engage in international dialogue on the U.S. role in the global economy.

To advance this goal, in October 1996, CED conducted the first Pacific Leaders Forum (organized in cooperation with the National Center for APEC). Held in Seattle, this effort attracted over 200 senior business leaders from Australia, Canada, China and Hong Kong, Indonesia, Japan, Malaysia, New Zealand, The Philippines, Singapore, South Korea, Taiwan, the United States, and Vietnam for a discussion of critical trade and investment issues.

**Purpose of This Statement**

**Legacy of International Leadership**

For our own, the Pacific Region’s, and indeed the world’s security and prosperity, the United States must expand, not limit, its role in Asia. Although complete isolation would in any case be impossible, trends that promote restrictive economic arrangements are harmful to the United States, Asia, and the world.

From its founding in 1942, CED has focused on stimulating international economic activity as a means of fostering worldwide economic growth and ensuring future stability. Early CED statements provided needed business support for such landmark initiatives as the Marshall Plan and the Bretton Woods Agreement.


From Promise to Progress: Towards a New Stage in U.S.-Japan Economic Relations (1994) was a joint statement of CED and its Japanese counterpart Keizai Doyukai. This report has been cited as being especially influential in helping shape recent U.S.-Japan trade agreements.
ACKNOWLEDGMENTS

Special thanks are due to members of the CED Asia Subcommittee (see page vi) and to the group's outstanding co-chairmen, Boyd E. Givan, Senior Vice President and Chief Financial Officer of The Boeing Company, and Clifton R. Wharton, Jr., former Deputy Secretary of State and former Chairman and CEO of Teachers Insurance and Annuity Association and the College Retirement Equities Fund (TIAA-CREF). Their depth of knowledge and breadth of experience provided the subcommittee with extraordinary leadership.

I also want to thank Boyd Givan and George F. Russell, Jr., Chairman of Frank Russell Company, the co-chairmen of the 1996 Pacific Leaders Forum. Former U.S. Secretary of State and CED Life Trustee George P. Shultz served as Honorary Chairman of this important event.

Dr. Isaiah Frank, the William L. Clayton Professor of International Economics at The Johns Hopkins University School of Advanced International Studies, served as project director for this statement. There are few in this field who can match Isaiah's thoughtful ability to analyze complex and difficult issues and to present these issues with such insight and clarity.

Finally, I must thank the funders that made it possible for CED to undertake this project: The Pew Charitable Trusts, Citicorp Foundation, The Boeing Company, Frank Russell Group of Companies, Hoechst Celanese Corporation, Pfizer Inc., Texaco Inc., Seafirst Corporation, and CED's Edmund B. Fitzgerald Program in International Studies, provided by Northern Telecom.

Josh S. Weston
Chairman
CED Research and Policy Committee
INTRODUCTION

The purpose of this policy statement is to identify, define, and make recommendations on the main economic policy issues in the Asia-Pacific region as a basis for a coordinated U.S. business position. The perspectives of Asian business leaders on many of the issues were put forward at the Pacific Leaders Forum convened by the Committee for Economic Development (CED) in Seattle in October 1996 in cooperation with the National Center for Asia-Pacific Economic Cooperation (APEC). In this statement, an effort is made to take those views into account, but responsibility for the statement rests entirely with CED.

The Asia-Pacific area has been transformed into the most dynamic economic region of the world. The American economic stake in the region is enormous. It is the fastest-growing and largest market for U.S. products, exceeding the combined size of the Canadian and Mexican markets, the two largest non-Asian markets for U.S. goods. U.S. trade across the Pacific has surpassed trade across the Atlantic for more than a decade (see Figure 1). Direct investment in the region by U.S. firms has been increasing at a more rapid rate than in any other area abroad. Moreover, because of its high-saving economies, the region has become the main source of capital to make up the continuing gap between what the United States spends and what it produces (i.e., the deficit in the U.S. current balance-of-payments account).

Because the economies of the area have grown in recent years at more than twice the rate of any other region, the World Bank has referred to this development as “The East Asian Miracle.” Accounting for the bulk of the area’s growth are eight countries: Japan, China (now including Hong Kong), Taiwan, Korea, and four Southeast Asian countries (Indonesia, Malaysia, Singapore, and Thailand). Over

Figure 1

U.S. Trade with Asia Has Outpaced Trade with Europe
1989 to 1995

Billion of U.S. Dollars

the past several years, the Philippines has also experienced impressive economic progress, and Vietnam may well emerge as the next economic frontier in East Asia with the potential of becoming another “Asian tiger.”

Asia’s success has been driven by the private sector. It is the result of the entrepreneurial activities of thousands of small, medium, and large business firms, both domestic and foreign, that have mobilized capital, technology, and managerial skills and applied them in innovative ways throughout the region.

At the same time, governments in the region have played a vital supportive role. In general, they have provided a responsible fiscal and monetary environment that has encouraged high rates of national saving. They have also placed high priority on education and improving the physical and institutional infrastructure, including strengthening the rule of law and reforming archaic financial systems. Agricultural policies have stressed productivity and have avoided excessive taxation of the rural economy.

Selective public subsidies and other interventions to foster specific industries and to encourage exports have been common in the region. However, the thrust of policy in recent years has been toward greater market orientation, including domestic deregulation and reduction of the substantial barriers to international trade and investment that have prevailed in the area.

Any explanation of the Asia-Pacific region’s economic success must include the favorable external environment. Growth has been heavily dependent on open world markets bolstered by a rule-based global trading system espoused and promoted by the United States. Especially important has been the assurance of a relatively open U.S. market, which, until the early 1990s, ranked at or near the top as an export destination for most East Asian countries.

Although the rapidly rising economic strength of the Asia-Pacific region is what has impelled the stepped-up U.S. engagement in the area, there are also vital security and political dimensions to the U.S. interest. For example, China’s very rapid economic growth is accompanied by a rapid of increase in its military expenditures. A major priority, therefore, is to build a solid political and economic relationship with China in order to forestall a future Pacific version of the Cold War.

More generally, peace and stability cannot be taken for granted in the Asia-Pacific area. It is a region with a history of adversarial relations among its major powers—Japan, China, and Russia—and keen memories of aggression and occupation in the smaller states. Since 1941, the United States has fought three major wars in the region. Flashpoints in North Korea or the Taiwan Strait could erupt at any time.

In addition to continuing to maintain a substantial military presence in Asia as a stabilizing force, the United States supports and participates in the ASEAN Regional Forum (ARF) as a mechanism for facilitating communication and building trust on security matters.1 Over the longer run, however, one of the best ways for the United States to prevent armed conflict and promote peace in the Pacific is to be engaged politically and to encourage a high degree of economic integration and interdependence through the mutual opening of markets to foreign trade and investment.

U.S. business has played a major role in the economic development of the Asia-Pacific region through trade, investment, technology transfer, and partnerships with domestic firms.

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1. The nine members of the Association of Southeast Asian Nations (ASEAN) are: Brunei, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.
In addition, it has worked closely with governments and private firms in the region to improve the infrastructure for business. Technical assistance has been provided in fields such as company law, accounting, information and telecommunications services, and financial systems, including banking, security markets, and insurance.

The Asia-Pacific Economic Cooperation (APEC) forum is the principal regional vehicle through which the U.S. government relates to the economies of the Asia-Pacific area collectively.\(^2\) However, when APEC began, it was as much a political enterprise as it was an economic initiative. Its impetus was to begin to create a sense of commonality in a region that, unlike Western Europe, is politically, culturally, and socially diverse. In the United States, APEC is helping to build a heightened public consciousness about the importance of Asia to this country and its future. It has also provided a valuable forum for the United States to listen to and learn about Asian perspectives and to expound long-held principles of its own.

APEC’s objective of free trade and investment early in the twenty-first century is far-reaching in its implications for both the countries of the region and the rest of the world. Concurrently with the APEC initiative, the results of the Uruguay Round are coming into force, and bold new regional economic arrangements are being forged in the Western Hemisphere and other parts of the world. These pathbreaking developments in the regime for international trade and investment are the backdrop against which the issues for the CED project on Asia need to be considered.

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2. The member economies of the Asia-Pacific Economic Cooperation (APEC) are: Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, the Philippines, Singapore, South Korea, Taiwan, Thailand, and the United States.
tional trading community, and we support China’s entry into the WTO, provided it abides by basic international trade and investment standards.

As for our important economic relationship with Japan, while we urge more use of the WTO in settling disputes, the United States should continue bilateral efforts with Japan to break down impediments resulting from the actions of private firms to restrict foreign trade and investment.

We also warn against letting concern over U.S. trade deficits with individual countries derail efforts to broaden trade and investment with Asia. U.S. trade and investment policy should focus on specific impediments to trade and investment rather than on bilateral surpluses or deficits with the United States.
Foreign investment and international trade are the principal means through which individual nations interact economically. Traditionally, trade was considered the engine of growth in the world economy, increasing at more than twice the rate of growth of world production. Over the past two decades, however, the rate of increase of trade has been greatly outpaced by the rapid rise of foreign direct investment (FDI). The difference was especially marked in East Asia and the Pacific (see Figure 2).

Moreover, many foreign markets are served more by foreign affiliates of multinational corporations than by exports. For U.S.-based firms, local sales of overseas affiliates have exceeded U.S. exports by a factor of more than two to one.3

In addition, much of foreign trade consists of intrafirm trade—that is, transactions between a parent firm located in one country and its affiliates in other countries. In the case of the United States, intrafirm trade by multinational corporations accounted for almost 50 percent of U.S. exports and 55 percent of U.S. merchandise imports in 1991.4 In short, in today’s global economy, international trade and investment are inextricably linked.

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ROLEs OF DOMESTIC AND FOREIGN CAPITAL

In Asia, the demand for capital is enormous. Much of this capital is required to finance the vast new physical infrastructure needed to keep up with soaring economic growth. This includes not only economic infrastructure, such as transport, power, and telecommunications, but social infrastructure such as schools, hospitals, housing, and water systems. The World Bank estimates that infrastructure investment alone for the Asia-Pacific area will be around $2 trillion over the next decade.

Historically, infrastructure investment has been the domain of governments and international public financial institutions such as the World Bank and the Asian Development Bank. Now, however, with the demand for infrastructure so enormous and pressing, governments are turning increasingly to the private sector, both domestic and foreign, to get many projects off the ground.

With the region’s domestic saving averaging more than 32 percent of the gross domestic product (GDP), most of the capital needs of the region are being financed internally. Only about 4 percent of all investment in East Asia over the next ten years is expected to be financed by foreign capital.

Efficient use of domestic resources can be substantially enhanced in Asia by improvements in the infrastructure for financial intermediation between savers and investors. Although commercial banks are likely to remain dominant for some time, nonbank intermediaries, such as insurance companies and pension funds, are potentially important sources of long-term finance. However, Asian financial systems need improvements in their legal, accounting, and regulatory regimes as well as effective rules for fuller disclosure. The World Bank, in collaboration with private business, should play a leading part in providing technical assistance for these purposes.

Despite its modest quantitative contribution to total investment in Asia, foreign capital has played a critical role, especially when the capital flow has been in the form of private direct investment. In 1995, net private capital flows to East Asia and the Pacific amounted to $98.1 billion, of which 55 percent was FDI. Along with FDI have come vital nonquantifiable resources in the form of new technology, know-how, management skills, and global marketing knowledge and facilities. It is the totality of these resource flows that has made foreign investment a driving force in global development.

ASYMMETRY IN NET CAPITAL FLOWS

Over the past decade, Japan has emerged as the world’s largest net exporter of capital, and the United States has become the world’s largest importer of capital. These flows are simply the counterpart of the current-account surpluses earned by Japan ($67 billion in 1996) and deficits incurred by the United States ($165 billion in 1996). The current-account balances reflect in turn the differences between national saving and investment in each country. No other country in the Asia-Pacific area remotely approaches Japan and the United States in terms of the absolute size of its global current-account imbalance.

