# SHAPING THE ASIA-PACIFIC FUTURE

## Strengthening the Institutional Architecture for an Open, Rules-Based Economic Order

**Olin Wethington and Robert A. Manning**

**Atlantic Council**

BRENT SCOWCROFT CENTER
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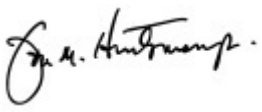
# FOREWORD

The world is at an inflection point, and the Asia-Pacific region is playing a key role in this historic transformation. The rise of Asia and the re-emergence of China is rippling through both regional and global institutions. Ever since the US clipper ship *Empress of China* sailed to Canton in 1784, the Asia-Pacific region has been an important part of American foreign policy. Today, of course, Asia has taken off, and US trade with the region has grown to new heights. The Obama administration's "rebalance to the Asia-Pacific region" is but the latest US effort to underscore the importance of Asia to American interests.

The growing economic weight of the $21-trillion Asia-Pacific economy with China—now the world's second largest economy—is, however, posing new challenges to time-tested institutions for governing global finance, monetary, and trade interactions. China is seeking to move the region in a Sinocentric direction. The recent controversy over China's recent addition to regional institutions, the Asian Infrastructure Investment Bank (AIIB), is just one piece in the puzzle of an increasingly dynamic world order in the twenty-first century.

Beijing's actions have given rise to a debate in the United States about the future of US policy toward China, a policy that has otherwise been consistent and bipartisan under eight US Presidents, from Nixon to Obama. Some advocate a diminution of US leadership to accommodate China and other emerging economies. At the other end of the spectrum, some propose isolating and containing China. Despite this polarized debate, however, there are other options for a viable future for two highly interdependent nations in a globalized world.

In this context, the Atlantic Council's Brent Scowcroft Center on International Security launched this project—Shaping the Asia-Pacific Future—to examine how to adapt US leadership to a changing region of diffused power in ways that advance US interests, regional prosperity and stability, and sustain the principles and norms that have enabled prosperity. Directed by Nonresident Fellow Olin Wethington, working with Resident Senior Fellow Robert A. Manning, this report, focused on the economic and finance institutional architecture in the region, includes observations from two fact-finding trips to China, the Republic of Korea, and Japan and from dozens of discussions involving policymakers, leading thinkers, and practitioners from both Asia and the United States. The recommendations in this report reflect a judgment that there is a plausible path toward an inclusive, prosperous, open, and rules-based economic order in the Asia-Pacific region—provided that the United States pursues a more proactive, forward-leaning engagement. The challenge for US policymakers is that they will need to act with strategic foresight and agility, and anticipate the contours of change in the region rather than succumb to the more simplistic approaches advocated by some in what has become an increasingly polarized debate.



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# EXECUTIVE SUMMARY

A global diffusion of power from West to East is unfolding with potentially profound challenges to the open, rules-based global order under which the global economy has flourished since 1945. Nothing better illustrates this trend than the shift of the center of economic gravity to the Asia-Pacific region. US leadership and the institutional arrangements that it has supported, underpinned by the US security guarantor role in East Asia, have been key to prosperity in the region.

Since World War II, US global economic strategy has been to pursue an open, rules-based order. The United States has relied on open market agreements, free movement of goods, services and capital, and institutions such as the International Monetary Fund (IMF), the World Bank, and, more recently, the World Trade Organization (WTO), with smaller regional multilateral institutions playing a supporting role. The underlying bipartisan premise in the United States was that expanding the circle of prosperity would lead nations to develop an inextricable stake in the stability of the international system and its norms and values. The belief was that, as rising powers integrated into the global system, they would seek to advance their economic and geo-political interests within established institutions, rather than challenge its structures or seek to create alternative institutions.

This broad bipartisan consensus pursued by eight Presidents since Richard Nixon is now being called into question in the United States, by some of our closest allies, and by a rising China taking a more assertive posture in regional and global affairs. While China has benefitted from the existing system and appears prepared to accept many dimensions of the existing order, it seeks to have significant influence globally and regionally and is also hedging and seeking to create new, more Sinocentric parallel institutions, as reflected in its recent Asian Infrastructure Investment Bank (AIIB) initiative.

Given these challenges, what long-term economic and financial institutional architecture in the Asia-Pacific region should the United States seek to build? What rules should guide the economic conduct of states, and how should the countries of the region embody those rules in institutions and arrangements in order to provide long-term durability?

Broad options range across the spectrum from diluting the Bretton Woods order and lowering standards to isolating China and continuing integration and the status quo with willing partners. For example, should the region soften the historic effort to build an open, rules-based order and instead give political priority to finding lowest-common denominator accommodation with rising powers in the face of new realities and pressures? Or should the region move to the other side of the spectrum and without abandoning entirely the "integration" approach, seek to isolate Chinese economic power and build an economic order among the like-minded that in essence seeks to contain Chinese power?

But there is a third alternative that this report recommends. The preferred scenario is a broadly inclusive, open rules-based order, adapting to the new economic weight of emerging economies with some alterations in governance structure, but with a more robust commitment of capacity and resources by the United States and its like-minded partners, enhancement of existing institutions and arrangements, and more effective, agile, and enlightened statecraft by the United States, leveraging the collective strength of partner countries.

The liberal open order will only endure and be deepened if the United States exerts a more robust leadership in Asia that goes beyond present levels of commitment. This report is an effort to closely examine the trade, financial, and monetary components of the emerging economic architecture in the Asia-Pacific and outline a path that can best shape that architecture in American interests and the interests of the region as a whole.

This report argues that the fundamental operating principles and tools designed to advance both US interests and global prosperity in the post-WWII period are durable: a market-based open trade and financial system; multilateral economic, financial, and political institutions with agreed rules and norms; and not least, a network of alliances and partnerships remain essential ingredients for sustaining a secure, prosperous, and inclusive regional and global order.

But these require proactive US efforts to shape the contours of change in the governance of the world financial system and the regional and global trade framework. With its economic and financial strength buoyed by entrepreneurial technology innovation, unrivaled military, the shale revolution and energy boom, and the appeal of its culture and political values, the United States is well-positioned to do this.

The United States should reject the bookend dangers of excessive accommodation on the one hand and containment on the other. Accommodation that diminishes an open, rules-based order is a slippery slope to an alternative system of weakened values and lower prosperity. Containment is at best a gradual slide to fragmentation and costly discriminatory trading blocs and as a practical matter, diminished prosperity for the region. There is a third way—a principled position combining vision and strength and a commitment to inclusiveness around high standards. The view that rising powers can be integrated into the existing order in a manner that addresses common interests remains valid. However, this can be achieved only with greater commitment to the region by the United States. The Trans-Pacific Partnership (TPP) represents the kind of forward-looking leadership the United States must be exerting. The TPP is strategically important because it incentivizes others to follow our rules. However, an enlightened, pro-active agenda needs to be undertaken by the United States more broadly, extending to the monetary, economic development, and financing fields and other dimensions of trade.

US leadership can best protect US interests by strengthening and reforming existing institutions and arrangements and integrating potentially competing regional institutions into a liberal, open rules-based order whose decision-making adjusts to the weight of emerging economies. To enhance the long-term economic prosperity of the Asia-Pacific area, the arrangements and institutions of the region must have broad support among the countries of the region; otherwise, these structures will be unstable. The United States should be prepared to accept new institutional frameworks that operate on the basis of high standards and are inclusive. As a Pacific power, the United States does not need to participate in all regional arrangements, but should welcome institutional initiatives of high quality and seek to influence those that are not to become more compatible with global norms and best practices.

Even with a rising China, system-threatening conflict is not pre-ordained. The United States, China, and other major countries, such as Japan, South Korea, and the members of the Association of Southeast Asian Nations (ASEAN), should be able to find common ground within an inclusive and open rules-based economic order. This may take some time and the pathway may be very rocky. Such an outcome is achievable, but not without more substantial US engagement in the region. This should be the goal of US policy.

The major established multilateral economic and financial institutions are reasonably strong. They have proven track records. The existing order has been the basis for growth and development for the past seventy years, and reliance on it continues. The system has shown the ability to make adjustments in policy and country representation, the failure of the US Congress to approve the 2010 IMF reform package notwithstanding. The Bretton Woods institutions have the flexibility to be further remodeled to better reflect geo-economic realities if proactive US leadership is exercised.

Since the 1997-98 Asian financial crisis, there has been impetus for pan-Asian arrangements, such as an Asian Monetary Fund, proposed at the time by Japan but ultimately not pursued. Yet there is trepidation and little enthusiasm for the Asia-Pacific becoming a Sinocentric sphere of influence. Asian countries seem prepared to accept Chinese initiatives only as a complement to the current order. Most nations want a strong US economic and security presence in the region and believe the economic order should be an open and inclusive architecture. In turn, the United States needs to devote more attention to understanding, apart from China considerations, Asian development and economic priorities. The United States has a positive message for Asia centered more on ideals and governance than on budgetary resources.

Finally, a re-energized, proactive US leadership in the Asia-Pacific requires getting our domestic house in order. This means sustaining a globally competitive economy and a more functional political system able to address key domestic and foreign challenges on a bipartisan basis.

This report recommends some specific actions to achieve these objectives. A summary of these recommendations is included herein and discussed in more detail in the body of this report. The authors of this report hope it will stimulate further thinking within political and policy circles in the United States and the region, particularly as the United States moves toward its 2016 national elections.

## Summary of Recommendations[1]

### *Overriding Dimensions*

Certain prerequisites of American power must be urgently addressed:

- Enhancing the foundations of economic strength at home
- Reducing the extent of dysfunction in the domestic political process
- Enlarging partnership with allies and like-minded countries in the region
- Exercising a more agile and effective economic statecraft

### *Monetary Institutions*

- *Pass IMF Quota Reform:* The US Congress, with all due speed, should pass the December 2010 IMF quota reform package. If the United States political process

1 This is a summary of recommendations. Full recommendations addressing monetary, financial, and trade topics are listed in subsequent chapters.

cannot deliver on the commitments of its Executive Branch, it is likely to provoke a crisis of legitimacy within the IMF and open the door to new, regional institutional initiatives.

- *Give Priority to the G20 Process for Macroeconomic Leadership in the Asia-Pacific Region:* Economic leadership for Asia should not be the purview of a G2 (the United States and China) or "Asia for Asians." Rather, the region should be integrated within the global process and its institutions and arrangements aligned with the global economic order.
- *Use the IMF and G20 to Further an Open Financial Market Policy Agenda for the Asia-Pacific Region:* The United States should more intensively utilize the IMF and G20 as major platforms for pursuing its agenda in the Asia-Pacific region of open and innovative financial markets, exchange rate convertibility, the elimination of capital controls, capital market development, and liberalization of investment regimes in the financial sector.
- *Give Emphasis to Monitoring the Impact of New Global Financial Regulatory Initiatives*: The United States should push for stronger monitoring of implementation of recent G20-led global financial regulatory initiatives, such as Basel III, and the impact of post-financial crisis G20 regulatory initiatives on economic growth and financial innovation. Through the Financial Stability Board, the G20 provides a mechanism for global alignment of financial regulatory policies, including those of Asia-Pacific countries.
- *Advocate Governance Arrangements in International Financial Institutions Based on Contribution to the Global Economy*: The United States should seek a fair allocation of quotas in the IMF reflecting economic contribution and responsibility. This has particular relevance to the Asia-Pacific region and should involve further shifts in quota from European countries. In addition, the United States should support the next selection of the IMF Managing Director and President of the World Bank, as well as the leaders of all multilateral lending institutions, based on merit, not nationality.
- *Press for Full Data Disclosure and Transparency:* The United States should press for full disclosure by all G20 countries, with particular application to countries in the Asia-Pacific region, of the investment of central bank reserve assets and of foreign exchange market intervention, and for enhancement of domestic economic and financial data reporting to the IMF.