America and Japan have attempted to coordinate their macroeconomic policies with a view to reducing their current-account imbalances. In the Framework Talks held by the two governments in 1993-94, expansionary

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Fiscal policies were recommended for Japan, and contractionary policies were proposed for the United States.* Similar recommendations to dampen the budgetary imbalances were included in a 1994 joint CED-Keizai Doyukai (Japan Association of Corporate Executives) policy statement. However, Japan’s fiscal surpluses of the late 1980s and early 1990s have been converted into substantial deficits as a result of a three-year economic slump and the public costs of reconstruction after the devastating Kobe earthquake.

Under these changed conditions, a new mechanism for discussion of mutual macro-economic problems has been established in the form of the Group of Six (G-6), an Asian counterpart of the Group of Seven. Consisting originally of the United States, Japan, China, Singapore, Australia, and Hong Kong, the group will meet annually to discuss a wide range of financial issues.

Unlike the United States, Japan has a high rate of private saving. This has allowed its budgetary deficit to be easily financed internally while permitting a continuing high rate of domestic private investment as well as net foreign investment, as reflected in ongoing surpluses in its balance of payments on current account.

Japan’s high rate of private saving has been justified on both internal and external grounds. Within Japan, many see it as essential to finance the future retirement needs of one of the world’s most rapidly aging populations.** Externally, Japan’s excess saving is welcomed by many poorer Asia-Pacific countries as a vital supplement to their own internally generated capital in helping to finance their steeply expanding development programs. From this standpoint, Japan is seen as fulfilling the proper role of a mature wealthy economy.

On the other hand, the United States is regarded by many developing countries as irresponsible in running large balance-of-payments deficits financed by drawing down the pool of international capital and accumulating a huge external liability amounting to $700 billion at the end of 1995.10 In terms of its own interests as well, the cumulation of U.S. current-account deficits is unfortunate. It entails a buildup of liabilities to the rest of the world that have to be serviced. The current trend is for an increasing volume of U.S. income to be paid out to foreigners and thus to be unavailable for domestic consumption and investment. The best way for the United States to correct its balance-of-payments deficit is to increase its national saving. Elimination of the U.S. budget deficit would be the most effective contribution to that objective in the medium term.11 Fortunately, a strong economy and sustained attention to deficit reduction in the past several years have reduced the deficit to less than one percent of GDP.

**FOREIGN DIRECT INVESTMENT**

The economic development of the original “Asian tigers” (Taiwan, Korea, Singapore, and Hong Kong) was facilitated by foreign financing, primarily in the form of official assistance. However, the inflow of foreign capital to today’s rapidly growing Asian developing countries consists overwhelmingly of private capital, of which FDI is the largest single component (see Figure 3, page 8).

The direct investment presence of the United States in the Asia-Pacific region has grown substantially, amounting at the end of 1995 to almost $126 billion, concentrated mainly in manufacturing. As host to American FDI, Asia-Pacific lags far behind Europe but now exceeds Latin America by a small

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*See memorandum by RODERICK M. HILLS, (page 37).

**See memorandum by RODERICK M. HILLS, (page 37).
Moreover, the preeminent position among foreign direct investors in the region is held by Japan, not by the United States.

**U.S.-JAPAN DISPARITY.** A striking feature of the distribution of FDI in the region centers on Japan. Although the 1994 total stock of Japanese FDI worldwide was $463 billion, Japan was host cumulatively to only $34 billion of FDI from all sources.\(^1\) Perhaps the most telling indicator of Japan’s anomalous position in terms of the foreign presence in its economy is the proportion of domestic sales provided by foreign-owned firms in Japan compared with other countries: 1.2 percent in Japan, 16.4 percent in the United States, 14.0 percent in Germany, 24.1 percent in the United Kingdom, and 28.4 percent in France.\(^2\) Given the strong positive relationship between FDI and trade, the low level of FDI in Japan undoubtedly exacerbates the trade tensions between Japan and other countries.

Although Japan has ended formal restrictions on inward foreign investment, we believe the extremely small presence of foreign enterprises can be explained, at least in part, by informal administrative restrictions and private barriers. The U.S. government should continue to press the government of Japan to take energetic steps to remove such barriers.

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The bilateral U.S. approach to Japan on this issue should be bolstered by multilateral action once the Multilateral Agreement on Investment (MAI) comes into being. The MAI is in an advanced stage of negotiation in the Organization for Economic Cooperation and Development (OECD). In addition to calling for national treatment (that is, the same conditions as those accorded to domestic firms) it is likely to provide facilities for the settlement of investment disputes. Included would be provisions for compensatory monetary damages in the case of investor-state disputes and retaliation in the case of state-state disputes.

**POLICIES OF EMERGING COUNTRIES AFFECTING FDI.** There are two types of public policies that affect the attractiveness of host countries to foreign direct investors: general economic policies that condition the environment for business and specific host-country policies intended to promote or control FDI. The most important general policies conducive to foreign investment are macroeconomic stability; transparency, and predictability of government regulation; equal treatment for domestic and foreign enterprises; and avoidance of restrictive trade policies. Countries interested in attracting foreign investment should pay particular attention to ensuring these basic conditions.

The most widely used special policy aimed directly at foreign investors is fiscal incentives, whether in the form of tax concessions or government subsidies. Although fiscal incentives are commonly regarded in developing countries as essential to attract foreign investors, it is open to question whether their benefits outweigh their fiscal costs.

Fiscal incentives for FDI distort the flow of foreign capital and encourage costly unproductive competition among developing countries in order to attract foreign investment. Moreover, they violate the basic principle of equal treatment for domestic and foreign firms. At bottom, most multinational companies look more to a country’s general and more enduring economic institutions and policies than to fiscal incentives, which can be given by one administration and taken away by the next. However, incentives are a fact of life. When granted, they should be available equally to domestic and foreign investors.

Another type of fiscal policy affecting the flow of FDI is intergovernmental agreements to avoid double taxation of foreign investors. Such agreements involve difficult questions, including issues of valuation relating to transfer pricing. Nevertheless, an attempt should be made in APEC or some other forum to develop principles to govern the division of tax revenue between host and home governments.

Of course, not all government policies directed specifically at multinational firms are for the purpose of promoting FDI. Some are intended to control the behavior of foreign companies in various ways. Known as performance requirements, they include prohibiting FDI in certain sectors, limiting foreign equity participation, requiring a minimum percentage of local content in production, and mandating a minimum volume of exports.

Performance requirements were on the agenda of the Uruguay Round negotiations, but most of them were deemed beyond the scope of the existing rules of the General Agreement on Tariffs and Trade (GATT). In the end, the round succeeded in banning only local-content and trade-balancing requirements (after a transition period) on the grounds of their inconsistency with GATT rules and their adverse effect on the efficiency of operation of foreign-owned enterprises.

Trade-balancing requirements mandate that a firm offset the foreign exchange cost of its imports by earning foreign exchange through exports. The purpose of local-content requirements is to protect existing host-country domestic industries that supply parts and intermediate products to affiliates of multinationals or to encourage the establishment or expansion of such industries (backward link-
ages). However, by forcing foreign affiliates to buy local supplies when imports may be cheaper or better, local-content requirements reduce the efficiency of foreign-owned firms and their ability to export competitively in world markets. In CED’s view, there are steps that a host government can take to promote domestic supplying industries, such as providing credit and training facilities, without resorting to local-content requirements or other forms of protection.

Unfortunately, there is a significant risk, especially with respect to the automotive sector, that some countries in the Asia-Pacific region (Malaysia and Indonesia, for example) will not meet their Uruguay Round commitments to eliminate these nontariff barriers by January 1, 2000. The U.S. government should give high priority to oversight of on-time compliance with the agreement reached to phase out local-content and trade-balancing requirements.

Beyond these regulations, which are covered by the World Trade Organization (WTO), performance requirements for foreign investment should be made subject to international discipline. However, pending the negotiation of a global or APEC investment code (see “Investment Code” pages 10-11), the United States should intensify its bilateral investment treaty program with particular attention to countries in the Asia-Pacific region. U.S. bilateral investment treaties include many of the key elements of projected multilateral codes, such as rights of establishment and national treatment.

FINANCIAL SERVICES. Major advances have been made in privatizing and liberalizing financial systems in Asia-Pacific. However, American financial institutions still face troubling barriers, especially in Japan, China, South Korea, and Taiwan. The barriers consist of obstacles to entry and discrimination relative to domestic firms once the institutions are established. Efforts in the Uruguay Round to open up markets to foreign financial institutions as part of the negotiations on trade in services ended in a standoff. Rather than holding up the whole Uruguay Round agreement, the parties agreed to continue negotiations for six months after the effective date of the agreement in January 1995. A financial services agreement satisfactory to the United States could not be reached at that time, but the negotiations were resumed in April 1997.

The United States accords national treatment to foreign financial institutions and is seeking similar treatment for American financial institutions abroad. In the Uruguay Round and in subsequent negotiations, the United States reserved the right to withhold national and most-favored-nation (MFN) treatment for new investments in financial services from countries that discriminate against the operations of American and other foreign financial institutions. CED recommends that the U.S. government refrain at this time from invoking its right to discriminate against foreign financial institutions while continuing to press for foreign liberalization of financial services.* **

INVESTMENT CODE. Despite the primary role of foreign investment in the globalization of the world economy, no multilateral institution comparable to GATT and the WTO exists to provide a framework of norms and a mechanism for resolving conflicts and removing obstacles to international investment.

Over time, the WTO may successfully sponsor the negotiation of a global investment code, thereby converting the WTO into a World Investment and Trade Organization (WITO). In the meantime, regional investment codes already exist de facto in the European Union and in the North American Free Trade Agreement (NAFTA) in the form of comprehensive safeguards for the rights of foreign investors. And the OECD is sponsoring the negotiation of a MAI applying to its members, a process in which the business community has actively participated through the Busi-

*See memorandum by HARRY L. FREEMAN, (page 37).

**See memorandum by MARTIN B. ZIMMERMAN, (page 37).
The question is whether progress toward a universal investment code can be accelerated by pursuing that objective on a regional basis in the Asia-Pacific area. An APEC investment code was proposed by the Pacific Economic Cooperation Council (PECC) in a draft submitted to the APEC ministers in 1993. In 1994, a set of “nonbinding investment principles” was adopted, but half of them fall short of desirable international standards. Other APEC advisory groups have also recommended the formulation of an investment code by APEC which could initially be adopted voluntarily by each of its members.

In a report to the APEC economic leaders submitted prior to the Subic Bay Summit meeting in November 1996, the APEC Business Advisory Council (ABAC) made an innovative proposal for strengthening investment standards. In addition to improving the non-binding principles, ABAC recommended the establishment of APEC Voluntary Investment Projects (AVIPs). Under this system, APEC economies can voluntarily apply a specific set of principles for enhanced investment protection to selected individual projects above and beyond the protection afforded by the non-binding investment principles. The inducement for establishing AVIPs is that financial markets reward strong investment-protection regimes with lower financial costs. CED endorses the AVIP proposal as a practical interim device for advancing investment protection in the APEC region. However, AVIPs are no substitute for a global rule of law in investment, and we urge APEC nations to adopt an investment code based on international norms as soon as possible.

Although the November 1994 Bogor Declaration of APEC heads of state did not include explicit endorsement of a formal investment code for the region, its stated goal was “free and open trade and investment in Asia Pacific no later than the year 2020.” If we interpret the Bogor Declaration as approval in principle of an APEC investment code, what should be the U.S. role? In developing an APEC code, the U.S. government should refrain from putting its own draft on the table at the outset. The specifics of the code should emerge from discussions among APEC government officials with the active participation of business representatives from member countries. At the technical level, however, liaison should be established with the OECD committee currently at work on the MAI for its members.

In developing an investment code, national and MFN treatment for foreign investors should, of course, be the basic norm. Among the other issues to be resolved are: how to define permitted exceptions to the right of establishment (e.g., for national security); whether special government incentives or disincentives that distort international capital flows should be discouraged; whether limitations should be categorically barred on the remittance of profits and royalties and on the repatriation of capital; whether common principles should be established to guide transfer pricing; whether, and the extent to which, subfederal units (state and local jurisdictions) should be bound by the code; whether facilities for mandatory arbitration should be established to resolve recalcitrant investment disputes; and whether the code should be binding or voluntary.