### *Finance and Infrastructure*

- *The United States Should Advocate a Strong Development Agenda for the Asia-Pacific Region, Including Infrastructure, alongside its Open Market Trade Agenda.* This is a top priority for most nations in the region and a key to their long-term economic growth. There are compelling elements of US leadership that do not require large US budgetary appropriations, including stronger support for local governance reforms, more effective delivery by existing multilateral institutions, leveraging private sector resources and encouraging larger resource contributions from like-minded partners in the region.
- *Launch a New Initiative to Enhance the Role and Effectiveness of the Asian Development Bank (ADB)*: The United States, Japan, and other like-minded ADB shareholders should launch a new initiative to further enhance the lending capacity of the ADB and improve the speed and efficiency of infrastructure project development and decision-making. The United States and Japan should take the lead in supporting a capital increase for the ABD in the 2016-18 timeframe.
- *Strengthen the Foundations of Private Sector Participation in Infrastructure Projects*: The United States should back an initiative, probably within the G20, on creating a more welcoming regulatory, legal and market environment for infrastructure financing by private investors and on supporting the development of an infrastructure asset class to support private institutional investment.
- *World Bank Reform in Support of Infrastructure Development in the Asia-Pacific Region*: The United States should consider placing greater reliance on guarantee instruments, including consolidation of the private sector guarantee operations of the Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation (IFC). In addition, the World Bank should consider increasing its lending capacity through leverage of IDA resources.
- *The United States Should be Prepared to Collaborate with New Multilateral Financing Institutions and Arrangements that Are Committed in Practice to High International Standards on Governance and Operations*. This principle should be applied to the AIIB.
- *Develop More Comprehensive and Effective Arrangements on Official Export Credits*: The Organization for Economic Cooperation and Development (OECD) Arrangement on Officially Supported Export Credits should be replaced by a new, stronger set of international guidelines for governing the provision of export credits. Congress

should continue authorization of the US Export-Import Bank, an important tool for ensuring that US firms are not competitively disadvantaged globally.

### *Trade*

- *Pass "Fast Track" Trade Promotion Authority and Conclude the Trans-Pacific Partnership in 2015:* The TPP represents the kind of forward-looking leadership the United States must exert in the region. The TPP is strategically important because it frames high standards of market openness among countries comprising 40 percent of the world economy and incentivizes outside countries to join. If Trade Promotion Authority (TPA) and TPP are not achievable in 2015, they should remain on the US agenda as a top economic priority, even into the next administration.
- *US Diplomacy Should Reach Beyond the Original Twelve Countries of the TPP*: The original twelve countries of the TPP should be the foundation on which to build an even broader Asia-Pacific trade partnership. Once TPP is concluded, the US should begin immediately to seek to incorporate other countries of the region into TPP. It should give priority to the Republic of Korea, Taiwan, and ASEAN countries, including, in particular, the Philippines, Thailand, and Indonesia. The United States should make it clear that it welcomes China's accession to the TPP.
- *Conclude BIT with China*: The United States should continue to assign priority to concluding a Bilateral Investment Treaty (BIT) with China. The run-up to President Xi Jinping's September 2015 visit to Washington, DC and the visit itself provide a significant opportunity to make progress in the negotiations; failure to do so in that context is likely to pass conclusion of the BIT to the next US administration.
- *Accelerate New Agreements with Like-Minded Partners*: The United States should step up efforts to conclude with like-minded trading partners sector-focused agreements, such as Trade in Services Agreement, Information Technology Agreement, Government Procurement Agreement, and bilateral investment agreements.
- *The United States Should Be Open to Dialogue on a Pathway to a Free Trade Area for the Asia-Pacific (FTAAP) while Giving Priority to TPP Enlargement*: The United States should indicate openness to dialogue within the Asia-Pacific Economic Cooperation (APEC) forum on the long-term goal of an FTAAP, but should give priority to extending participation in TPP.
- *Re-establishing in the United States a More Unified Direction on Trade Liberalization Will Require Politically Addressing the Effects of Globalization on Workers*. The recent debate on Trade Promotion Authority and Trade Adjustment Assistance laid bare the wide political divide on trade policy in the United States. It seems clear that re-establishing a bipartisan consensus favoring trade liberalization necessitates that those seeking to extend trade liberalization must at the same time address the effects of competitive dislocations and unfair foreign practices on American workers and firms.

# CHAPTER 1

## INTRODUCTION: CHALLENGES TO THE CURRENT ORDER

A global diffusion of wealth and power, from the West and North to the East and South, is unfolding, posing potentially profound challenges to the open, rules-based global order under which the world economy has flourished since 1945. Nothing better illustrates this trend than the shift of the world economy's center of gravity to the Asia-Pacific region.

This economic transformation in the Asia-Pacific region has been building for half a century. It began in the 1960s, when Japan's economy took off, followed by the growth of the four "Asian Tigers" (South Korea, Singapore, Hong Kong, and Taiwan) in the 1980s, and later other countries within the Association of Southeast Asian Nations (ASEAN). The transformation has been most dramatic over the past two decades with the emergence of China. While the efforts of Asian peoples and governments have been—and continue to be—the driving force behind the region's success, US leadership and the institutional arrangements it has supported have facilitated Asian growth and prosperity, as have the US security guarantor role in East Asia and the competitive strength and ingenuity of US industrial and financial firms. These efforts have shaped what we have come to call "globalization."

Since World War II, US global economic strategy has pursued an open, liberal, and rules-based order. The United States has relied on open market agreements and global institutions, such as the International Monetary Fund (IMF), World Bank, and, more recently, the World Trade Organization (WTO), with smaller, regional multilateral lending institutions playing supportive roles in the global economic architecture. Since the 2007-08 financial crisis, the G20 has become an important part of the consensus-building process. The underlying premise was that expanding the circle of prosperity would lead nations to develop an inextricable stake in the stability of the international system, including its norms and values. The strategy was based on a belief that as rising powers integrated into the interdependent global system, they would find their interests adequately served. Thus, they would advance their economic and geopolitical interests within established institutions, rather than challenge their structures and norms or seek to establish alternative institutions.[2]

The elements of this open, rules-based order include the following: market access; free movement of goods, capital, and services; open investment regimes; nondiscrimination; rule of law; protection of intellectual property rights; floating exchange rates; regulatory convergence; private sector development; effective dispute resolution mechanisms; and rules of fair competition.

This broad consensus is increasingly being called into question in the United States, by some of its closest allies in the Asia-Pacific region, and by a rising China taking a more assertive posture in regional and global affairs. The institutional challenges are varied and come from multiple sources. At the broadest level, some commentators observe a historic shift in the global and regional balance of economic power, and the inevitable rivalry between rising and declining powers. Most recently, some have asserted that the China-supported Asian Infrastructure Investment Bank (AIIB) could reflect a tipping point, where the United States no longer undergirds the international economic system. In recent years, the following critiques of the current global and regional economic and financial architecture have been prominently voiced (these views are noted without commenting on their merits):

> Global institutions and governance structures no longer reflect the proportionate weight in the world of twenty-first century economic and financial actors, and do not adequately address the pressing needs of the region, such as infrastructure.
>
> The values of open market competition and a relentless search for yield have led to unsustainable inequalities in income and wealth, and a disregard of financial risk—leading to the global financial crisis of 2008-09.
>
> China is rapidly building national power across economic and military lines, and will use its power to continue gaining influence, both on its periphery and globally. The rise of China has major implications for the structure and operation of regional arrangements and institutions. China wishes to, over time, become preeminent in Asia and beyond and will use its economic strength to enhance its relative position.
>
> Major areas of economic activity in Asia lack adequate "rules of the game," or agreed-upon standards of behav-

2 G. John Ikenberry, "The Rise of China and the Future of the West," *Foreign Affairs*, January/February 2008, https://www.foreignaffairs.com/articles/asia/2008-01-01/rise-china-and-future-west.

ior. In many of these areas—such as state supports and subsidies for enterprise, data and information flows, intellectual property rights, and government procurement—common agreement will be difficult to achieve, at least in the short run. Many of these substantive policy differences relate to the nature of underlying political systems. Under this view, China's authoritarian, statist approach cannot be reconciled with the United States-led, rules-based order. Thus, the region is headed for fragmentation and competing economic blocs that existing institutional structures cannot manage.

Many of the United States' closest friends in Asia privately, and increasingly publicly, voice concerns as to the strength of the US commitment to Asia, despite the Obama administration's "pivot" or "rebalance" strategy. They do not doubt US capacity, but are unsure of American political will or its ability to overcome domestic political dysfunction. These Asian nations fear a tired, inward-looking America. Moreover, US partner countries in Asia are mystified by weak economic statecraft by the United States. These concerns could, in time, weaken Asian support for current institutions and dampen Asian willingness to support the norms of an open, rules-based system.

In the face of these challenges, this report contends that the United States should rethink its policy toward the Asia-Pacific region, with the goal of achieving a broad bipartisan consensus. This report argues that a liberal, rules-based economic order that is inclusive of all major powers in the region should remain the goal of US policy. This report also seeks to explain why this is a wise choice for the United States and the region. However, erosion of the current order can be prevented—and progress toward a durable, open, rules-based institutional architecture can be achieved—only if the United States elevates its engagement and commits to more robust and assertive economic and financial leadership in the Asia-Pacific region. The sections in the second half of the report are devoted to specific recommendations: overarching dimensions, monetary, finance and infrastructure, and trade.

# CHAPTER 2

# REGIONAL ECONOMIC DYNAMISM AND THE RISE OF CHINA

## Asia Comes of Age

The shift in economic momentum and wealth to Asia has been broad-based. China's economy alone grew from $200 billion in 1980 to $10.3 trillion in 2014. Asia now boasts a $21 trillion economy, including the world's second largest (China) and third largest (Japan) economies. The ten ASEAN nations, most less developed or middle income, together have an economy worth more than $2.3 trillion.[3]

The economic dynamism of Asia has been due in no small part to the fact that Asians are increasingly trading with, and investing in, each other. As the Asian middle class has grown, consumption of goods and services has increased. The region relies less on US markets, and more on intra-regional trade. This reflects a global trend; globalization has become more region-centric in Asia and other major economic regions (e.g., the European Union (EU) or North America after the North American Free Trade Agreement (NAFTA)). Asia alone accounts for some 35 percent of the global economy, and holds more than $6 trillion in foreign reserves (China alone holds $3.88 trillion).[4] Supply chains have naturally reinforced regional links.

Yet, while the distribution of economic and financial power in the world has shifted, the structure of the international system's institutions has not been fundamentally altered since 1947. In regard to decision-making, it has remained largely static. For example, a European always serves as the head of the IMF, and an American as head of the World Bank.

China has fewer voting shares in the IMF than France or the United Kingdom, even though its economy is more than four times larger than either of these EU nations.[5] China's role is similarly circumscribed in the Asian Development Bank (ADB), which, by tradition, has a Japanese head. Similarly, institutions like the International Energy Agency (IEA)—created in the 1970s by the OECD to help consuming nations—still do not include China, the world's largest energy consumer, or India, which also drives the growth of global energy demand.

In light of these realities, it should not be surprising that there are burgeoning efforts to fashion Asian regional institutions that better reflect these patterns. This has been particularly true since the 1997-98 Asian financial crisis, a traumatic event that had a devastating impact on the economies of Thailand, Indonesia, and South Korea. The IMF's attempts to impose ill-considered conditionality, based on experiences in Latin America, sparked widespread resentment in the region. The 2007-08 US financial crisis deepened Asian concerns about economic volatility, and reinforced Asian countries' efforts to create their own shock absorbers.

In addition, driven by Asian-centric global supply chains, an explosion of bilateral and multilateral free trade agreements (FTAs) has occurred over the past two decades. ASEAN has been at the forefront of this frenzy of overlapping Asian-Pacific bilateral and multilateral trade arrangements. There are now more than two hundred of them, with two proposed overarching accords, the TPP and the Regional Comprehensive Economic Partnership (RCEP), seeking to consolidate them. Similarly, the pan-Asian Chiang Mai currency swap arrangement and AIIB also reflect the inter-Asian economic dynamic and efforts to insulate the region from shocks like the 1997-98 financial crisis (see figure 4).

## The Rise of China

No nation has benefited more than China from integration into the United States-led international system. Though it benefits from participation in existing institutions, China wants a significant presence and recognition of its great power status, and will seek to enhance its influence in decision-making over time. China will also look for avenues to create new channels of economic influence more responsive to its interests. China wants the benefits of global and regional economic participation, while it pursues its own strategic interests at the same time. Integration into the international economy is central to China's development strategy—its growth would falter without it. China wants the benefits of international integration without giving up its ability to steer its domestic economic policy, and without economic integration undermining the legitimacy of its

3 World Bank, "GDP (Current US$)," http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?page=5.
4 World Bank, "Total Reserves (Includes Gold, Current US$)," http://data.worldbank.org/indicator/FI.RES.TOTL.CD.
5 International Monetary Fund, "IMF Members' Quotas and Voting Power, and IMF Board of Governors," https://www.imf.org/external/np/sec/memdir/members.aspx; Szu Ping Chan, "Britain Edges Past France on World Stage," *Telegraph*, December 26, 2014, http://www.telegraph.co.uk/finance/economics/11313327/Britain-edges-past-France-on-world-stage.html.

one-party-dominated political system.

This outlook helps explain China's proposal for an Asian Infrastructure Investment Bank (AIIB). The AIIB is one component of a much larger set of economic, financial, monetary, and political/security initiatives (including the New Development Bank, otherwise known as the BRICS Bank, and the Silk Road Fund) and aspirational goals through which China seeks to define its ascendant role as a major global and Eurasian power (see table 1). Nonetheless, China seeks to downplay the notion that these initiatives reflect a competing Chinese vision of the regional, and perhaps global, order. When questioned about the AIIB, Chinese Premier Li Keqiang emphasized that China is not seeking "to reinvent the wheel." The AIIB, he said, "is intended to be a supplement to the current international financial system. China wants to work with others to uphold the existing international financial system."[6]

This appears to be part of a Chinese hedging strategy, similar to other pan-Asian efforts working to revamp existing institutions while simultaneously devising new ones. Thus, Beijing works to alter existing institutions to reflect its new weight, or to gradually displace them with new, Sinocentric institutions. However, China is not abandoning existing institutions. It has increased its investments in the IMF and the World Bank (through the International Development Association and International Finance Corporation trust funds) over the past decade, and continues to support the WTO.[7]

Until the financial crisis of 2008-09, China seemed to largely follow former leader Deng Xiaoping's foreign policy dictum: "Hide your strength, bide your time." The collapse of Lehman Brothers, and the financial crisis and deep recession, seemed to mark a turning point. Many Chinese analysts overreacted and viewed the crisis as an indicator of terminal US decline and a collapse of US ideology, and seemed to believe China's moment had arrived.[8] China's Central Bank began speaking of the RMB replacing the dollar.[9]

## Enter Xi Jinping: China's Pivot Outward

With the ascension of Xi Jinping in 2012, Beijing's foreign policy has become increasingly assertive on behalf of what it calls its "core interests." Though China has increasingly deployed its economic and financial prowess to enlarge its regional and global role, what garnered the most attention until recently was its political/military activity—particularly with regard to disputed island territories in the East and South China Seas, as well as provocative air and naval responses to the US military presence in these areas.

Prior to Xi's ascendance, an array of Chinese aid and loans, along with the growing use of the renminbi (RMB) in trade in Asia, had increased China's footprint substantially. This was also achieved by resource-driven aid and investment in Africa and Latin America (see figure 2). As discussed above, the trend toward institutionalized pan-Asian trade and financial cooperation has been evident since the late 1990s and is not unique to China. However, as highlighted by the AIIB and the "One Road, One Belt" plan, Xi's ascendance has taken Chinese initiatives to a new level and articulated a vision that appears to challenge the current order.

Xi's activism, to some extent, appears to be a Chinese response to the Obama administration's pivot or rebalance to Asia. Bordered by fourteen countries, China has sought to turn a geographic liability into an asset by pivoting west to Eurasia. The new Silk Road Economic Belt and Maritime Silk Road is a bold initiative to create an infrastructure of roads, railways, pipelines, and power grids integrating what Sir Halford Mackinder famously considered the Eurasian "world island" on China's periphery.[10] Similarly, the maritime road idea involves building ports and other infrastructure to link the Pacific and Indian Oceans, stretching from China to the eastern coast of Africa.

Xi's vision also extends to the realm of security. In a May 2014 speech to the Conference on Interaction and Confidence-Building in Asia (CICA), a grouping of Central and South Asian states, Xi criticized "outdated thinking from the age of Cold War," and called for a new "security concept" of "cooperative security." Xi argued that "it is for the people of Asia to run the affairs of Asia, solve the problems of Asia, and uphold the security of Asia."[11] Unlike the economic initiatives, this "Asia for Asians" line, the intensity of which has varied over time, seemed a transparent effort to

6 Lionel Barber, "Interview with Li Keqiang," *Financial Times,* April 15, 2015, http://www.ft.com/intl/cms/s/0/3a42d156-e288-11e4-aa1d-00144feab7de.html#axzz3Zpr5vJSo.
7 World Bank, "Country Summary: China," https://finances.worldbank.org/countries/China.
8 Yong Dong, "China: The Post-Responsible Power," *Washington Quarterly*, spring 2015, https://twq.elliott.gwu.edu/sites/files/downloads/Yong.pdf.
9 For a sample of talk at the time, see Steven LeVine, "China's Yuan, the Next Reserve Currency?," *Bloomberg Business Week*, May 26, 2009, http://www.businessweek.com/globalbiz/content/may2009/gb20090522_665312.htm.
10 Artyom Lukin, "Mackinder Revisited: Will China Establish Eurasian Empire 3.0?," *Diplomat*, February 7, 2015, http://thediplomat.com/2015/02/mackinder-revisited-will-china-establish-eurasian-empire-3-0/.
11 Xi Jinping, "New Asian Security Concept for New Progress in Security Cooperation," speech delivered at the Fourth Summit of the Conference on Interaction and Confidence Building Measures in Asia, May 21, 2014, http://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1159951.shtml.

## Table 1. Parallel Institutions

| CHINA-CENTERED AND PAN-ASIAN INSTITUTIONS | KEY FEATURES | PARALLEL TO |
|---|---|---|
| **Financial and Monetary Policy** | | |
| BRICS New Development Bank (NDB) | Development bank with a focus on infrastructure, founded in July 2014 with headquarters in Shanghai; Indian presidency for the first five years. | World Bank, regional development banks |
| Asian Infrastructure Investment Bank (AIIB) | ADB members were invited to join in; fifty-seven founding countries (as of May 2015). | ADB |
| BRICS Contingency Reserve Arrangement (CRA) | Reserve pool (100 billion USD) for crisis liquidity (signed in July 2014). | IMF |
| Mechanisms for internationalizing the RMB | Twenty-eight agreements on direct exchange of RMB with other currencies; treaties on clearing banks in nine countries; seven country-specific Renminbi Qualified Foreign Institutional Investor (RQFII) quotas; twenty-eight swap agreements with central banks. | Established currency market mechanisms |
| Shanghai as global financial center with RMB-denominated futures markets | State Council decision (2012) to turn Shanghai into a global financial center; approval of Shanghai Free-Trade Zone (August 2013). RMB-denominated futures markets for crude oil, natural gas, petrochemicals (August 2014); gold trading platform (fall 2014); six other international commodities futures markets are in the planning stage. | Established centers for financial, commodities, and futures markets |
| China International Payment System (CIPS) | CIPS for international RMB transactions (April 2012); Sino-Russian negotiations on alternatives to SWIFT (fall 2014). | Established payment systems (CHIPS, etc.) |
| **Transregional Infrastructure Projects** | | |
| One Road, One Belt | Large-scale infrastructural and geostrategic projects (announced by President Xi Jinping in November 2013) that aim at opening up new land and maritime trading corridors across Eurasia. | New Silk Road (United States, 2011), Eurasian Economic Union (Russia) |
| **Security** | | |
| Conference on Interaction and Confidence-Building Measures in Asia (CICA) | A security forum originally initiated by Kazakhstan (1999); China serves as chair 2014-16. | ARF |
| Shanghai Cooperation Organization (SCO) | An international organization (established in 2001) by China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan with a security focus. In 2014, India, Iran, and Pakistan applied for membership. | CSTO, ARF |
| **Diplomatic Forums** | | |
| Boao Forum for Asia (BFA) | An annual forum founded in 2001 for decision-makers from politics, business, and academia with a regional focus on Asia. | WEF/Davos |
| **Pan-Asian Trade, Finance, Monetary Policy** | | |
| Regional Comprehensive Economic Partnership (RCEP) | A free trade agreement planned to be concluded by the end of 2015 and to encompass three billion people and 40 percent of world trade. | TPP, TTIP |
| Chiang Mai Initiative Multilateralization (CMIM); ASEAN Plus Three; Asian Macroeconomic Research Office (AMRO) | Reserve pool (increase to 240 billion USD in effect since July 2014) for crisis liquidity ("Multilateralization" started in March 2010; AMRO established in April 2011, status as international organization since October 2014). | IMF |

*Source*: China Monitor, Mercator Institute for China Studies (MERICS).

push the United States out of the region, and had little resonance in the Asia-Pacific. Most nations have been troubled by China's assertive military behavior, fear what would likely be a Sinocentric security system, and have gravitated toward the United States and each other in response.