INTERNATIONAL PORTFOLIO INVESTMENT

Portfolio investment consists of cross-border private flows of capital that, unlike FDI, do not imply management control over the foreign project or enterprise that is the object of the financing. Included in portfolio investment are commercial bank lending, bond purchases, and equity investment.

15. ABAC consists of three business representatives from each APEC country.
16. APEC Economic Leaders’ Declaration of Common Resolve (Bogor, Indonesia, December 15, 1994).
The composition of portfolio flows to developing countries has changed radically over the past 20 years. In the 1970s, portfolio financing was channeled primarily from foreign commercial banks to governments. When the debt crisis erupted in the early 1980s, private financing to government borrowers in the developing world virtually dried up, and potential investors were also wary of lending to private borrowers in those countries. With the recent improvement in the macroeconomic and regulatory environment in many developing countries, portfolio flows have revived. However, most of the funds have gone to private borrowers, and the source of financing has largely shifted from banks to nonbanks (especially mutual and pension funds) through the vehicles of bond issues and equity investment.

Portfolio flows to developing countries have increased dramatically in recent years, from $7.5 billion in 1989 to $55.8 billion in 1993. Although most of the financing has consisted of debt instruments (bonds, certificates of deposit, and commercial paper), investment in equities has also risen rapidly, tripling to $13.2 billion during the 1989-1993 period.

The explosive growth of portfolio investment in developing countries has been largely confined to a select group of countries in Latin America and Asia-Pacific. In the latter region, 83 percent of bond flows in 1994 went to China, Korea, and Thailand; and 82 percent of equity flows went to China, Korea, and Indonesia.

Inward capital flows are strongly correlated with economic growth and macroeconomic stability in recipient countries. However, they also reflect the state of liberalization of financial markets, especially the extent of controls on cross-border financial flows. Developing countries in Asia should be encouraged to gradually remove restrictions on capital inflows as an important step in widening the range of countries benefiting from the ability to draw on foreign savings.

In recent years, the sources of portfolio capital flows have become quite diversified. They include mutual funds, institutional investors such as pension funds and life insurance companies, securities traders, and citizens of host countries living abroad. This diversity reduces the risk of a sudden and simultaneous drying up of flows such as occurred with commercial bank loans in the 1980s. However, the volume and sources of portfolio flows could be expanded by the relaxation in source countries of regulations, often at the state level in the United States, on the investment policies of insurance companies and other institutional investors. Steps along these lines to liberalize capital outflows should be seriously considered by the United States and other industrial countries, consistent with the fiduciary responsibilities of their regulators.

Unlike debt instruments, whether in the form of bonds or traditional commercial bank loans, foreign investment in equities has the advantage of matching service payments (i.e., dividends) to ability to pay, thereby serving as an effective instrument for sharing risk between the provider and the recipient of capital. A growing number of developing countries have established stock markets which have facilitated the mobilization of risk finance and contributed to improved corporate financial structures.

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17. Another perspective on the pull of these capital markets was given by Malcolm Binks, Senior Vice President of Merrill Lynch International, at the Pacific Leaders Forum in Seattle on October 1, 1996. Of the $750 billion invested in Merrill Lynch accounts, the proportion invested outside the United States (much of it in Asia-Pacific markets) rose from 3 percent to 10 percent in just five years.


Despite the striking advances made by major emerging equity markets in the developing world, the state of many others discourages both domestic and foreign investors. These markets are characterized by high concentration and volatility, lack of liquidity, inadequate disclosure and regulation, and weak capacity to enforce rules.

APEC should cooperate with the World Bank and the International Monetary Fund (IMF) in a program to improve these conditions by assisting governments to establish adequate institutional, legal, and regulatory structures for the proper functioning of domestic securities markets. As a first step, APEC should establish a new Working Group on Capital Markets to gather data on existing conditions in member countries and to make recommendations directed initially to the improvement of their equity markets.

The financial crisis that erupted in Mexico in late 1994 underlines the vulnerability of emerging markets to misguided domestic macroeconomic policies, especially in economies that have experienced large inflows of volatile foreign capital. The dangers include excessive expansion of money and credit, increased inflation, appreciation of the real exchange rate, and a deterioration in the current account.

The support package of $50 billion hastily arranged for Mexico by the United States was a one-shot ad hoc operation that is unlikely to be repeated. In order to forestall the sudden loss of investor confidence in a country’s finances, such as the Mexican peso crisis of 1994, the IMF has been working on a two-tier approach: First, it has developed a monitoring and early-warning system in the form of a set of standards to improve the timely distribution of financial data by governments. Second, it has sponsored a negotiation among its members to enlarge by $47 billion the original $24 billion General Arrangements to Borrow (GAB), so that lines of credit would be available in an emergency to protect the currencies not only of the major industrial powers but also of cooperating developing countries.

Under the expanded GAB, the U.S. commitment would rise by 58 percent, from $6.16 billion to $9.73 billion. Although the increase would require Congressional approval, it would not entail any actual U.S. budget outlay or add to the federal deficit. If the GAB were activated, the United States would lend, not to the country in crisis, but to the IMF. The loan would be secured, therefore, by the IMF’s own financial reserves, including billions of dollars’ worth of gold. In our view, the expanded IMF emergency fund constitutes a constructive multilateral response to future Mexico-type financial crises. We recommend its prompt approval by the U.S. Congress.*

OFFICIAL DEVELOPMENT FINANCE

In terms of dollar volume, Japan is the number-one provider of official development assistance globally ($13,396 million in 1995). The United States is a distant third ($7,187 million), ranking slightly behind France ($7,437 million).20

As a provider of assistance specifically in Asia, Japan overshadows all other countries. Almost 62 percent of Japanese foreign aid went to Asia in the 1994-1995 period, compared with less than 17 percent of U.S. assistance. The major individual recipients are China, Indonesia, India, the Philippines, and Thailand.21

The heavy concentration of Japanese aid in Asia can be ascribed to historical ties, geographic proximity, and an exceptionally high correlation between the directions of Japan’s aid and trade.

Neither the United States nor Japan is particularly generous as an aid giver if the crite-
tion of generosity is official development assistance (ODA) as a percentage of gross national product (GNP). By that standard, Japan’s 0.28 percent only slightly exceeds the average of 0.27 percent for all donor countries of the OECD. The United States ranks lowest of OECD aid givers, spending only 0.10 percent of its annual GNP for ODA.22

The volume of American ODA in 1995 fell 37 percent below its 1992 level and is likely to decline further.23 An evaluation of U.S. foreign aid performance by the OECD Development Assistance Committee (DAC) reflects alarm over the sharp decline. According to the DAC, this seeming withdrawal from traditional leadership is so grave that it “poses a risk of undermining political support for development cooperation” in other donor countries.24

The case for U.S. economic assistance abroad has always rested on multiple objectives: promoting economic development in low-income countries; meeting emergency needs in the world’s poorest nations; expanding opportunities for U.S. trade and investment, and advancing U.S. strategic and political interests. With the collapse of the Soviet empire, however, there has been a shift in emphasis from using aid to counter Cold War rivals to supporting emerging democracies in Eastern Europe and the independent states of the former Soviet Union. High priority is also being given to dealing with transnational problems such as environmental degradation and rapid population growth.

U.S. assistance for development comprises only half of one percent of the federal budget, far less than estimated by the public in opinion surveys. A concerted effort should be made by the U.S. business community as well as by the government to counter the gross public overestimation of the share of foreign assistance in the federal budget as part of a program to raise the U.S. contribution while taking into account the need to balance the budget.

In the case of Japan, the problem is not the volume of aid but the way in which it is deployed. The percentage of Japanese aid formally tied to purchases from Japan is relatively low, but much of the aid is informally tied. This is accomplished by allocating aid to specific projects or products for which Japan has a competitive advantage or by requiring that feasibility studies be carried out by Japanese engineering firms with close ties to Japanese trading and manufacturing companies.25 Because of these practices, critics have stated that the Japanese aid program is designed more to foster the commercial interests of the donor nation than to stimulate economic development in the recipient country. We believe that private Japanese business organizations, concerned about the health of the global economy, are in the best position to influence Japanese aid policy to reduce its trade-promotion orientation and increase its development value to recipients.

22. OECD, Development Cooperation 1996, Annex Table 6a.
23. OECD, Development Cooperation 1996, Annex Table 20.
Despite the dynamic role of rapidly increasing foreign investment in Asia, trade (both exports and imports) continues to play a critical part in the economic development of the region, and issues of trade policy remain high on the agenda of international economic negotiations. Moreover, multinational corporations seek not only a market presence in Asian countries through foreign investment but also unimpeded market access for their firms’ exports from production bases at home and elsewhere within or outside the region.

U.S. TRADE BALANCES WITH THE ASIA-PACIFIC REGION

The United States has experienced large global merchandise trade deficits continuously for the past decade. Since 1991, the deficits, which had been declining from their 1987 peak, have again risen sharply. In 1996, the merchandise trade deficit amounted to a record $188 billion.26

If we disaggregate the U.S. global merchandise trade deficit geographically, we find its main locus to be in U.S. trade with East Asia and the Pacific. As shown in Figure 4, the

26. However, America has been running surpluses in service trade in recent years. As a result of a services surplus of $73 billion, the 1996 balance on goods and services amounted to $114 billion. But when the balances on investment income and unilateral transfers (both negative) are taken into account, the full current account for 1996 was a deficit of $165 billion. U.S. Department of Commerce, U.S. International Transactions: Fourth Quarter and Year 1996 (Washington, D.C.: U.S. Government Printing Office, March 13, 1997).

Figure 4

U.S. Merchandise Trade Balance with Selected East Asian and Pacific Countries
(In Millions of Dollars)

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<tr>
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<tr>
<td>Brunei</td>
<td>$424</td>
<td>$442</td>
<td>$330</td>
<td>$152</td>
<td>$326</td>
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<td>Indonesia</td>
<td>-1,750</td>
<td>-2,665</td>
<td>-3,712</td>
<td>-4,076</td>
<td>-4,273</td>
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<td>Malaysia</td>
<td>-3,831</td>
<td>-4,499</td>
<td>-7,012</td>
<td>-8,637</td>
<td>-9,283</td>
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<td>Philippines</td>
<td>-1,597</td>
<td>-1,364</td>
<td>-1,832</td>
<td>-1,712</td>
<td>-2,019</td>
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<td>Singapore</td>
<td>-1,687</td>
<td>-1,120</td>
<td>-2,339</td>
<td>-3,227</td>
<td>-4,089</td>
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<td>Thailand</td>
<td>-3,540</td>
<td>-4,775</td>
<td>-5,446</td>
<td>-4,683</td>
<td>-4,139</td>
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<tr>
<td>Vietnam</td>
<td>5</td>
<td>7</td>
<td>122</td>
<td>54</td>
<td>285</td>
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<tr>
<td></td>
<td></td>
<td>-11,976</td>
<td>-13,974</td>
<td>-19,889</td>
<td>-22,129</td>
<td>-23,192</td>
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<tr>
<td>Australia</td>
<td>5,188</td>
<td>4,979</td>
<td>6,581</td>
<td>7,466</td>
<td>7,816</td>
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<tr>
<td>China</td>
<td>-18,309</td>
<td>-22,777</td>
<td>-29,494</td>
<td>-33,790</td>
<td>-39,553</td>
<td></td>
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<tr>
<td>Hong Kong</td>
<td>-716</td>
<td>319</td>
<td>1,748</td>
<td>3,940</td>
<td>4,034</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>-49,601</td>
<td>-59,355</td>
<td>-65,669</td>
<td>-59,137</td>
<td>-49,214</td>
<td></td>
</tr>
<tr>
<td>South Korea</td>
<td>-2,043</td>
<td>-2,336</td>
<td>-1,629</td>
<td>1,196</td>
<td>3,001</td>
<td></td>
</tr>
<tr>
<td>Taiwan</td>
<td>-9,346</td>
<td>-8,934</td>
<td>-9,633</td>
<td>-9,682</td>
<td>-12,385</td>
<td></td>
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</tbody>
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<td></td>
<td>-86,803</td>
<td>-102,078</td>
<td>-117,985</td>
<td>-112,136</td>
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</thead>
<tbody>
<tr>
<td></td>
<td>-96,106</td>
<td>-132,609</td>
<td>-166,121</td>
<td>-173,424</td>
<td>-187,674</td>
</tr>
</tbody>
</table>

United States has run a bilateral deficit with most countries in that region. The exceptions are Australia, Hong Kong, South Korea, Brunei, and Vietnam. For the area as a whole, the deficit was $109 billion in 1996, the bulk of it concentrated in Japan ($49 billion), China ($40 billion), and Taiwan ($12 billion).

Should the United States worry about its large and growing merchandise trade deficits with East Asia and the Pacific? In particular, should it mount a special effort to improve its rapidly deteriorating bilateral merchandise trade balance with China as it has done in the past with Japan?

In considering this question, we should bear in mind that the best indicator of a country’s international economic position is not any particular bilateral trade balance but, rather, its global current-account position. In addition to merchandise trade, the current account reflects the balance in service trade, investment income, and unilateral transfers. And in the global context, a current-account surplus with some countries may be offset by deficits with others.

In the case of China, despite its $34 billion bilateral merchandise trade surplus with the United States in 1995,\(^27\) that country’s global current-account surplus was only $1.6 billion, an amount equal to two-tenths of one percent of its GDP. And as shown in Figure 5, most of the other countries in the Asia-Pacific region experienced overall current-account deficits in 1995 despite their trade surpluses with the United States.

A final point to bear in mind is that a country’s global current account is overwhelmingly a function of its macroeconomic policy. It reflects the balance between a nation’s aggregate output and expenditure, a difference largely determined by its fiscal, monetary, and exchange rate policies. In the case of the United States, the 1996 current-account deficit of $165 billion reflects mainly domestic conditions: the combination of a low level of private saving relative to private investment and a large federal budget deficit.

Although global current-account imbalances depend on macroeconomic policies, the composition and direction of a country’s trade can be substantially influenced by microeconomic policy—that is, policy toward trade and foreign investment, including import protection, export subsidization, and regulations pertaining to foreign direct investment. U.S. concerns should be focused, therefore, primarily on specific Asian restrictions that distort the pattern of foreign trade and investment rather than on Asian balance-of-payments surpluses or deficits that largely reflect domestic macroeconomic policies.

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\(^{27}\) U.S. official data seriously overstate the bilateral deficit with China. U.S. sales to China via Hong Kong middlemen are entered by the Department of Commerce as exports to Hong Kong. But the Department counts as imports from China all Chinese products reexported from Hong Kong to the United States, including value added by Hong Kong companies. According to Nicholas Lardy, the China specialist at The Brookings Institution, the upshot is that the real U.S. trade imbalance with China in 1996 is likely to total about $25 billion, one-third less than the $38 billion projected on the basis of U.S. government data. *Brookings Policy Brief*, no. 10 (November 1996).

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### Figure 5

#### Current-Account Balances, 1995

(In Billions of U.S. Dollars)

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount</th>
<th>Percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>-148.2</td>
<td>-2.0</td>
</tr>
<tr>
<td>Japan</td>
<td>111.3</td>
<td>2.2</td>
</tr>
<tr>
<td>China</td>
<td>1.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>-4.9</td>
<td>-3.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>15.1</td>
<td>17.8</td>
</tr>
<tr>
<td>Taiwan</td>
<td>4.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Korea</td>
<td>8.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Malaysia(^a)</td>
<td>-4.1</td>
<td>-5.9</td>
</tr>
<tr>
<td>Thailand</td>
<td>-13.6</td>
<td>-8.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>-2.0</td>
<td>-2.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>-7.0</td>
<td>-3.5</td>
</tr>
<tr>
<td>Australia</td>
<td>-19.2</td>
<td>-5.5</td>
</tr>
<tr>
<td>New Zealand</td>
<td>-3.8</td>
<td>-6.3</td>
</tr>
</tbody>
</table>

(a) Data for Malaysia are for 1994.

TRADE POLICIES OF DEVELOPING COUNTRIES OF THE REGION

Most of the developing countries of the Asia-Pacific region initially adopted the import-substitution model of development. However, unlike Latin American countries, they abandoned this protectionist strategy early in favor of export-oriented growth policies. Trade restrictions were substantially reduced, competitive exchange rates were adopted, and a variety of specific export-promotion measures were introduced. A major recent advance in liberalization is the commitment of many Asian nations under the 1997 International Telecommunications Agreement to join other countries in opening their domestic markets to international telecommunications services and facilities.

Despite the growing openness of the Asia-Pacific economies, substantial tariff and nontariff barriers to market access remain. Foreign companies face a wide range of restrictive measures not only in terms of market access for their products but also in the form of barriers to trade in services, obstacles to investment, inadequate protection for intellectual property, and anticompetitive practices in the private sector.

In the past, U.S. policy has relied heavily on ad hoc, bilateral and public efforts to open Asian markets in specific areas. Although U.S. clout, especially relative to the smaller Asian economies, has often been effective in winning concessions, the political fallout in those countries has generally been negative. U.S. approaches are widely seen as employing bullying tactics, especially when bolstered by implicit or explicit threats of trade sanctions.

Except for China and Taiwan, all APEC members are also members of the new WTO and are therefore subject to its rules. When a bilateral trade dispute falls within the competence of the WTO because a violation of GATT rules is alleged, the United States should resort to the improved WTO dispute-settlement facility, which has worked well since its inception in January 1995.

REGIONAL VERSUS GLOBAL APPROACHES TO TRADE AND INVESTMENT LIBERALIZATION

As regional economic arrangements proliferate around the world, a question arises: Do these arrangements conflict with or undermine the global liberalization that has been pursued for almost half a century through GATT? This issue becomes especially important now that the Uruguay Round has been successfully completed and GATT has been converted into a strengthened WTO with promising prospects for continued progress in the multilateral dismantling of barriers to trade and investment.

On the one hand, there are those who see the institutionalization and widening of new regional trade arrangements as a clear threat to the existing global trade regime based on the fundamental principle of equal treatment for all nations. In Europe, the Economic Union has been expanded from 12 to 15 members, with a strong likelihood of further enlargement to include a number of countries in Eastern Europe. In the Western Hemisphere, numerous preferential regional arrangements exist, such as NAFTA, Mercosur, and the Andean group, and they are likely to consolidate over the next decade into a free trade area of hemispheric scope. In Asia, the prospective nine-country ASEAN free trade area is being subsumed within the wider plans for APEC free trade among 18 countries, with the possibility of further enlargement in the future. In Africa, too, a number of regional trade groupings have been spawned.

The worry about these regional developments is threefold: First, by their nature, they accord preferential treatment to their members and therefore may harm other countries by diverting trade from them. Particularly

28. China has applied for WTO membership. For a discussion of this issue, see pages 24–26.
onerous in this respect are industry-specific rules of origin that increase protection for particular sectors, such as the NAFTA rules for textiles, apparel, and automobiles. Second, by centering the attention and energy of officials on the complex tasks of negotiating the specifics of the regional arrangements, the worldwide approach to liberalization through GATT and the new WTO may be neglected. Third, as production becomes increasingly globalized, the business horizons of multinational firms are transcending not only national boundaries but regional ones as well. Economic fragmentation of the world through separate regional economic arrangements could complicate international trade and investment and pose obstacles to efficient worldwide operations.

On the other hand, there is strong support for the view that liberalization should be pursued on all fronts, whether unilateral, bilateral, regional, or global. According to this view, the less-than-global approaches can be effective over time in facilitating and accelerating the more difficult global moves to open trade and investment, leading ultimately to deeper worldwide economic integration. In smaller groupings, progress is more feasible beyond the reduction of tariffs and nontariff barriers. Negotiations on such matters as intellectual property rights, investment, product standards, and competition rules can move faster within regional groups than within the WTO, an organization of 128 members.29

GATT attempts to ensure that liberalization should be pursued on all fronts, whether unilateral, bilateral, regional, or global. According to this view, the less-than-global approaches can be effective over time in facilitating and accelerating the more difficult global moves to open trade and investment, leading ultimately to deeper worldwide economic integration. In smaller groupings, progress is more feasible beyond the reduction of tariffs and nontariff barriers. Negotiations on such matters as intellectual property rights, investment, product standards, and competition rules can move faster within regional groups than within the WTO, an organization of 128 members.29

GATT attempts to ensure that regional free trade arrangements are consistent with multilateral liberalization through certain conditions set forth in Article XXIV of the agreement relating to the formation of customs unions and free trade areas. For example, the preferential treatment accorded to members of a free trade area is to be achieved only by eliminating trade barriers among members, not by raising barriers against nonmembers.

In light of the spread of preferential arrangements around the world, GATT Article XXIV should be reviewed with the objective of strengthening the contribution of regional free trade areas to more open markets globally. By establishing the Committee on Regionalism, the WTO has already taken a first step to address concerns that proliferating regionalism could undermine the prospects for further multilateral liberalization. Thus far, however, the Committee has been largely concerned with developing procedures for better monitoring of regional arrangements without dealing with the substance of Article XXIV.30 In our view, the Committee on Regionalism should also promptly address the need to strengthen Article XXIV of GATT, including the adoption of sharp limits on the use of industry-specific rules of origin that can exacerbate the trade-diversion effects of regional trade arrangements.

ASIA-PACIFIC ECONOMIC COOPERATION FORUM

When APEC was launched in 1989 at Australia’s initiative, it seemed as though it would be just another forum for unfocused talk and pious statements. However, with the rapidly increasing economic importance of the Asia-Pacific region, the Clinton Administration decided to throw its weight behind APEC. It seized the opportunity of the U.S. chairmanship in 1993 to upgrade the scheduled meeting in Seattle from the level of ministers to one of heads of state and decided to work energetically with the other key governments to help give APEC shape and substance.

To advance that objective, an advisory Eminent Persons Group (EPG) was formed under

29. As of November 15, 1996, 28 additional countries, including China and Russia, have applied for WTO membership.

30. The importance of better monitoring should not be minimized. Of the 109 regional trade agreements notified to the GATT under Article XXIV between 1948 and 1995, only 64 working parties had completed their reviews of the agreements. Of those 64 working parties, only 6 reached a conclusion as to the consistency of the regional trade agreements with the conditions specified in Article XXIV. Jaime Sierra et al., Reflections on Regionalism for the WTO: A Report of the Carnegie Endowment Study Group (Washington, D.C.: Carnegie Endowment for International Peace, 1997).
the chairmanship of C. Fred Bergsten, Director of the Institute for International Economics. The EPG produced reports in 1993, 1994, and 1995 which became a significant part of the Summit meetings held in those years.

At the November 1994 Bogor Summit, the United States and 17 other Pacific Rim countries\(^\text{31}\) agreed to remove trade and investment restrictions by the year 2020, a move that would transform the region into the world’s largest free trade area. For the industrial countries of APEC, whose trade constitutes the bulk of the area’s total trade, the target date for complete liberalization is 2010.

The APEC Economic Leaders’ Declaration of Common Resolve at Bogor also emphasized the importance of an open system of global trade and investment and pledged to accelerate the implementation of the Uruguay Round and “to undertake work aimed at deepening and broadening” its outcome. The Declaration also expressed the leaders’ determination “to pursue free and open trade and investment in Asia-Pacific in a manner that will encourage and strengthen trade and investment liberalization in the world as a whole.” Thus, the heads of state at the Bogor Summit saw APEC, not as an alternative, but as a complement to multilateral negotiations on trade and investment.

How to reach the APEC goals of free trade and investment for the region was supposed to be hammered out at the November 1995 Summit in Osaka, Japan. The results, however, fell short of U.S. initial expectations. Instead of a collectively agreed plan and timetable, the leaders committed their governments only to “individual action plans” consisting of voluntary liberalization measures to be announced individually at the 1996 gathering in the Philippines at Subic Bay. Compared to the bold declarations at the 1994 Bogor meeting, the Osaka results were a realistic reminder of the difference between the “Asian way” and the U.S. preference for a precise schedule for meeting the announced trade- and investment-liberalization goals.