Importantly, however, Xi Jinping has broken the code to one of the secrets of US success in Asia: the provision of public goods. That phrase can be found in several major speeches. In a speech to CEOs at the China-hosted Asia-Pacific Economic Cooperation (APEC) Summit in November 2014, Xi said, "As its overall national strength grows, China will be both capable and willing to provide more public goods for the Asia-Pacific and the world, especially new initiatives and visions for enhancing regional cooperation."[12] In a major speech at the March 2015 Boao Forum for Asia (China's answer to Davos and the World Economic Forum), Xi spoke of a "community of common destiny."

Of course, outlining an aspirational vision and implementing ambitious policies are two very different things, especially when those policies entail massive investments in less-developed, and often corrupt, neighboring states in central Asia. The United States spent more than $30 billion in aid to Pakistan over the past sixty years, with little to show for it.[13] Will China's pledge of $46 billion for Pakistani infrastructure necessarily be any different? (see figure 2A) Moreover, there has been a large gap between many of Beijing's grandly proclaimed aid and investment initiatives and the actual amount delivered (see figure 2B).

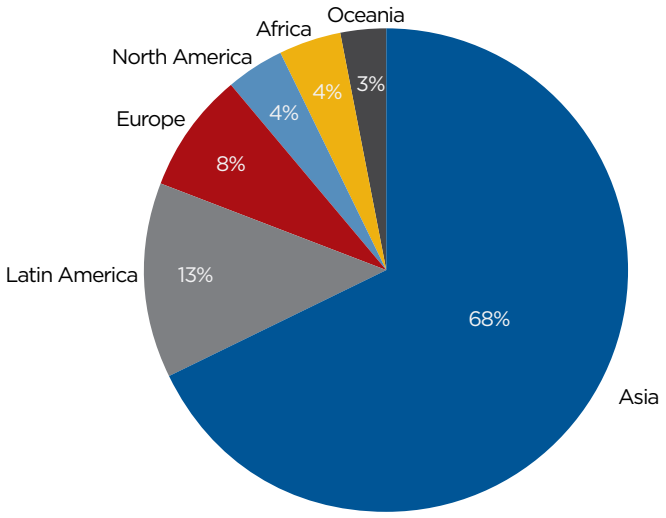
However, a $50 billion BRICS New Development Bank, a $40 billion New Silk Road fund, and the AIIB all testify to China's seriousness.[14] These initiatives would also conveniently help absorb China's excess industrial capacity in steel, cement, and other sectors, with contracts likely directed to Chinese state-owned enterprises. China's National Development and Reform Commission (NDRC) released a still-vague "action plan," published in *China Daily*, and Xi has appointed a "Special Leading Group" to oversee these initiatives.[15]

Some argue that China is pursuing a grand strategy to displace the United States and dominate Asia. However, it is the authors' assessment that, at a minimum, Beijing seeks to be a major global power with a role commensurate with what it views as its comprehensive national strength. As Michael Swaine, advocating his own balancing strategy, put it in a recent article, "By necessity, their objective is to reduce their considerable vulnerability and increase their political, diplomatic, and economic leverage in their own backyard to a level where Chinese interests must be reflected in those major political, economic, and security actions undertaken by neighboring states."[16]

The new realities of China's reemergence suggest that the basic assumptions underlying a bipartisan US policy consensus toward China, pursued in general by eight US Presidents, are increasingly open to question. Since Richard Nixon's opening to China in 1972, US policy has reflected both convergent and competitive dimensions in the relationship. The United States has sought to cooperate with China where possible, to facilitate its integration into the international system, and to manage and narrow differences. The hope was that as China integrated itself into the globalized economic and political system, Beijing, which has been a principal beneficiary of the United States-led system, would see its interests best served by being a "responsible stakeholder" in that system—one that would not be static, but would adapt to new economic realities. When then-Deputy Secretary of State Robert Zoellick raised this idea in 2005, it was a reasonable notion; China's economy was substantially smaller than it is now ($10.3 trillion in 2014).[17]

12 Xi Jinping, "Seek Sustained Development and Fulfill the Asia-Pacific Dream," speech delivered at the APEC CEO Summit, November 9, 2014, http://www.apec-china.org.cn/41/2014/11/13/3@2580.htm.
13 Susan B. Epstein and K. Alan Kronstadt, "Pakistan: U.S. Foreign Assistance to Pakistan," Congressional Research Service, July 1, 2013," https://www.fas.org/sgp/crs/row/R41856.pdf
14 "BRICS Bank, AIIB, Silk Road Fund Will Play Complementary Role to Other Lenders: Cambodian PM," Xinhua, reposted on China.org, http://www.china.org.cn/world/Off_the_Wire/2015-03/05/content_34967363.htm.
15 "Initiative Offers Roadmap for Peace, Prosperity," *China Daily,* March 30, 2015, http://www.chinadailyasia.com/chinafocus/2015-03/30/content_15245315.html.
16 Michael D. Swaine, "Beyond American Predominance in the Western Pacific," Carnegie Endowment for International Peace, April 2015.
17 Robert B. Zoellick, Deputy Secretary of State, Remarks to National

### Figure 1. Distribution of China's Foreign Direct Investment, 2013




*Source*: World Resources Institute.

The erosion of the US consensus reflects a growing sense that the competitive aspect of the bilateral relationship is becoming more prominent, with China increasingly posing a challenge to US interests. The business community, a key pillar of support for the US-China relationship, is becoming less enthusiastic. Faced with a slowing Chinese economy, increasing labor costs, and regulatory bias favoring Chinese domestic companies, US foreign direct investment (FDI) in China fell by 9.3 percent from 2013 to 2014.[18]

Two major reports, both released in April, reflect this growing doubt among the intellectual and political elite about US policy toward China. A report released by Harvard University's Belfer Center calls for a "new framework of constructive realism for common purpose."[19] A more pessimistic Council on Foreign Relations (CFR) report calls for a new grand strategy to counterbalance China, starting from the premise that "the American effort to 'integrate' China into the liberal international order has now generated new threats to US primacy in Asia."[20] Although these two reports offer contrasting solutions, the authors share their view as to the need for a rethink. The current US policy toward the region is inadequate to confront current challenges. The pivot, or rebalance, has been overhyped and under resourced, and the economic statecraft of the rebalance has been insufficient.

This report is an effort to closely examine the trade, financial, and monetary components of the emerging economic architecture in the Asia-Pacific. It is also an effort to outline a path that is neither unacceptably accommodating nor confrontational, but can best cope with an inevitably larger Chinese footprint. It assumes the United States will remain a Pacific power, and that the region is a priority interest. It seeks to identify how enlightened, proactive US leadership and policies can best protect US interests by strengthening and reforming existing institutions, as well as channeling potentially competing regional institutions into a liberal, open, rules-based order.

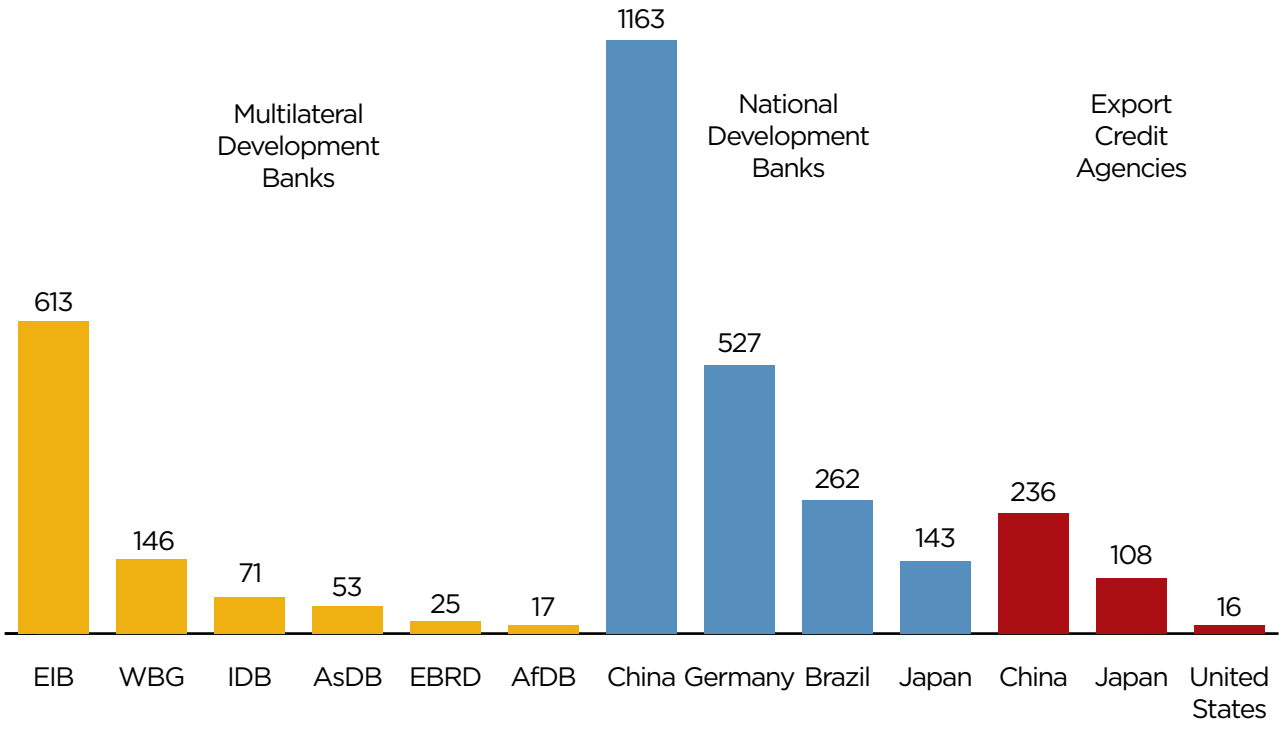
Committee on U.S.-China Relations,"
New York, US Department of State press release, September 21, 2005, http://2001-2009.state.gov/s/d/former/zoellick/rem/53682.htm.

18 Simon Denyer, "U.S. Companies Feel a Chill in China, Even as Many Still Rake in Profits," *Washington Post*, July 4, 2014, http://www.washingtonpost.com/world/us-companies-feel-a-colder-wind-in-china-even-as-many-still-rake-in-profits/2014/07/03/dcbfa233-ee13-4e67-b791-3b3e38bca890_story.html.

19 Kevin Rudd, *The Future of US-China Relations Under Xi Jinping: Toward a New Framework of Constructive Realism for Common Purpose* (Cambridge: Belfer Center for Science and International Affairs, Harvard Kennedy School, April 2015).

20 Robert D. Blackwill and Ashley J. Tellis, *Revising US Grand Strategy toward China*, Council Special Report no. 72 (Council on Foreign Relations, March 2015).

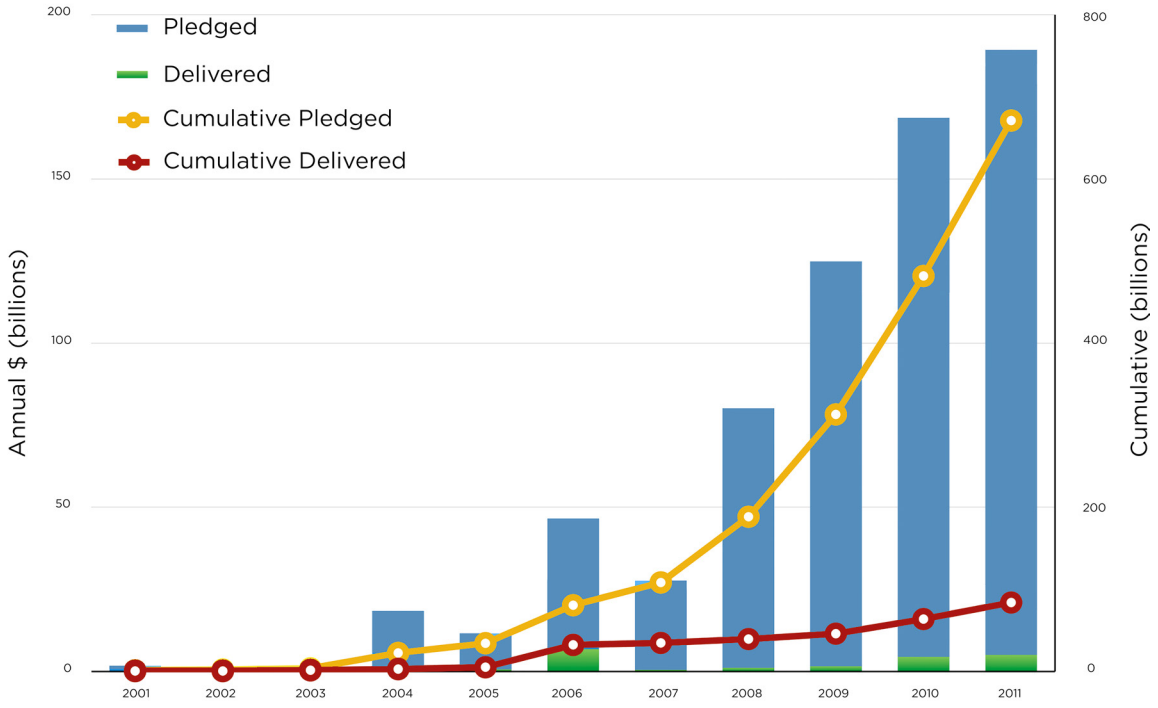
**Figure 2A. China Goes Global: Outstanding Loans of MDBs, NDBs, and ECAs, 2013 (US$ billion)**




*Source*: World Resources Institute.

Like most putative great powers, China seeks to play a larger role in writing the rules of the global order. If not rejecting the system, it seeks to better shape it to mesh with Chinese interests and ambitions. This report, however, proceeds from the view that, even with a rising China, there is a realistic prospect that the United States, China, and other major countries—such as Japan, South Korea, and the ASEAN states—can find common ground within an inclusive and open, rules-based economic order. This might take some time, and the pathway may be very rocky. Such an outcome is achievable, but not without more substantial US engagement in the region.

### Figure 2B. China's Worldwide Foreign Aid, Annual and Cumulative Costs, 2001-11




China's pledged and delivered foreign aid are represented in billions of US dollars (left scale), and China's cumulative pledged and cumulative delivered foreign aid are represented in billions (right scale). *Source*: RAND.

# CHAPTER 3

# STRENGTHENING THE OPEN, RULES-BASED ECONOMIC ARCHITECTURE

Given the perceptions and trends summarized above, what long-term economic and financial institutional architecture should governments seek to build in the Asia-Pacific region by 2030? In other words, what rules should guide the economic conduct of states, and how should the countries of the region embody those rules in institutions and arrangements that provide long-term durability?

Broad options can be framed. For example, should the region soften the historic effort to build an open, rules-based order and instead give political priority to finding lowest-common denominator accommodation with rising powers in the face of new realities and pressures? Or should the region move to the other side of the spectrum and without abandoning the "integration" approach, seek to isolate Chinese economic power and build an economic order among the like-minded that in essence seeks to contain Chinese power? Or is the realistic best-case scenario a broadly inclusive, open, rules-based order, adapting to the new economic weight of emerging economies with some alterations in governance structure—but with a more robust commitment of capacity and resources by the United States and its like-minded partners, enhancement of existing institutions and arrangements, and more effective and assertive US statecraft, leveraging the collective strength of partner countries?

This report recommends the latter alternative. The liberal, open order will only endure and be deepened if the United States exerts a more robust, reform-minded leadership in Asia that goes beyond present levels of commitment. To enhance the long-term economic prosperity of the Asia-Pacific area, regional arrangements and institutions must have broad support among the countries of the region; otherwise, these structures will be unstable. The United States should be prepared to accept new institutional frameworks that operate on the basis of high standards and are inclusive. The United States does not need to participate in all arrangements, but should welcome institutional initiatives of high quality and seek to align those that are not with global norms and best practices.

## Why Should the Asia-Pacific Region Pursue an Open, Rules-Based Order?

The world is long past the 2008-09 financial crisis and the calls for a new Bretton Woods system, allowing us to look back with perspective. The global system survived, learned lessons, and was strengthened in many ways. The IMF found new mandates and the G20, with its broadened representation, added a new sense of legitimacy to the global order. Despite the many critiques of the system, including concerns that globalization is increasing inequality, declarations of the end of the Washington Consensus, and calls for a new Bretton Woods, there have been few actionable proposals with realistic solutions around which a new systemic framework can be built.

The major established, multilateral economic and financial institutions are reasonably strong. They have proven track records. The existing order has been the basis for growth and development for the past seventy years, and reliance on it continues. The system has shown the ability to make adjustments in policy and country representation. The Bretton Woods institutions have the flexibility to be further remodeled to better reflect geoeconomic realities, if proactive US leadership is exercised.

Since the 1997-98 Asian financial crisis, there has been an impetus for pan-Asian arrangements as a buffer against future crises. Yet there is trepidation and little enthusiasm for the Asia-Pacific becoming a Sinocentric sphere of influence. Moreover, there tends to be an assumption that China's rise will continue to be linear. Managing through the economic slowdown will be an arduous process whose end state is not guaranteed. Asian countries seem prepared to accept Chinese initiatives only as a complement to the current order. Most nations want a strong US economic and security presence in the region, and believe the economic order should be open-architecture and inclusive. On a regional basis, the articulated goal is to widen the circle of prosperity as a result of high standards and rules that serve the collective best interest—a convergence of interests with those of the United States.

China itself exhibits ambivalence as to the merits of the current economic order. China has benefitted from the existing system, but wishes to have more significant influence

globally and regionally. While China appears prepared to accept many dimensions of the existing order and has increased its investment in the Bretton Woods institutions, it is also hedging and seeking to create new, more Sinocentric parallel institutions. If the United States and other countries that share a strong belief in the open, liberal order wish to avoid an erosion of the commitment to that order, they will need to articulate and energetically work for a durable set of standards, as well as a sound institutional framework that is inclusive and reflects economic realities. In addition, the United States will need to work with partners to devise assertive and forward-looking strategies to reinforce that framework.

The United States should reject the bookend dangers of excessive accommodation and containment. Accommodation that diminishes an open, rules-based order is a slippery slope to an alternative system of weakened values and lower prosperity. Containment is, at best, a gradual slide to fragmentation and discriminatory trading blocs that, as a practical matter, diminish prosperity for the region. There is a third way—a principled position combining vision, strength, and a commitment to inclusiveness around high standards. The view that rising powers can be integrated into the existing order, in a manner that addresses common interests, remains valid. However, this can be achieved only with greater commitment to the region by the United States.

# CHAPTER 4

# OVERARCHING DIMENSIONS OF US LEADERSHIP IN THE ASIA-PACIFIC REGION

The sinews of US global leadership have been the multiple dimensions of unparalleled US assets—economic and financial strength, technology, entrepreneurial innovation, military and diplomatic capabilities, natural resources, and the appeal of US culture, and political and social values. In this sense, domestic and foreign policies are deeply and inexorably intertwined. Current domestic problems notwithstanding, no other nation has the panoply of components of national power possessed by the United States, nor is any likely to do so by 2030. Yet, most of the current and emerging global problems cannot be addressed unilaterally by the United States or any other power. In this more complex world, US leadership needs reenergizing and should adopt a more agile style to lead coalitions of the willing and able. With US diplomacy and economic statecraft operating in an increasingly difficult environment, there will be a greatly reduced margin for error.

## Strength Begins at Home

One large strategic question facing the United States in the generation ahead is how to avoid a negative future of drift—an eroding international system dissolving into inward-looking nationalism, and zero-sum behavior and mindsets on the part of major powers. Sustaining America's will and capacity for leadership will be necessary but not sufficient to maintain and adapt the current international economic, political, and security arrangements robustly enough to meet current and emerging challenges. At this historic juncture, when power is more diffuse, the questions of how norms and rules are shaped and enforced and who will supply what public goods to sustain a buoyant global polity are key to the viability of the evolving global order. Strength at home is a prerequisite for the United States' ability to sustain a leadership role. This requires a dynamic, globally competitive economy, as well as a political system able to address key domestic challenges: refurbishing dilapidated infrastructure; reducing the national debt; reforming corporate taxes; investing in basic and precompetitive research and development (R&D) to maintain US innovation; and improving the education system.

In the period since the 2008 financial crisis, reports of US decline have proven greatly exaggerated. Indeed, the United States has demonstrated relative resilience. With economic growth at 2.5 percent in 2014, and projected at 3 percent for 2015, the United States is the fastest-growing G7 nation. The US budget deficit has declined to 2.7 percent of gross domestic product (GDP), and is projected to drop to 2.4 percent through 2018.[21]

A key factor driving US economic resilience has been the unexpected bounty of the shale revolution, the combination of computer-aided horizontal drilling and hydraulic fracturing known as "fracking." The United States has become the world's largest producer of oil and gas hydrocarbons. It is projected to surpass Saudi Arabia as the world's top oil producer by 2017 and become a net exporter by 2030.[22] There are ample natural gas reserves to meet current US demand for a century, with modest projections for the growth in demand.

Cheap natural gas has provided a competitive advantage rippling through other sectors of the economy. In energy-intensive industries such as chemicals, iron, steel, cement, and petrochemicals, this has led to a resurgence of manufacturing, including substantial foreign investment from Europe and Japan to these industries.[23]

The economic fundamentals are in place to position the United States to play a leadership role globally, including in the Asia-Pacific region. The overarching challenge is whether the political will can be mustered to address significant political challenges as discussed above.