To show their continuing commitment to those goals, however, a number of countries promised to speed up tariff reductions and other trade-liberalizing measures that were already under way. China went further and, with an eye to its application for WTO membership, unilaterally stated that it would cut tariffs in 1996 on more than 4,000 items by an average of at least 30 percent. Since China’s tariffs average about 40 percent, a 30 percent reduction amounts to only 12 percentage points.

On other fronts, Osaka initiated some useful steps. It set the year 2000 for the simplification of customs within the APEC region and the establishment of a computerized database of tariff information. The “Action Agenda” also includes proposals for the liberalization of government procurement, the simplification and harmonization of standards, and group efforts in critical infrastructure areas such as telecommunications, transportation, and energy. For example, it establishes an Asia-Pacific Research Center to develop a model for promoting much-needed investment in power plants by removing institutional, regulatory, and procedural barriers.

At the Subic Bay 1996 Summit, APEC members submitted individual action plans of varying significance. Although some plans consisted of liberalization of specific products, others were merely affirmations of trade measures already taken. Still other action plans consisted of trade-facilitation measures rather than liberalization per se. It remains to be seen, therefore, how effective the voluntary approach to broader trade liberalization will be.

The modest steps toward liberalization included in the individual action plans announced at Subic Bay were almost completely overshadowed by what proved to be

\[^{31}\text{The 18 members are Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, the Philippines, Singapore, South Korea, Taiwan, Thailand, and the United States.}\]
the centerpiece of the 1996 APEC Summit: the U.S. proposal to eliminate tariffs on a wide range of information technology products by the year 2000. Despite initial resistance from APEC’s less developed economies, President Clinton’s personal intervention and lobbying succeeded in producing a concluding declaration by the APEC leaders endorsing a global information technology agreement to be negotiated in the WTO. The agreement would “substantially eliminate” tariffs on such goods by 2000 while recognizing the “need for flexibility” in the negotiations.

A promising development prior to the 1996 Summit was the establishment of the APEC Business Advisory Council (ABAC) as a permanent private-sector advisory body to succeed the Pacific Business Forum. At its initial meeting in Manila in June 1996, ABAC decided to concentrate on five important areas: cross-border flows of people, goods, services, information, and capital; finance and investment within APEC; infrastructure; small and medium enterprises and human resources development; and economic and technical cooperation. ABAC has already made valuable practical recommendations on these subjects, and we urge business leaders in all APEC countries to give ABAC their strong support.

A number of issues will have to be faced as APEC moves toward its stated goals:

1. On what basis should members be sorted out for the target dates of 2010 and 2020? Countries unequivocally classified as developed (the United States, Japan, Canada, Australia, and New Zealand) are clearly subject to the 2010 target. But what about Singapore, which has a per capita income exceeding that of New Zealand? And can Taiwan and South Korea be considered today as other than industrialized economies?

   In our view, a reasonable standard for differentiating countries for the two target dates would be a 1994 per capita income of $10,000 based on World Bank purchasing power parity (PPP) estimates. According to this standard, all the aforementioned countries, including Taiwan and South Korea, would be considered developed and subject to the 2010 target, and all other APEC members would qualify for the later date.

2. What should the commitment to free and open trade cover? Should agriculture be explicitly included? What about services?

   As explained in the section on agriculture (pages 26-27), reform of domestic agriculture and liberalization of agricultural trade are vital to the long-run health of the economies of the region. As for services, they constitute one of the most rapidly growing sectors in the majority of APEC countries. Liberalization of agriculture and services globally was among the most important achievements of the Uruguay Round negotiations. Agriculture and services should certainly be included in the APEC commitment to free trade.

3. How will nonmembers be treated? Should the Eminent Persons Group’s proposal for “open regionalism” be adopted? Essentially, it would encourage APEC members to liberalize individually to nonmembers either unconditionally or on a mutually reciprocal basis. The latter method could raise questions of consistency with GATT rules. Another possibility is for groups of APEC members to liberalize “cooperatively” to nonmembers.

   We believe APEC members should be encouraged to reduce trade and investment barriers to nonmembers even as they liberalize internally. In order to avoid conflict with the most-favored-nation principle of GATT and to maximize APEC’s contribution to global free trade, APEC liberalization to nonmembers, whether carried out individually

32. PPP estimates of per capita incomes are calculated by converting national currencies into dollars based on their relative purchasing power, rather than on market exchange rates. In general, the poorer the country, the higher its per capita income in dollars estimated by the former, compared with the latter, conversion method.
or cooperatively, should be on an unconditional basis.

4. The voluntary approach to reducing impediments to trade and investment adopted at Osaka has been called the “Asian way” of liberalization. Although it confirms the Bogor goals of free and open trade and investment by 2010 for developed countries and 2020 for developing countries, it permits APEC members to move at their own pace. Is this approach likely to prove successful? Should another effort be made to establish agreed schedules and timetables?

Although we would prefer that APEC articulate a clear plan and schedule for reaching the agreed targets, Osaka revealed little support among Asian countries for what many regard as the legalistic “Anglo-Saxon” approach. Moreover, they have pointed to the large-scale unilateral reduction of tariffs and nontariff barriers in the area as evidence of the efficacy of the voluntary approach. The United States should, therefore, accept the looser “Asian way” of allowing each country to proceed toward the free trade goal at its own pace. However, in order to exert pressure for advancing toward free trade, the United States should propose that APEC develop a common yardstick for gauging progress and publish annual reviews evaluating measures taken by individual countries to meet the agreed targets.

5. What should be the future U.S. role in APEC? Without fast-track authority, the United States was unable to take the lead at Osaka or to match other countries’ down payments on trade liberalization. However, acting under authority left over from the Uruguay Round negotiations, President Clinton was able, at the 1996 Summit in the Philippines, to persuade the heads of state to issue a statement calling for negotiation of an information technology agreement in the WTO. This U.S. initiative was unquestionably the major achievement of the 1996 APEC Summit.

Realistically, there is no alternative to U.S. leadership in an organization dedicated to the goal of free and open trade and investment. No other large APEC country has demonstrated a strong commitment to these principles and a willingness and capacity to step out front and take the lead.

However, the U.S. role as leader must be different from what it was after World War II, when the U.S. economy virtually dominated the world. At that time, the three pillars of the present global economic system (GATT, IMF, and the World Bank) were conceived and established at U.S. initiative. With the present wider diffusion of wealth and economic power and heightened national sensibilities, particularly in the developing world, America’s new role both globally and in APEC must be that of raliere of nations: The United States must project a coherent strategy to advance the common interest and inspire and induce collective action by its own example and by patient consultation with its principal trading partners in both the industrial and the developing worlds.

EAST ASIAN ECONOMIC CAUCUS

The East Asian Economic Caucus (EAEC) is an initiative of Prime Minister Mahatir of Malaysia, who has long sought a role for Asia in world affairs independent of Western influence. The organization would be composed of the nine ASEAN countries plus Japan, South Korea, and China; but it would exclude the United States, Australia, and other non-Asian members of APEC. Although the purposes of the group have not been spelled out with clarity, the intention appears to be to create an East Asian bargaining unit as a counterweight to the European Union and the projected Western Hemisphere Free Trade Area, of which NAFTA would be the nucleus.

Japan was initially wary of the Mahatir initiative, but both Japan and China have
expressed some support for it. Even Keidanren, the influential Japanese business organization, disclosed at one point that it was actively considering endorsement of Japanese participation. According to Keidanren staff, the reason was that “Japanese business executives have become fed up with constant U.S. trade complaints and see little reason to offend an Asian leader who wants to establish a regional dialogue.”

Another reason for the appeal of EAEC is the common view in Asia that NAFTA and its likely enlargement signify a primary U.S. commitment to the Western Hemisphere rather than to Asia.

We share the concerns already expressed by the U.S. and Australian governments about EAEC’s exclusivity and its likely effect in contributing to the very three-bloc world that most APEC participants are trying to avoid. Moreover, EAEC would separate the two prime players in APEC—the United States and Japan—whose bilateral economic ties have a profound effect on the regional economy.

U.S.-JAPAN BILATERAL TRADE ISSUES

The most contentious bilateral issue between individual APEC members has been the U.S. trade relationship with Japan. The nature of the strains in that relationship has been clearly laid out, from a private-sector viewpoint, in successive CED-Keizai Doyukai joint policy statements. At the government level, the issue has been a major preoccupation of both the previous and present U.S. administrations. They have carried on a series of often acrimonious bilateral meetings with the Japanese under the aegis first of the Structural Impediments Initiative (SII) and then of the Framework Agreement. The controversy over Japanese imports of autos and auto parts was just the most recent example of bitter conflict between the two countries. At times, the bilateral economic disputes have provoked mutual recriminations that have threatened to sour the vital overall political-security alliance between the two countries.

We believe the time has come to back off from the special bilateral U.S. pressure and threats of sanctions on Japan and to rely increasingly on the strengthened multilateral dispute-settlement facility established in the WTO on issues that lie within its jurisdiction.

Since the facility began operations in January 1995, it has worked well and much to the benefit of the United States. Of the 128 member countries of the WTO, the United States has been the major user of the dispute-settlement process and for the most part has prevailed in the cases it has brought on behalf of American exporters. Recently, a U.S. complaint about unfair Japanese taxes on liquor was decided against Japan, opening the way for American liquor exporters to sell their products at lower prices in Japan. Still pending is the important U.S. complaint filed in June 1996 in the controversy between Eastman Kodak and Fuji Photo over market access for film in Japan. A ruling in this case could help to clarify the issues relating to private restrictive practices in the distribution sector.

Many of the bilateral controversies between the United States and Japan would clearly fall within the competence of the WTO dispute-settlement facility because they relate to matters specifically covered in GATT. Other issues, such as foreign investment restrictions and the private collusive practices of Japanese firms that impair market access, are not now explicitly addressed in GATT, although preparatory work toward including competition policy is under way in the WTO Secretariat. Until WTO rules are established on these subjects, disputes will continue to require bilateral solutions.

Another justification for shifting the emphasis in U.S. disputes with Japan from the special bilateral approach to the multilateral

framework is the change in the Japanese economic position relative to the rest of the countries in the Asia-Pacific area. As shown in Figure 6, Japan’s share of world income is projected (under the medium projections) to decline by the year 2003, while the shares of China and the rest of Asia-Pacific are expected to increase substantially. These trends reflect what appears to be a permanent slowdown in the long-term growth rate of Japan, while China and the rest of the region are likely to maintain their exceptionally high real growth over the coming decade.

**Figure 6**

*World Income Shares, 1993 to 2003*

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Note: Shares are calculated from purchasing-power-adjusted national income figures.


**Figure 7**

*U.S. Trade Shares, 1993 to 2003*

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Note: The data are for U.S. merchandise exports and imports combined.


The trends in GDP growth rates underlie the related decline in the importance of Japan as a U.S. trading partner compared with that of the other countries of the region. Figure 7 shows that U.S. trade with China and the rest of the Asia-Pacific region already substantially exceeds U.S. trade with Japan. Moreover, the share of U.S. merchandise trade with Japan is estimated (again using the medium projection) to decline by 10 percent over the 1993-2003 decade, while the trade share of China and the rest of the region is projected to increase by about 20 percent.

Attitudes in some parts of the U.S. business community appear to reflect these trends.
Although Japan remains by far the largest single market in Asia for many U.S. firms, a *New York Times* report from Tokyo states: “More and more, American companies seem to be less mindful of Japan, lured instead by faster growing, less-developed markets in China and elsewhere in Asia. Japan is perceived as an already mature market in which it is expensive to operate, with strong domestic competitors and numerous regulations and other barriers.”

Although the bilateral approach to trade issues with Asian countries has often been acrimonious, it has led to important steps in opening markets. In the case of Japan, for example, liberalization agreements have been reached in a number of sectors including construction, plate glass, medical equipment, telecommunications, cellular phones, and most recently, the primary insurance market, which covers mainly life, auto, fire, and other casualty insurance. The bilateral approach has also been effective in improving intellectual property protection and market access in a number of other Asian countries. **In favoring greater reliance on the WTO dispute-settlement facilities for issues covered in agreements administered by the WTO, we do not mean to preclude initial efforts to resolve such disputes through bilateral consultation and diplomacy. However, threats of sanctions or other punitive action should be avoided in favor of recourse to the WTO.***

**CHINA IN THE GLOBAL ECONOMY**

China’s economic achievement over the past 15 years has been stunning. Since 1980, its GDP has grown at an average annual rate of 8.2 percent, a pace matched by only one other country in the world, South Korea. China’s trade has been expanding even more rapidly than its GDP, doubling every seven years and more than quadrupling over the period since 1980. Over 80 percent of its exports are manufactured products. And it is also on the way to becoming one of the world’s largest markets for imports (see Figure 8).

At the same time, foreign investment has been pouring into China. In 1996, China received $52 billion of private capital flows, by far the largest inflow into any country in the developing world. Of this amount, 81 percent was in the form of foreign direct investment** (see Figure 9).

As a major player in the global economy, China wants very much to become a member of the WTO. Membership in the WTO would recognize China’s “rightful” place in the global economic system, would consolidate and grant respectability to its emerging presence in international markets, and would provide a legal guarantee that other countries would not discriminate against its exports.

However, China’s behavior with respect to trade and foreign investment raises questions about the country’s readiness to join an organization based on the principles of mutual liberalization, nondiscrimination, and respect for intellectual property rights (IPRs). China blocks some imports with layers of testing requirements and licensing procedures that serve only protectionist purposes. Many rules and subsidies vary from province to province and are too opaque to allow outside examination to determine whether they are in conformity with the obligations of WTO membership.

In defense of these protectionist policies, the Chinese point to the still-functioning state-owned sectors, where production is highly inefficient by international standards. Without protection, they argue, these industries would require even larger direct state subsi-

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*See memorandum by HARRY L. FREEMAN, (page 37).

**See memorandum by MARTIN B. ZIMMERMAN, (page 38).
dies than they now receive in order to survive, or else millions of Chinese workers would be rendered unemployed. Any abrupt moves to liberalize trade in these sectors would destabilize the Chinese economy and society. The West should therefore be tolerant of China’s strong preference for a gradual approach to trade liberalization.

China’s policies have been especially weak regarding IPRs. It has pirated as much as $1 billion annually of intellectual property in the form of pharmaceuticals, computer programs, music recordings, films, and books that have been copied and sold at home and abroad without compensation to foreign holders of patents, copyrights, and trademarks. In February 1995, the United States reached an agreement with China for the protection of IPRs, but its enforcement has not been effective. Chinese factories continued to produce millions of illegal copies of American films and software, prompting the United States to threaten sanctions again. Although China

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**Figure 8**

**Chinese Exports and Imports Have Grown in Tandem**

1987 to 1994

Billions of U.S. Dollars


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**Figure 9**

**Foreign Direct Investment and Net Total Private Capital Flows into China**

1990 to 1996

Billions of U.S. Dollars

claims that substantial progress is being made, it remains to be seen how effective the new agreement reached in 1996 will be in reducing piracy and strengthening enforcement of IPRs.

China has also been restrictive with respect to foreign investment. For example, American and other foreign auto companies have been told they must start making parts in China before being considered for permission to build an assembly plant. The government further insists that China retain majority control of any assembly plant regardless of the amount each party contributes to a joint venture. In addition, state enterprises have defaulted on their loan obligations to a number of foreign banks.36

As one of the world’s ten largest exporters, China belongs in the WTO. The question is: Under what conditions?

It would be unwise for the United States to yield to domestic pressure to link Chinese accession to noncommercial considerations. However important we regard human rights, workers’ rights, weapons proliferation, and China’s policy toward Hong Kong, such linkage is deeply resented by China, would not be supported by other major members of the WTO, and is unlikely to be effective. China has told Washington that the talks on accession should not be used as a “dirty-laundry hamper” filled with other issues.37

A major objective of U.S. economic policy toward China should be to ensure that China plays by the rules of the international trading system. However, there are some in China who see the rules as stacked in favor of the interests of richer and more powerful countries and against the poorer and weaker ones and who, in any case, question why China should follow any rules it did not participate in writing. Moreover, they note that China already receives de facto from all countries the single most important benefit that membership in the WTO has to offer: MFN status.

Given these attitudes and the reality of China’s current trade practices, it is prudent to require that as a condition for accession, China show its good faith by adopting elementary fair trade and investment practices domestically. As a minimum, it should be required to ensure effective protection of intellectual property rights, get rid of domestic-content requirements imposed on foreign investors, and make its laws and regulations transparent so that foreign governments and the WTO can monitor the degree of China’s conformity to the rules. With these basic reforms in place, the United States should support China’s accession, including a reasonable, specific phase-in period for complying with the WTO rules and liberalization commitments.38

AGRICULTURE

Three trends—population growth, income increases, and urbanization—will drive the food and agricultural systems of the Asia-Pacific region well into the next century. Total consumption will grow, but a dramatic change in dietary patterns will be more important. At low income levels, per capita grain consump-


38. However, China’s accession to the WTO would not result in the automatic granting by the United States of permanent MFN treatment to its trade with China. Under the Trade Act of 1974 (Title IV), MFN treatment is denied to communist countries unless the President invokes a waiver permitting him to grant MFN treatment for a 12-month period. However, the waiver can be revoked by a joint resolution of Congress. Unless Title IV is amended or repealed, the United States would be obliged to opt out from applying the provisions of GATT to China, which it can do under Article XIII of the WTO charter entitled “Non-Application of Multilateral Trade Agreements between Particular Members.” A bill has been introduced in the House of Representatives by Congressmen Bereuter and Ewing that would amend Title IV by authorizing the President to extend permanent MFN status to China under certain conditions. However, early enactment of the bill is unlikely.
tion rises steeply as incomes increase. At middle income levels, consumption of meat, sweeteners, and vegetable oils accelerates, which increases the resources required to meet per capita food demand. Urbanization further intensifies the use of resources through stepped-up requirements for transportation, handling, processing, packaging, and preparation.

By and large, the land resources to serve Asia’s rapidly rising food demand lie elsewhere. Much of that land is in North America, where food demand should increase only 20 percent over the next 30 years, compared to 100 percent in East Asia and 150 percent in South Asia. These trends imply that international trade will have to play a key role in satisfying Asia’s food needs in the years ahead.

Unfortunately, agricultural trade liberalization in Asia has not kept up with the reduction of trade barriers that has occurred in the manufacturing sector. Levels of protection in agriculture range from 3 percent of farm output value in New Zealand to 75 percent in Japan. Intercommodity distortions also vary greatly, from low protection on some commodities to prohibitive restrictions on others. Processing activities are especially subject to steep effective protection, with duties higher as the commodity moves up the processing chain.

Prerequisite to the liberalization of agricultural trade is the reform of domestic agriculture, involving the alignment of domestic with world prices. Any support to domestic producers should take forms that do not distort production or marketing patterns.

Changes in national investment policies are also required. Most Asian countries must build a whole new infrastructure for delivering farm inputs, handling and processing farm outputs, and delivering foodstuffs. This needs to be done in line with global comparative advantage in order to avoid the huge costs of protecting or writing off uneconomic investments.

Restrictions on inflows of foreign know-how and capital should be lifted so that they can contribute fully to building the infrastructure system as quickly and efficiently as required.

Finally, exporters must guarantee food-importing countries security of supplies. Access to food should be provided on the same basis as for domestic customers. Political sanctions or short-supply controls should be ended.

**In sum, we recommend an open global food system requiring initiatives on four fronts: domestic farm policy reform; national investment policy changes; trade and investment liberalization; and assured access to supplies for food deficient countries.**

### PRODUCT STANDARDS

Differences in national product standards and testing procedures are widespread in the Asia-Pacific region, constituting barriers to international trade and investment. Costs rise as businesses have to adjust their product runs to the special requirements of individual economies. This problem is well recognized in the United States and the European Union, and a transatlantic accord was concluded in 1997 to deal with it. **We are pleased to note that APEC has established a subcommittee which has started to work on this issue.**

Some differences in standards are justified because of variations in climatic, environmental, or other domestic conditions. However, the adverse international economic effects of legitimate differences can be reduced through a policy of mutual recognition of national standards and certification and testing procedures, provided certain minimum requirements are met. Harmonization and mutual recognition have been recommended for APEC by both the Eminent Persons Group and the Pacific Business Forum.

However, standards are sometimes adopted as covert barriers to trade where more
traditional restrictions in the form of tariffs and quotas are ruled out by international commitments or are otherwise not feasible. This problem can be mitigated by requiring full transparency and an authoritative scientific basis for standards.

RESTRICTIVE BUSINESS PRACTICES

One of the topics proposed by the Eminent Persons Group for discussion at the November 1994 APEC meeting in Indonesia was anticompetitive practices in the private sector. However, the subject was not referred to either in the Joint Ministerial Statement or the Leaders’ Declaration issued at the conclusion of the meeting.

Restrictive business practices have been an important element in some of the bilateral disputes in the region, especially between the United States and Japan. However, national policies on competition vary widely: Some members of APEC have elaborate antitrust policies; others have no laws in this field or are just beginning to develop them. Moreover, the extent of enforcement of existing legislation differs greatly among countries of the region.

Because anticompetitive practices in the private sector can undermine trade agreements to foster fair competition, an open world trading system would function more effectively if private restrictive practices could be prevented. It is for this reason that the subject has been placed on the post-Uruguay Round GATT agenda. Active preparations for negotiating a global competition code are already under way in the WTO.

Progress in addressing anticompetitive practices on the global front is bound to be slow. It can be accelerated by efforts at the APEC level to strengthen and harmonize national competition policy. A first step would be to gather information on national policies and assess their effects on the flow of trade and investment.

Vast new investments in public infrastructure are required in the Asia-Pacific area. The region’s rapid industrialization has outpaced the capacity of existing facilities, including power, water, roads, harbors, and telecommunications. Unless massive improvements are undertaken, rapid economic growth will not be sustainable.

Most infrastructure projects are undertaken by public authorities. Financial issues relating to the sources of capital for those investments are addressed on pages 5-14. Here we focus on the extent to which public procurement in Asia-Pacific is carried out on the basis of competitive principles.

Unfortunately, much public procurement in the area is not open to true competitive bidding. Even where laws and regulations prescribe transparency and competition, obstacles to granting contracts to foreign firms are widespread. The devices used cover a wide spectrum that includes arbitrary standards, biased certification procedures, and specifications tailored to the qualifications of local firms.

Only two Asian countries, Japan and Korea, are signatories of the new Agreement on Government Procurement concluded in the GATT Uruguay Round. The Uruguay Agreement provides that every step of a national tendering process be governed by the principles of national treatment, nondiscrimination, and transparency.

However, the Uruguay Agreement also expands the coverage of the Tokyo Code by including services and construction as well as some coverage of subcentral governments and government-owned utilities. It tightens Code discipline by requiring a bid-challenge procedure that for the first time grants foreign firms direct access to enforcement procedures under the regulations of the importing country.

The United States should attempt to persuade Asian countries, other than Japan and Korea, to sign the new GATT Agreement on Public Procurement and to bring their prac-
tices into conformity with it. To do so would benefit both purchaser and supplier. It would mean lower costs for Asian infrastructure and export opportunities for foreign firms.

Competition in procurement can also be distorted because of government subsidies to particular firms or domestic industries, such as the aircraft industry. Such practices can be constrained by applying the subsidy disciplines of the Uruguay Round agreement to which all WTO members have subscribed.

A present reality is the aggressive promotion of foreign sales of domestic products by senior officials of the major industrial countries. Typically, the products involved are big-ticket items of capital equipment, such as power-generation and telecommunications products, aircraft, and supercomputers. The customer is often a foreign government in which critical decisions occur at key points of influence, access to which may require the intervention and support of high-ranking officials of the foreign exporter’s government. In order to ensure a more level playing field for U.S. suppliers, senior officials of the U.S. government should lend their support for major foreign sales of U.S. products, especially when the customer is a foreign government.*

LABOR STANDARDS AND INTERNATIONAL TRADE

There have been growing calls in the United States and some European countries for linking access to markets with the acceptance and observance of certain international labor standards, such as the prohibition of child labor and the protection of workers’ rights to organize and bargain collectively. GATT permits import restrictions on products made with prison labor (Article XXe) but otherwise does not allow the use of trade sanctions as a means of improving labor conditions.