There is broad, bipartisan support for sustaining the US economic and military posture in the Asia-Pacific. A redefined, active, and agile US leadership, along with sound statecraft, will be required to fashion new partnerships with emerging powers and nonstate actors, in order to preserve and update the open, rules-based norms of the international system.

21 Congressional Budget Office, "The Budget and Economic Outlook: 2015 to 2025," https://www.cbo.gov/sites/default/files/cbofiles/attachments/49892-Outlook2015.pdf.
22 Elisabeth Rosenthal, "U.S. to Be World's Top Oil Producer in 5 Years, Report Says," *New York Times*, November 12, 2012, http://www.nytimes.com/2012/11/13/business/energy-environment/report-sees-us-as-top-oil-producer-in-5-years.html?_r=0; Oil production is now 9.3 million barrels per day (mb/d), the highest level since 1994. Natural gas production is 72 billion cubic feet per day (bcf/d), about 40 percent of which is from shale. US Energy Information Agency, "U.S. Crude Oil Production in 2013 Reaches Highest Level Since 1989," March 12, 2014.
23 "From Sunset to New Dawn," *Economist*, November 16, 2013, http://www.economist.com/news/business/21589870-capitalists-not-just-greens-are-now-questioning-how-significant-benefits-shale-gas-and.

Sound statecraft will also necessitate a stronger institutional and human resource capacity in the US departments and agencies that deal with international affairs.

The so-called "rebalance to Asia" has reinforced ties with US allies and security partners in the region, as evidenced in the new US-Japan Joint Defense Guidelines released during Japanese Prime Minister Shinzo Abe's recent state visit.[24] However, economic statecraft has been less adroit. The United States' initially hostile response to China's AIIB proposal confused many in Asia. Economic diplomacy has focused on the Trans-Pacific Partnership, with mixed success. Political difficulties in getting the trade promotion authority essential for the deal has led many in Asia to fear that US political paralysis and partisan discord might raise questions about the durability of the US commitment to the region.

Similarly, congressional failure to approve the 2010 IMF reform, which would have increased voting rights for China and several other emerging economies, sowed doubt among Asians about US leadership. Absent adroit US stewardship to adapt regional and global financial institutions to better reflect the economic weight of China and other emerging economies, the legitimacy of those institutions could erode, and support for alternative institutions might grow.

The United States' fundamental operating principles and tools, designed to advance US interests in the aftermath of World War II, appear durable. Essential ingredients for sustaining security and prosperity continue to include: a strong, credible defense; a market-based, open trade and financial system; multilateral economic, financial, and political institutions with agreed-upon rules and norms; and, not least, a network of alliances and partnerships. But these require proactive US efforts to shape the contours of change in the governance of the world financial system, and the regional and global trade framework.

## Robust US Engagement in the Asia-Pacific Is Not a Capacity Issue

As the world's largest and most innovative economy, the United States has the human talent and financial resources needed for robust engagement. Today, the United States lacks internal consensus on objectives and means. There are real concerns that trade and globalization are fostering more inequality, displacing US jobs and endangering the environment. In any case, if the United States cannot forge internal political agreement to invest in a more assertive regional strategy, then the United States, over time, will be left with a more Sinocentric and fragmented regional order. The integration strategy is still essential, but it requires more dynamic US economic leadership for it to work. The United States must up its game. There is a price for political polarization and dysfunction. The United States must deliver politically, in a way that convinces allies of the durability of commitments to the existing order. Difficulties in persuading the US Congress to approve an IMF quota package, trade promotion authority ("fast track") and US Export-Import Bank Reauthorization reflect weak political leadership domestically. Partisan polarization on international economic issues should not be seen as a permanent feature of the American political landscape. Perhaps the 2016 presidential election and its results will offer an opportunity for a more unified, bipartisan commitment to stronger US engagement in the Asia-Pacific region. The measure of any such US commitment is progress on many of the issues this paper has identified.

24 Aaron Mehta and Paul Kallender-Umezu, "US, Japan Strike New Military Agreement," *Defense News*, April 27, 2015, http://www.defensenews.com/story/breaking-news/2015/04/27/us-japan-new-military-agreement/26443297/.

# CHAPTER 5

# BRETTON WOODS MONETARY ARCHITECTURE

## Seventy Years of the Bretton Woods Architecture: Its Evolution and Its Enduring Strengths and Weaknesses

For the last seventy years, the Bretton Woods institutions—the International Monetary Fund and the World Bank—have provided the overall institutional architecture for the global economy, and the Asia-Pacific region as well. Over time, other institutions have been added, including the World Trade Organization and the various regional multilateral development banks such as the Asian Development Bank. The major shareholders of the IMF and World Bank have shown themselves able to adapt those institutions to changing global economic circumstance—from the termination of gold convertibility of the US dollar in 1971, to the oil price shocks of the 1970s, to the Plaza and Louvre Accords to stabilize exchange rates in 1985 and 1987, to the Latin American debt crisis in the late 1980s, to the Asian financial crisis in 1997, and to the global financial crisis in 2008-09.

These crises notwithstanding, the contribution that the Bretton Woods institutions have made to Asia-Pacific economic development, growth, and financial stability has been profound. Despite well-founded critiques of specific policies associated with it and considerable turmoil and conflict at various times in its history, this global architecture as a whole, along with its more-focused regional institutions such as the ADB, has been an integral part of the growth story in Asia in the past decades. Today, it is recognized as such by most countries in the region.

During the seventy years post-Bretton Woods, the US dollar has held the role of predominant reserve currency in the global economy. Despite the presence of other reserve currencies, in particular the euro, the dollar has provided the primary source of liquidity to the global economy; US monetary authorities have demonstrated a willingness to provide global leadership in times of financial crisis and balance-of-payments volatility.

## Beyond the 2008-09 Financial Crisis: IMF Institutional Reform and the G20

The 2008-09 financial crisis led to strong calls for a "new Bretton Woods" and a reformed architecture for coordinating policies among major countries. Within some parts of Europe—and certainly in Asia, particularly in China—there were calls for major reform of the Bretton Woods architecture and the replacement of the dollar as the world's primary reserve currency. In that timeframe, China called for the end of dollar hegemony and the use of the IMF's Special Drawing Rights (SDR) as a new international reserve currency. For some, the 2008 crisis signaled the breakup of the Washington Consensus—the liberal international economic order, of which the Bretton Woods institutions were a central part.

The financial crisis has not led to the dramatic reform some were seeking. Nonetheless, the global financial crisis was the trigger for establishing the G20 as the primary forum for discussion and coordination of global financial and economic policies. The G20 replaced the G7 and G8 as the "steering group" among major economies.

The United States was a driving force in establishing the G20—motivated by the belief that with the rise of new centers of economic power and the strength of globalization, a new mechanism with broad representation was required to address financial shock on an emergency basis, to coordinate an agenda that would reduce the effects of future crises and to restore global economic growth. A centerpiece of that agenda—pursued by the newly created Financial Stability Board, with a mandate to bring about harmonization among major markets—was financial regulatory reform to place new capital adequacy standards on banks, to enhance financial supervision, and to deal with other structural weakness, such as over-the-counter (OTC) derivatives trading.

In managing the financial crisis and its aftermath, the G20 saw a key role for the IMF in identifying financial vulnerabilities in the system and in providing mechanisms through which balance-of-payments issues could be addressed. The IMF, post-financial crisis, has a new sense of mission and authority. As the crisis in US financial markets receded, the

IMF's mandate enlarged, as it took on the task of seeking to manage (with the European Central Bank) the euro crisis, the debt crisis and rescheduling in Greece, and economic turmoil in Ukraine and in Iraq, Syria, and other Middle Eastern countries.

As part of the G20 response to the global financial crisis, and in an effort to provide a governing structure in the IMF that is more reflective of certain large, emerging markets' contributions to the global economy, an agreement was reached in December 2010 on a wide-ranging package of IMF institutional reforms. This package doubled the IMF's core quota resources and revised the IMF voting shares, including significant increases in voting share for China, Brazil, and Mexico, offsetting reductions in European shares and virtually no change in US voting power.

## Rising-Power Demands for Reform Focus on Governance and Larger Voice

China has continued to be supportive of the IMF, while simultaneously pressing for governance reforms and raising longer-term questions as to IMF legitimacy and capacity. This two-pronged approach appears to reflect China's recognition of the positive international role played by the IMF. In terms of core mission, since 2008 there has been a massive expansion of IMF lending capacity. There has also been a shift away from traditional IMF support for austerity, and toward greater flexibility and acceptance of deficit financing and unconventional monetary approaches, and more patience with the domestic reform pace and trajectory of member countries. Though this could change over time, apart from governance, China is not pressing for large, actionable proposals for IMF reform.

China and many others periodically call for improved macroeconomic policy coordination. However, in this world of sovereign states, there is little appetite to delegate new authority to the IMF, G20, or Financial Stability Board (FSB) to override sovereign decision-making. In short, major powers, including China and the United States, prefer a platform for policy discussion and voluntary coordination as to how domestic policies or financial regulation might be harmonized. Major powers are prepared to utilize peer pressure mechanisms to sustain implementation of consensus, but there is no enforceability and no hard legal sanctions.

Since the 2008-09 financial crisis, there has been a massive expansion of IMF lending capacity to address payment imbalances and vulnerabilities. The IMF quota has doubled, and bilateral lending commitments have been obtained in the euro context. Globally, the system is better able to withstand financial shocks. At the same time, the major shareholders desire advance warning of vulnerabilities, and see the utility of advance mobilization of liquidity in the face of possible future financial shocks or imbalances. Calls for a new global currency to serve as an alternative to the dollar are now muted. In 2009, China had suggested that the world adopt the SDR as an international reserve currency. However, although there may be theoretical arguments for reducing dollar hegemony and for a new currency regime, no major power today places this high on its agenda. Major shareholders appear to recognize that alterations will take time, and that the rise of new reserve currencies must be accepted by the market.

Regarding the IMF's process of reviewing economies of IMF member countries, its so-called "surveillance," there is broad agreement that this is an important function. Countries may not welcome international pressures on imbalances or for financial market opening, but the surveillance process provides only passing discomfort, and the G20 sees the necessity for IMF assessment of global risk to the financial system.

As to financial regulatory action to create more resilience in the system, the agenda proposed by the G20 in the wake of the 2008-09 financial crisis has essentially been put in place. Activity has now shifted to less regulated areas of the financial system ("shadow banking") and the monitoring of regulation implementation. At a political level, this process has been widely accepted. China has supported the FSB agenda, and has not sought distinct regulatory approaches. In fact, China has four globally systemically important banks (G-SIBs), so designated by the FSB.

Regarding policy advice and conditionality, the IMF post-2008-09 financial crisis has shown flexibility sufficient to maintain broad G20 support. China is now a creditor and can take a firm line on needed adjustment in a borrower, though it wishes for the international community's patience with respect to its own stated intention to move to currency convertibility and the elimination of capital controls. Though an annoyance, China views this as a manageable cost of participation in the IMF, rather than fundamentally interfering with its domestic decision-making. China itself has adequate reserves and would not expect, even in a period of financial crisis, to borrow from the IMF and subject itself to IMF policy conditionality. Over time, as its voice in the institution grows, China can be expected to place its own mark on the substance of IMF policy advice.

Governance is the area of IMF reform where the greatest conflict of interest among major powers can be expected in the years ahead. The debate on governance will likely fall into the following categories:

- implementation of the 2010 quota reform package;

there will also be pressures for further revision of quotas (assuming passage of the 2010 agreement);

- revision of decision-making process to eliminate the US veto, though this cannot happen without US concurrence; and
- selection of the head of the IMF based on merit, rather than nationality.

The G20 process will be the primary channel for the resolution of IMF governance proposals. Representing some 85 percent of the global economy and over two-thirds of the world's population, the G20 has emerged as the major venue on global financial institutional governance in the aftermath of the 2008-09 financial crisis.[25] China will assume the presidency of the G20 in 2016 and can be expected to place the issue of governance high on the agenda of the G20 Summit. It will predictably push for agreement on the package of governance reforms described above. If the US Congress has not passed the 2010 package by then, China will likely press for implementation of the 2010 reforms without action by the US Congress. In sum, if allowed to fester, the governance issue threatens to provoke a crisis of legitimacy for the IMF and significant damage to US interests and global standing.

China could also propose "institutionalization" of the G20, such as the creation of a permanent G20 secretariat, as some within State Council circles have already suggested, but China has not yet formally conveyed its intentions.

## Asian Monetary Fund: A Long-Term Dream or a Realistic Initiative?

The IMF has been the primary international organization providing liquidity and balance-of-payment support for Asia in times of financial crisis. However, the Asian financial crisis of 1997 triggered the emergence of specific regional arrangements directed at addressing financial shocks and balance-of-payments issues—in part due to Asian unhappiness with the IMF's response to the 1997 crisis. The concept of an Asian Monetary Fund was first proposed by Japan during the 1997 crisis. At that time, the United States opposed the initiative, and the proposal faded away. However, post-crisis, finance ministers of ASEAN Plus Three (APT)—China, Japan, and South Korea—agreed in May 2000 to establish a network of bilateral swap arrangements (referred to as the Chiang Mai Initiative) that would be available in the event of a future Asian crisis. During the subsequent global financial crisis, the same groups of finance ministers agreed to integrate these swap lines into a pooled arrangement referred to as the Chiang Mai Initiative Multilateralization (CMIM). Under CMIM, the swap arrangement was increased to $120 billion in 2010 and to $240 billion in 2012. China and Japan each contributed $38.4 billion, and South Korea contributed $19.2 billion.[26] Under the CMIM, a country in crisis may draw beyond 30 percent of its line only if it has an IMF program in place, with policy conditionality.

In April 2011, the APT finance ministers also agreed to establish in Singapore the ASEAN Plus Three Macroeconomic Research Office (AMRO), a regional macroeconomic surveillance unit to monitor and analyze regional economies and to support CMIM decision-making. By agreement of the parties, the first head of AMRO was a Chinese national, and the second was Japanese.

The progress achieved in the past five years by these arrangements reflects the APT governments' commitments to strengthening regional financial cooperation in order to ring-fence their economies from global shocks, as well as from financial instability within the region. However, although CMIM and AMRO have the potential to become the building blocks for an Asian Monetary Fund, challenges remain as to their effectiveness and capacity in terms of becoming a regional financial safety net and credible surveillance unit for the APT economies. Some weaknesses can rather easily be addressed with political will, such as the small size of AMRO's staff capacity compared to the surveillance offices of the IMF and ADB. There has also been debate regarding the adequacy of CMIM resources compared to what was required during the Asian financial crisis, or compared to the European Stabilization Facility as a percentage of GDP. The needed financial resources might also be addressed with sufficient political will.

Nonetheless, although the CMIM and AMRO have the potential to evolve into an Asian Monetary Fund, at this point there does not appear to be a supporting narrative. While there are still widespread feelings in Asia that the IMF is not responsive to Asian requirements, there is also recognition in Asia that the IMF, post-Asian financial crisis, has learned lessons and that the Asian voice is now enlarged through the G20. Moreover, major Asian countries have self-insured against payments vulnerabilities by accumulating large reserves. These reserves and bilateral swap lines, in effect, reduce the need for an Asian monetary institution. The bilateral swap lines now in place, together with the Chiang Mai Initiative Multilateralization, provide a significant pool of liquidity, though a pool smaller than the IMF's lending capacity. Moreover, CMIM is not delinked from the IMF, as access-

25 Austrian Government, Department of Minister and the Cabinet, "Fact Sheet: Why the G20 Is Important," https://g20.org/wp-content/uploads/2014/12/Fact%20sheet-Why%20the%20G20%20is%20important.pdf.

26 Chalongphob Sussangkarn, "The Chiang Mai Initiative: Origin, Development, and Outlook," ADBI Working Paper Series no. 230, ADB Institute, July 2010, http://www.adb.org/sites/default/files/publication/156085/adbi-wp230.pdf.

ing more than 30 percent of a country's line still requires an IMF program with policy conditionality.

There could be incremental movement toward an Asian monetary regime with the growing development of CMIM and AMRO, but there is no political urgency for it. Consensus in that direction is burdened by political issues among participating CMIM countries—most importantly, the rivalry between China and Japan. Nonetheless, the medium-term possibility of an alternative monetary institutional structure in Asia cannot be entirely discounted. China could decide, for geopolitical reasons, to announce backing for the Asian Monetary Fund concept, even without clear support from other major players such as Japan—perhaps during the next regional crisis, though less likely in normal times. The odds of this would increase should the IMF experience a crisis of legitimacy over governance issues. China has sufficient resources to pursue this proposal outside the CMIM, and even to shift its CMIM resource commitment into a new institution. Whether China could garner the support of ASEAN countries for such a move might depend on whether other, stronger countries fear spillover effects, and whether other vulnerable countries are experiencing immediate balance-of-payments difficulties, though Asian countries would not want a Chinese veto over their balance of payments financing needs.

## RMB Internationalization: Its Implications for Institutions and Markets

Beginning in 2009, China embarked on a policy of deliberately seeking to internationalize the RMB—that is, to push the use of the RMB to settle trade contracts, to encourage its use in offshore financial and investment transactions, and to ultimately become a reserve asset held by central banks throughout the world. Since that time, the use of RMB for trade settlement in China's import and export transactions has increased dramatically to 30 percent. The amount of RMB held offshore by financial institutions and investors has also grown, though in a more limited manner. As a reserve currency, the RMB remains small, less than 1 percent of assets globally held by central reserve managers. By comparison, approximately 62 percent of reserve assets are in US dollar-denominated assets, and 23 percent are in euro-denominated assets.[27]

Clearly, if the RMB were to become more widely used in investment transactions and in holdings of central banks, over time this would have market implications as well as, perhaps, geopolitical implications. However, there are constraints on the ability of Chinese authorities to create demand for the RMB beyond what the market would do. Foremost, the ambition of China to internationalize the RMB will depend on significant development of policy on several fronts—that is, development of its domestic equity and debt markets, capital account liberalization, and the convertibility of its currency. Foreign holders of RMB will undoubtedly require deep and liquid domestic capital markets in China. Achieving this will take time; this is acknowledged by China's monetary authorities, who are quick to say they do not see the RMB rivaling the US dollar before 2030-35. They do hope for the RMB to eventually become a significant reserve currency in a multi-reserve currency world. However, the speed with which the RMB is internationalized will be determined by the extent and pace of China's financial markets, capital control, and exchange rate liberalization. In other words, its future is primarily within China's hands; today, it is not constrained by international financial institutions or other major powers.

One step forward in the RMB's march to become a significant reserve currency would be inclusion in the IMF's SDR basket of currencies. The SDR is an IMF-created unit of account whose value is based on a basket of major currencies. (It is not an international currency, although it does serve as a reserve asset.) Today, that basket consists of the US dollar, the euro, the British pound, and the Japanese yen. Over the course of 2015, the IMF will be undertaking a review of whether to add the RMB to the SDR basket. China has indicated a strong desire to be included in the basket—in part, because of the legitimacy inclusion would presumably accord the RMB. There are criteria under IMF rules for including a currency in the SDR basket, one of which is that the currency be "freely usable" internationally. Whether China meets that standard will be debated within the IMF later in 2015.

In late May, IMF management took the position that China's currency is no longer "undervalued." This reverses its previous criticism of China's management of the RMB, and appears to place the IMF at odds with the US position that China derives unfair advantage from a significantly undervalued currency. The new IMF management stance will play into the decision later this year about whether to add the RMB to the SDR basket. Although China's RMB has experienced real, effective appreciation, China continues to run sizable current account surpluses and strong inflows of foreign direct investment. Moreover, greater appreciation appears required to reduce external imbalances and support internal rebalancing away from growth led by exports and fixed asset investment. China needs to make further progress in reducing exchange rate intervention, and permit the market to assume a greater role in determining the value of the RMB. This being the case, the United

27 "China on the World Stage," *Bloomberg Brief*, April 27, 2015, http://www.bloombergbriefs.com/content/uploads/sites/2/2015/04/China-Global-Stage.pdf.

States should support the inclusion of the RMB in the SDR basket—provided China has first reached full liberalization of its capital account, free convertibility of its currency, and full disclosure under IMF reporting standards of its foreign exchange reserves and their composition and its foreign exchange market intervention.

The United States should, in diplomatic terms, position itself as a dynamic reformer, not a defender of the status quo. Rising powers can be expected to make an ongoing and escalating set of demands for greater voice and representation. However, the United States' ability to manage these pressures will depend, in part, on its ability to get out front on issues and demonstrate the value of its leadership to friends and allies, rather than responding defensively, or being dragged belatedly into adjustment or compromise.