In Europe, labor standards are commonly discussed under the “social clause” or “social charter.” In the United States the issue arose in the context of the negotiations on NAFTA. It was addressed, along with environmental standards, in side agreements that proved necessary for Congressional approval of NAFTA. However, NAFTA simply calls for each country to be diligent in enforcing its own standards, rather than requiring adherence to commonly agreed international standards. In practice, U.S. firms typically adhere to higher labor standards than those mandated by the local law of countries in which they operate.

The rationale for linking trade liberalization and labor standards is twofold: to help improve the lot of the poor and vulnerable abroad and to prevent competition from countries with poor working conditions from undermining the position of labor at home.

Asian countries, as well as other nations in the developing world, have generally opposed linking trade and labor standards. They have argued that the best approach to improving labor standards is, not to try to push them up through legislation, but to pull them up through economic growth. Taiwan and Korea are cited as examples. In Taiwan, real wages are eight times higher than they were a generation ago; and in Korea, they are more than six times higher.39

CED believes that there is merit in the Asian position. Moreover, if labor standards are included in trade agreements, they could easily become protectionist devices for restricting imports from low-wage countries on the grounds of “unfairness.”

We therefore concur in the principle included in the declaration of the 1996 WTO ministerial meeting in Singapore that the preferable way to deal with this issue is through the International Labor Organization (ILO). The ILO has a long record of work for the improvement of labor standards in which national differences in levels of economic development are taken into account.

*See memorandum by RODERICK M. HILLS, (page 38).

CROSS-CUTTING ISSUES

ENVIRONMENT

Any Western traveler in the rapidly developing countries of the Asia-Pacific region is struck by the extreme degree of air pollution in major cities such as Bangkok and Jakarta. More generally, environmental degradation in the form of air, water, and soil pollution has grown at an accelerating rate. At the same time, the rising standards of living associated with economic growth have increased both the demand for environmental improvement and the capacity to allocate economic and technological resources to coping with the problems. Today, there is wide recognition of the need to balance growth with preserving the environment; nearly $50 billion is spent each year on pollution control in Asia.

National action to clean up the environment should be facilitated by policies adopted at the regional level. For example, in its report for the Bogor meeting of APEC, the EPG called for international agreement on internalizing environmental protection costs and recommended that APEC advance that objective by endorsing the “polluter pays” principle. The EPG report also proposed the sharing of environmental technologies and joint funding of environmentally sound development projects, with the costs of controlling cross-border pollution borne by APEC members on the basis of ability to pay. In addition, it endorsed the development of common methodologies of risk analysis and the exchange of scientific data and analyses.40

Ultimately, environmental standards and actions will reflect national priorities and economic capacities and will therefore have to be dealt with by individual countries. However, all governments should educate their citizens about the importance of environmental preservation and should encourage improved practices in the private sector. Foreign direct investors can lead the way in this regard because they usually ratchet up environmental standards in their own operations.

The relation between trade and environment policies is high on the global agenda of the WTO. One of the questions to be addressed is the implications for competitiveness of variations among countries in environmental production standards. Do low standards provide an unfair advantage in international trade and investment, and should restrictive action therefore be permitted against countries with the lower standards? It is precisely this possibility of trade sanctions that has made many developing countries suspicious of any attempts to deal with the environmental problem in the WTO or, more generally, in the context of international trade issues.

In our view, APEC can play a bellwether role in the WTO by addressing these issues in the regional context in advance of their being taken up in the global body. In par-

ticular, APEC is an appropriate forum for designing protections against the application of trade sanctions against developing countries with lower environmental standards.

A related issue concerns transborder environmental spillovers and the effects of domestic economic activity on the global commons such as the ozone layer. Some internationally negotiated agreements on these matters incorporate trade restrictions as ultimate enforcement mechanisms. **Safeguards should be established in the form of access to international dispute-settlement facilities such as the WTO in cases where trade sanctions are used to enforce international environmental agreements.**

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**TECHNOLOGY TRANSFER AND THE PROTECTION OF INTELLECTUAL PROPERTY**

Technology is transferred among countries through a variety of channels. One is simply international trade, through which developing countries acquire products embodying advanced technology and through which the population at large becomes exposed to new technological accomplishments and possibilities. This channel should be greatly facilitated by the Information Technology Agreement initiated at the Subic Bay APEC Summit in November 1996 and negotiated the following month at the first ministerial meeting of the WTO in Singapore. The Agreement requires the phaseout of tariffs by the year 2000 in a wide range of information technology products, including computers and software.

Another channel is the cross-border education of students in science and engineering. According to a recent report of the Institute of International Education, about 450,000 foreign students are enrolled in American universities, and well over half of these students come from Asian countries. About 40 percent of the foreign students are enrolled in science and engineering programs.41 A third vehicle for technology transfer is joint research and development by individuals and companies of different nationalities. For example, DuPont and IBM have laboratories in Japan, and AT&T has teamed up with a Korean firm, Goldstar Semiconductor, to manufacture public telephone exchanges and local area networks.

Finally, the bulk of technological transfer occurs through the operations of multinational firms, both by the production activities of their foreign affiliates and their contractual arrangements to license technology and provide services to unaffiliated companies. Indeed, in a number of developing countries, the prime consideration in permitting a foreign firm to establish an affiliate is its technological rather than its financial contribution. The globalization of the market for technology has underlined the importance of worldwide legal protection for invention and innovation. In a number of Asian countries, however, the most innovative American companies have often been the victims of piracy and counterfeiting that have deprived them of much of the fruits of their investment and effort. Although piracy of intellectual property is still widespread in China, progress is being made in enforcing IPRs there.42 Nations lacking effective protection for intellectual property, such as India, are beginning to realize that they themselves have been adversely affected by the resulting damper on inward foreign investment and on the development of their own innovations.*

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42. Statement of Robert Holleyman, President of the Business Software Alliance at Pacific Leaders Forum, Seattle, October 1, 1996.

*See memorandum by JOHN DIEBOLD, (page 38).
To deal with this problem, the GATT Uruguay Round addressed the issue of the protection of IPRs. The final agreement establishes higher standards for the protection of a full range of IPRs and provides for the enforcement of those standards both internally and at the border. Included are patents, copyrights, trademarks, industrial designs, trade secrets, and integrated circuits.

In order to enlist the concurrence of the developing countries, the GATT Intellectual Property Agreement had to provide for transition periods of 5 to 11 years for the application of its provisions to them. Because piracy and counterfeiting are still widespread in Asia, the U.S. government should continue its efforts to improve the protection of intellectual property in the region, including a reduction of the phase-in period for conforming to the GATT rules and application to property in the development pipeline in sectors such as pharmaceuticals.

A related problem is how to protect the security of proprietary information in light of dramatic ongoing innovations in communications technology. With advances in telecommunications such as the Internet and on-line services, borders are disappearing. At the same time, the ability to inflict viruses or to create other kinds of malfunctions in the so-called information superhighway can be extremely damaging to international trade and investment.

The information security issue is on the agenda of the OECD, which has developed guidelines to lift curbs on encryption software. Cooperative arrangements should be established between the OECD and APEC as a means of engaging a wider group of Asian countries in the task of improving information security.

CORRUPTION AND CODES OF CONDUCT

An issue related to public procurement is that of bribery and corrupt practices. Bribery distorts markets and hampers economic performance. It creates a barrier to fair competition and trade that puts at a disadvantage companies that refuse to engage in the practice. Weak governments are further undermined by corruption, and emerging democracies are threatened.

Where public procurement is subject to bureaucratic discretion rather than competitive principles, opportunities for granting favors and for other forms of corruption proliferate. The incidence of corruption is also related to the lack of a reliable legal system (China) and low pay for civil servants (Vietnam). Although outright bribes in return for construction contracts are not uncommon in Asia, more often the corrupt practice takes a subtler form, such as putting an official’s son through college in America.

Some foreign firms play the game on the principle that “when in Rome, do as the Romans do.” However, U.S. firms are constrained by the provisions of the Foreign Corrupt Practices Act (FCPA). How serious a competitive disadvantage does the FCPA pose for U.S. firms, and what can be done about it?

Based on a report on Asian corruption by a Hong Kong firm, Political and Economic Risk Consultancy, The Economist states that “big firms can usually find ways to avoid corruption in all but the relatively minor day-to-day dealings with low-level bureaucrats. Big multinationals can go right to the top of a ministry, and avoid lowly officials trying to line their pockets. For smaller companies with less clout, it can be tougher.”

Whatever the conditions prevailing in a particular country, the FCPA may be less of a constraint than is generally believed. The Act distinguishes bribes, which are prohibited, from “facilitating payments,” which are permitted. The distinction is not simply euphemistic. Bribes are a payment to induce a foreign official to do what he is not supposed to

do, whereas a facilitating payment is intended to induce a foreign official to do expeditiously what he is supposed to do—for example, issue routine permits to do business, process government papers such as visas, or clear merchandise through customs.

In any case, the Clinton Administration has been trying on several fronts to level the playing field. In the OECD, it pushed hard in 1994 for a code on bribery, but the initial result was a considerably watered-down set of principles, and implementation was strictly voluntary. The United States has also been pressing other OECD countries to criminalize bribery and, at a minimum, to alter the common practice of allowing the deduction of bribes from company tax returns.

Finally, in May 1997, the OECD member countries agreed to negotiate by the end of the year a binding international convention to criminalize bribery of foreign public officials. They also agreed to put antibribery legislation before their parliaments by April 1998 with a view to having it come into force by the end of that year. We strongly support the combination of an OECD convention and a collective pledge to legislate by specific deadlines as a promising approach to outlawing bribery in international transactions. The United States should encourage APEC members who are not also members of the OECD to sign on to the convention when it is completed.

On the global front, the United States succeeded in December 1996 in getting the United Nations General Assembly to adopt the Declaration against Corruption and Bribery in International Transactions. In addition, the U.S. Trade Representative has suggested that the issue of “illicit payments” in international transactions be taken up in the WTO as part of a new negotiation on competition policies affecting international trade. We support the suggestion of the U.S. Trade Representative, but we recommend that the subject of corrupt practices also be placed on the agenda of APEC. Because APEC has less than one-seventh the membership of the WTO, more rapid progress is likely at that level.

Recently, the Clinton Administration issued a voluntary set of “Model Business Principles” as guidelines for U.S. firms in conducting business abroad. The principles broadly parallel the content of codes of conduct that leading U.S. multinationals, such as Caterpillar, have long espoused on their own. In addition to the avoidance of illicit payments, the model principles include provisions for a safe and healthful workplace, fair employment practices, responsible environmental protection, and the maintenance of a corporate culture that respects free expression and does not condone political coercion in the workplace. The last item is intended partly to strike a blow for human rights now that the issue of China’s human rights record has been severed from the issue of its MFN status.

The United States should request that APEC circulate the “Model Business Principles” to Asian firms as useful reference points for framing their own codes of conduct.*

HUMAN RIGHTS

Human rights in Asia became a salient issue in the U.S. debate on extending MFN treatment to China. That debate highlighted many of the questions underlying the effort to influence Asian government policies in a number of sensitive areas of domestic civil and political life.

Human rights are generally taken to comprehend the right to participate effectively in the political process, including freedom of expression, assembly, and association. They also include protection against physical abuse to the person as well as arbitrary interference with property. Some would go further and include economic and social rights such as freedom from hunger, the right to education, and the right to a minimum standard of health care. However, such rights depend not just on institutions and practices but also on the avail-

*See memorandum by RODERICK M. HILLS, (page 38).
ability of resources and therefore are tied to a nation’s stage of economic development.

A central question in the human rights debate is whether there is any correlation between the level of economic development and the protection of civil and political rights. In Asia, growth has been characterized by a general shift to a market economy, including the gradual relaxation of government intrusion into and regulation of the private sector and the liberalization of restrictions on transactions with the rest of the world. All this implies a diffusion of power and decision making away from the central authorities, the rise of a middle class, and inevitable demands for democratization. Our view is that if economic growth and prosperity continue, human rights protection is likely to improve gradually, as has been the case in Korea and Taiwan.

Another view is that there is a distinctive “Asian model” of development, epitomized by Singapore and the pronouncements of its former long-time Prime Minister, Lee Kuan Yew. This view stresses efficiency, not democracy, and holds that order and discipline are more important than freedom. Given the well-known weaknesses of the “permissive societies of the West,” this view argues that Western countries should not attempt to impose their standards on culturally distinct Asian nations.

If Western countries seek to advance human rights in Asia, the tools available to them can range from diplomatic persuasion and protests to threats or actual imposition of economic sanctions. Included in the latter are trade measures, restrictions on private investment, and the withholding of aid. However, the rising economic strength of Asia-Pacific countries has weakened the ability and willingness of industrial countries to use the available tools effectively. This is particularly true of Japan and Western Europe, but even the United States has decided to separate human rights issues from the granting of MFN treatment for China.

CED believes that in the absence of cooperation by other major industrial countries, economic sanctions would be ineffective in altering the behavior of a targeted country and would place U.S. firms in a disadvantageous position. However, the United States should use diplomatic efforts to stress to Asian authorities the importance that this country attaches to progress in the protection of human rights.

Western economic relations with Asian countries consist primarily of the activities of thousands of business firms, rather than of government-to-government contacts. One way of enlisting the support of the private business sector to advance human rights in Asia is U.S. government encouragement of the adoption and dissemination of corporate codes of conduct. The codes generally include principles respecting freedom of expression and opposing political coercion in the workplace.
Three overarching developments have shaped the world economy in the past decade: the triumph of the market over command-and-control economies, marked by the end of the Cold War; the rapidly expanding interaction of countries in world trade and investment; and unprecedented rates of economic growth and structural change in East Asia and the Pacific.

These three developments are interrelated. The collapse of the Soviet economy was a major cause of the political disintegration of the country and the end of the Cold War. But it also induced sweeping economic reforms in the states of the former Soviet Union and contributed to progress in reform already under way in much of the developing world. Macroeconomic stability has been pursued, state enterprises have been privatized, intrusive domestic government regulations and controls have been relaxed or lifted, and restrictions on international trade and capital flows have been sharply reduced.

Of all the regions of the world, the developing nations of East Asia have proved to be the principal beneficiaries of liberalization and globalization, racking up sustained rates of growth never experienced in the older industrial economies of Europe and North America. Because of its size and diversity, China has dominated the trends in the region, assisted by substantially open markets for its exports to the industrial world and by massive inflows of foreign investment, far exceeding capital flows to any other developing country in East Asia or elsewhere.

The United States shares both political and economic interests with the Asia-Pacific region. Our military commitment in the area is intended, not to dominate other countries, but to help preserve peace and security in a part of the world with a history of deep adversarial relations among its major powers, Japan, China, and Russia. The stabilizing role of the U.S. military presence is particularly welcomed by the smaller countries of the region, many of which have vivid memories of aggression and occupation by the larger states.

Growing economic interactions between the United States and Asia-Pacific have yielded substantial mutual gains. Expanding trade and foreign investment in response to market forces entails positive-sum transactions in which both sides benefit enormously in terms of greater efficiency in production and lower prices and wider variety in consumption.

Over time, privatization and the shift to a market economy also lead to a dispersion of power in society, the rise of a middle class, and demands for greater political freedom. At the same time, the revolution in information technology and the large-scale presence of Asian students in American and other Western universities are spreading knowledge about the advantages of democratic forms of government. In the final analysis, increasing prosperity and exposure to more open societies generate internal pressures for broader participation in the political process that far outweigh ad hoc external pressures for the advancement of human rights.
Although domestic policies are critical to economic growth, the relative openness of the U.S. market has made a major contribution to Asia’s economic success. The United States is by far the largest non-Asian market for Asian products, exceeding all of Western Europe by a wide margin. More than 80 percent of Asia’s exports consist of manufactured products.

Within Asia, trade liberalization is proceeding on three fronts. The first consists of the unilateral reduction of tariffs and nontariff barriers as an inherent part of individual countries’ basic structural reforms. The second is liberalization moves undertaken or committed within a regional context such as ASEAN and APEC. The third is that, with the exception of China and Taiwan, virtually all Asian countries are members of the WTO and therefore participants in multilateral negotiations for both the liberalization of trade in goods and services and the improvement of the framework of international rules and disciplines governing world commerce. As one of the world’s major economies, China belongs in the WTO, and we hope that negotiations for its accession will prove successful.

Some have feared that APEC, with its large and diverse membership, is likely to undermine progress in the WTO. However, APEC is involved not only in trade liberalization but also in many aspects of trade and investment facilitation that are not yet on the WTO’s active agenda but that are of keen practical interest to the business community. Moreover, the Subic Bay Summit demonstrated that APEC is capable of serving as a spur to action in the WTO, as in the announcement by the APEC leaders of their intention to negotiate in the WTO an agreement for free trade in a wide range of technology products. Most important, APEC has been instrumental in reducing traditional North-South ideological conflict and confrontation and bringing together a highly diverse group of countries on a common conceptual framework for an open world economy.

Foreign investment has been a bigger story in recent years than trade. True, Asian exports have increased rapidly since 1990, doubling in the case of China to $121 billion.44 But the annual flow of foreign private capital to East Asia has risen at an even steeper pace, increasing fivefold since 1990. In 1995, the flow reached almost $100 billion, 46 percent of which went to China.45 More than half of foreign private capital flows for East Asia has been in the form of direct investment, but substantial flows have also occurred in portfolio investment in both stocks and bonds as well as in lending by commercial banks.

International institutions such as the WTO, the IMF, and the World Bank have contributed greatly to the expansion of global trade and investment. By exerting pressure for the removal of trade and capital restrictions and for the reform of domestic regulations, they are helping to create a more integrated global economy in which the economic significance of political boundaries is steadily eroding.

However, the key role in the economic ascent of the Asia-Pacific nations has been played by business. In contrast with the steep rise in private capital flows to the region, official capital flows have stagnated and now amount to less than seven percent of the total inflow. The Asia-Pacific community will be shaped more by day-to-day business dealings and partnerships between local and foreign enterprises than by government-to-government relations.

Most important, by transcending national and regional boundaries, global business has become a powerful force in opposition to deeply rooted, narrow, and exclusive geographic nationalism with all its destructive political and economic potential. Working as partners— with each other and with governments and international institutions—far-sighted business leaders have a vital role to play in promoting prosperity through freer and more open markets for trade and capital in the evolving Asia-Pacific region.

45. World Bank, World Debt Tables, 1996, Volume 1, Table 1.2.
A precursor to the Framework Talks in addressing U.S.-Japanese saving-investment imbalances was the Structural Impediments Initiative, which was undertaken by President Bush in 1989.

The high Japanese saving rate has financed additional capital formation to raise productive capacity for the approaching demographic transition. However, compared with the United States, Japan has not provided adequate retirement programs to direct the fruits of this productive capacity to future retirees.

With regard to financial services negotiations, those are ongoing and the chance of some kind of acceptable agreement by year end 1997 looks good at this writing. However, we need to emphasize that the old phrase “no deal is better than a lousy deal” may still apply here. The United States is open and wants to remain open; if the other countries do not go in this direction, with commitment, then it is entirely proper for the United States to reconsider its openness policy at some level.

Regarding CED’s recommendation on financial services, as the WTO Financial Services negotiations resume, now is not the time for Treasury negotiators to take the threat of withholding MFN treatment off the table, as recommended. There is no more evidence that in this round of negotiations, developing countries will make sufficient market liberalization offers than they did in previous rounds.

I disagree with the recommendation to expand the IMF emergency fund. A larger fund is more likely to encourage irresponsible behavior than to cure it.

One of the problems in skillfully drafting a document such as U.S. Economic Policy Toward the Asia-Pacific Region, and this document is skillfully drafted, is that events frequently overtake drafting. In discussing U.S. trade policy toward Japan, the statement talks of increased U.S. use of the WTO dispute settlement mechanisms. The United States now has around 30 cases brought where it is the complaining country, about one-third of the total complaints in the process. The United States has adopted a “liberalization by litigation” strategy which, thus far, has worked very well in decreasing bilateral confrontation outside of the WTO framework.

I would advocate a stronger tone towards eliminating Japanese trade restrictions, which still form very substantial barriers to U.S. and other exports.
Regarding CED’s recommendation on U.S. negotiating tactics and use of the World Trade Organization (WTO) to resolve trade issues, the WTO should be the multilateral venue of choice to resolve international trade issues, but it is far too early for the United States to adopt a policy to withhold using its own trade laws to resolve bilateral issues, as recommended. The WTO dispute settlement mechanism is new and while promising, is still being tested. In the auto industry, for example, Indonesia is the first strong case to emerge, with a settlement appearing to be imminent. Nevertheless, all dispute settlement options need to be available to deal with the many trade restrictive measures that have not been handled well in the GATT framework, such as restrictive distribution or discriminatory regulation. Also, it is unwise to let Japan “off the hook” bilaterally, as recommended, since many Asian countries—witness South Korea—are following similar restrictive policies as Japan. The U.S. government should serve as a rallying of nations, but this should be accomplished by promoting a policy where the U.S. government continues to use all its available resources to open markets.

Certainly the U.S. government should intervene to create a level playing field for U.S.-based businesses. However, I disagree with the recommendation that senior officials of the U.S. government should become “salesmen” for U.S. business. That mercantilist attitude is not consistent with a free trade environment.

Considering the long and fruitful history of scientific and technological innovation in China—ample to fuel forty years of research by the Needham Institute at Cambridge University—some benefit might accrue in enforcement of current Intellectual Property Rights (IPR) rules by emphasizing the likely growth in direct economic interest on the part of countries such as China in the building of their own IPR positions. That is, as long as they don’t start asking for royalties on paper, gunpowder, ship rudders, the magnetic compass, or the escapement mechanism of clocks!

After all, with over a million programmers already in training, it is hard to believe that China will not shortly be a major originator of software.

I agree that corrupt practices be on the agenda of APEC, but I do not believe that trade talks should be the focus of corrupt practices. Nor do I believe that President Clinton’s set of “Model Business Principles” should be endorsed by CED. There are many models of corporate conduct codes. We can endorse the principle without suggesting that the drafting of such codes is a function of the central government.
OBJECTIVES OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT

For more than 50 years, the Committee for Economic Development has been a respected influence on the formation of business and public policy. CED is devoted to these two objectives:

To develop, through objective research and informed discussion, findings and recommendations for private and public policy that will contribute to preserving and strengthening our free society, achieving steady economic growth at high employment and reasonably stable prices, increasing productivity and living standards, providing greater and more equal opportunity for every citizen, and improving the quality of life for all.

To bring about increasing understanding by present and future leaders in business, government, and education, and among concerned citizens, of the importance of these objectives and the ways in which they can be achieved.

CED’s work is supported by private voluntary contributions from business and industry, foundations, and individuals. It is independent, nonprofit, nonpartisan, and nonpolitical.

Through this business-academic partnership, CED endeavors to develop policy statements and other research materials that commend themselves as guides to public and business policy; that can be used as texts in college economics and political science courses and in management training courses; that will be considered and discussed by newspaper and magazine editors, columnists, and commentators; and that are distributed abroad to promote better understanding of the American economic system.

CED believes that by enabling business leaders to demonstrate constructively their concern for the general welfare, it is helping business to earn and maintain the national and community respect essential to the successful functioning of the free enterprise capitalist system.
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Close relations exist between the Committee for Economic Development and independent, nonpolitical research organizations in other countries. Such counterpart groups are composed of business executives and scholars and have objectives similar to those of CED, which they pursue by similarly objective methods. CED cooperates with these organizations on research and study projects of common interest to the various countries concerned. This program has resulted in a number of joint policy statements involving such international matters as energy, East-West trade, assistance to developing countries, and the reduction of nontariff barriers to trade.

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<tr>
<th>CED Counterpart Organizations</th>
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<tbody>
<tr>
<td>CE</td>
<td>Circulo de Empresarios</td>
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<td>CEDA</td>
<td>Committee for Economic Development of Australia</td>
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<td>Centre for Finnish Business and Policy Studies</td>
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