## Recommendations

- *Pass IMF Quota Reform*: The US Congress, with all due speed, should pass the December 2010 IMF quota reform package. If the United States' political process cannot deliver on the commitments of its executive branch, it is likely to provoke a crisis of legitimacy within the IMF and open the door to new, regional institutional initiatives. The G20 has shown patience with the delay—perhaps because it recognizes the political complexities of the US domestic process and it continues to value strong American leadership within the institution. However, this tolerance likely has its limits. Failure to approve the package will undermine the United States' persuasive ability to generate support for its own substantive policy initiatives on international economic and financial matters.
- *Give Priority to the G20 Process for Macroeconomic Leadership in the Asia-Pacific Region*: Economic leadership for Asia should not be the purview of a G2 (the United States and China) or "Asia for Asians." Rather, it must be connected to a global process. Otherwise, fragmentation will emerge, along with divergent norms and standards. Through the FSB, the G20 provides a proven mechanism for the alignment of financial regulatory policies on a global basis. If the G20 demonstrates its effectiveness, alternative mechanisms will lack support. US activism can help bolster the G20.
- *Use the IMF and G20 to Further an Open Financial Market Policy Agenda for the Asia-Pacific Region:* The United States should more intensively utilize the IMF and G20 as major platforms for pursuing, in the Asia-Pacific region, its agenda of open and innovative financial markets, exchange rate convertibility, the elimination of capital controls, capital market development, and liberalization of investment regimes in the financial sector.
- *Give Emphasis to Monitoring the Impact of New Global Regulatory Initiatives*: The United States should push for stronger monitoring of implementation of the recent global financial regulatory initiatives, such as Basel III, and the impact of regulation on economic growth and financial innovation.
- *Expand Peer Review*: Major power support for reliance on soft law approaches to compliance with best international practice and agreed-upon standards will not change anytime soon. The United States should place greater emphasis on new and expanded peer review mechanisms as an aid to compliance.
- *Advocate Governance Arrangements Based on Contribution to the Global Economy*: The United States should position itself as seeking fair allocation of quotas reflecting economic contribution and responsibility, and not as the defender of the status quo. There is still a need to distribute away from Europe and toward emerging markets. In addition, the United States should announce that the next selection of the IMF Managing Director and President of the World Bank, as well as the leaders of all multilateral lending institutions, should be based on merit, not nationality. As to the inclusion of China's RMB in the SDR basket, the United States should position itself as welcoming inclusion—provided China reaches full liberalization of its capital account, free convertibility of its currency, and disclosure of foreign exchange market intervention.
- *Press for Data Disclosure and Transparency*: The United States should press for full disclosure by all G20 countries of the investment of central bank reserve assets and foreign exchange market intervention, and for enhancement of domestic economic and financial data reporting. Not all major Asian countries provide sufficient transparency to permit the G20 and IMF to benchmark progress toward economic and financial reform, or to perceive financial weaknesses in these economies.

# CHAPTER 6

## FINANCING DEVELOPMENT AND INFRASTRUCTURE IN THE ASIA-PACIFIC REGION

Over the past seventy years, both bilateral government financing and multilateral development banks have supported development and infrastructure financing in the Asia-Pacific region. The Bretton Woods arrangement in 1945 created the global World Bank Group to address poverty and development on a multilateral basis. On a regional basis, the Asian Development Bank was established in the 1960s to complement the World Bank architecture.

Historically, the United States and Japan have been the two largest bilateral donors of official development assistance (ODA), and their official export credit agencies have also been significant sources of infrastructure and project finance.

During the past two decades, China has also entered the development and infrastructure finance field in a major way. Its policy banks have become the world's largest financing source of infrastructure projects (see table 3). In 2012, the China Development Bank, China's primary policy lending institution supporting infrastructure, became the world's largest financing institution—exceeding annual lending by the World Bank and the Asian Development Bank combined.[28]

Today, the only international agreement specifying rules governing export financing by governments is the OECD Arrangement on Officially Supported Export Credits. However, its members include only OECD countries; China and other BRIC countries are not bound by its provisions. Over the past decade, the percentage of official support for exports in compliance with the OECD Arrangement has declined significantly, from approximately two-thirds in 2004 to no more than one-third in 2013.[29]

The need for infrastructure in Asia is enormous. The Asian Development Bank estimated in 2012 that the region required an additional $8 trillion in infrastructure investment through 2020.[30] Government-related financing, including from the multilateral development banks, will not be sufficient to fill this gap. The ADB's 2014 operations, including cofinancing, totaled $21.6 billion, 80 percent of which was for infrastructure, or less than 2 percent of Asia's infrastructure needs. It follows that projects will be heavily dependent on private capital—which has been reluctant to invest on a long-term basis. Institutional investors, in particular, are unwilling to commit major resources for large projects without various guarantees, which governments are reluctant to provide. In addition, in many instances, there is a mismatch between available investment options and the low credit ratings of emerging market borrowers. Moreover, policy uncertainties, political risk, and a lack of sound regulatory and legal framework discourage long-term investment. Bankable projects are probably much fewer than estimated; local governance poses great challenges to project development. Infrastructure as an asset class is undeveloped. It lacks a broad spectrum of investment vehicles, standardization, and efficient secondary markets to link demand for such investment with large pools of long-term capital.

The Asian Infrastructure Investment Bank (AIIB) initiated by China is proposed as part of the solution to the large infrastructure financing gap in Asia. Momentum behind the AIIB has been generated by the perception that the World Bank Group and ADB are slow and inefficient, their projects are complicated, if not overly designed, and they are unable to mobilize the huge amounts of capital needed. The entrance of the AIIB has focused the region and the global development community on the rules governing behavior related to financing infrastructure. In proposing the AIIB, is China seeking to create a parallel, but different, set of rules? Or is the AIIB complementary to the existing system?

More broadly, many commentators and analysts have seen the AIIB as a reflection of the rise of China and, amid criticism regarding the dominance of US-led global financial institutions, of China's intention to play a more assertive role on international economic matters—and even challenge the post-World War II consensus through creation of parallel financing institutions over which it can exercise greater influence. There is a widely held view that US opposition

28 Kevin Currey, "Some Evolving Trends at the World Bank," Briefing Note, Bank Information Center, May 2014, p. 7, http://www.bicusa.org/wp-content/uploads/2014/07/Some-Evolving-Trends-at-the-World-Bank.pdf.

29 *Export-Import Bank of the United States Annual Report 2014*, p. 12, http://www.exim.gov/sites/default/files/reports/annual/EXIM-2014-AR.pdf.

30 ADB, *Infrastructure for Supporting Inclusive Growth and Poverty Reduction in Asia* (Mandaluyong City, Philippines: 2012), http://www.adb.org/sites/default/files/publication/29823/infrastructure-supporting-inclusive-growth.pdf.

to the AIIB, at least until recently, has been a diplomatic failure for the United States. Former US Treasury Secretary Lawrence Summers went so far as to suggest that the launch of the AIIB "may be remembered as the moment the United States lost its role as the underwriter of the global economic system."[31]

China has characterized the AIIB as complementary and has articulated its willingness to sign on to standards compatible with those of the Bretton Woods multilateral development banks. Such high standards center around the following: inclusive shareholder governance and transparency; genuine multilateral decision-making; safeguards regarding the environment and population displacement; open procurement; and considerations of debt sustainability.

In a recent *Financial Times* interview, Premier Li Keqiang stressed that China does not "want to reinvent the wheel." Li said, "I wish to emphasize that the AIIB and ADB can work in parallel in promoting Asian development. And the initiative of AIIB is not to reinvent the wheel. Rather it is intended to be a supplement to the current international financial system. China wants to work with others to uphold the existing international financial system. . . . And if there is a need for reforming the current system, we are also ready to work with other countries to help make the system more just, reasonable and balanced."[32]

China appears to be setting for itself a high bar for judging the AIIB's operational effectiveness. It is very difficult to run a multilateral development bank, and, if the AIIB seeks to borrow on capital markets, it will be subject to market discipline and global standards for issuers, as well as all the same forces, including interest group politics, that have made infrastructure financing challenging for existing institutions.

The ADB has taken a collaborative approach toward the AIIB, offering to cofinance infrastructure investments with the AIIB once it is established and assuming it adheres to international standards on safeguards and governance. Moreover, the ADB has indicated a willingness to provide the AIIB with technical assistance, particularly in its start-up phase. The United States is now on record as favoring a collaborative approach with the AIIB, and between the AIIB and other multilateral lending institutions.

Even with the initiatives outlined above, there is significant room for further enhancing the role of the ADB in infrastructure development in the Asia-Pacific region. The United States should partner with Japan and other major ADB shareholders willing to join in a new initiative to enhance the role of the ADB where the United States already has influence. The focus should be enhancing the ADB's lending capacity through more effective leveraging of private sector cofinancing, through streamlining the internal infrastructure project design and approval process and through eliminating red tape, to make ADB a faster and more efficient organization without compromising on appropriate standards. A recent initiative of the ADB to merge its two lending windows, the Asian Development Fund (ADF) and its ordinary capital resources (OCR), will increase the ADB's lending capacity by 50 percent as of 2017.[33] Moreover, ADB President Takehiko Nakao recently suggested the possibility of a capital increase for the ADB.[34] The ADB currently has $165 billion in capital and the World Bank group $233 billion, compared to the $50 billion pledged by China for the AIIB, and perhaps another $50 billion from other AIIB members. These institutions together do not themselves have sufficient resources to fill the infrastructure gap, though they can leverage private capital.

In late May 2015, Prime Minister Abe announced a plan to significantly expand Japan's financing for infrastructure projects in Asia, including larger lending capacity for the ADB—perhaps through a capital increase and increased financing from the Japan Bank for International Cooperation. Abe pledged approximately $110 billion over the next five years.[35] Included in that amount is the previously announced merger of the ADB lending windows discussed above. Though no mention of the AIIB was made in Abe's announcement, the initiative is presumably at least partially in response to the AIIB. Moreover, as an apparent contrast to the AIIB, Abe emphasized Japan's preference for "high quality" and "innovative" infrastructure projects, and for mobilizing private sector investment financing.[36]

31 Lawrence Summers, "Time US Leadership Woke up to New Economic Era," *Financial Times*, April 5, 2015, http://www.ft.com/intl/cms/s/2/a0a01306-d887-11e4-ba53-00144feab7de.html#axzz3aDDzez9K.

32 "Transcript: Li Keqiang," *Financial Times*, April 15, 2015, http://www.ft.com/intl/cms/s/0/3a42d156-e288-11e4-aa1d-00144feab7de.html#axzz3aDDzez9K.

33 Asian Development Bank, "ADF-OCR Merger to Boost Support for Region's Poor," May 2, 2015, http://www.adb.org/news/adf-ocr-merger-boost-support-region-s-poor.

34 "Asian Development Bank Pledges to Increase Lending, Cooperate with China-Led Bank," *Japan Times*, May 5, 2015, http://www.japantimes.co.jp/news/2015/05/05/national/politics-diplomacy/asian-development-bank-pledges-to-increase-lending-cooperate-with-china-led-bank/#.VXW_nE3bKUk.

35 Leika Kihara and Linda Seig, "Japan Reveals $110 Billion Plan to Fund Asian Infrastructure, Eye on AIIB," Reuters, May 21, 2015, http://www.reuters.com/article/2015/05/21/us-japan-asia-investment-idUSKBN0O617G20150521.

36 John Manning, "Can BRICS New Development Bank Compete with ADB and World Bank?," *International Banker*, June 8, 2015, http://internationalbanker.com/banking/can-brics-new-development-bank-compete-world-bank-imf/.

## United States Requires a Robust Long-Term Infrastructure Development Agenda in the Asia-Pacific

US national interests require that the United States advocate a strong development agenda for the region—in addition to its open market/trade agenda, which has garnered more attention over the years. A sustained US effort to boost infrastructure development in the region and strengthen the regional financing architecture is not merely a tactical short-term play to turn the page on the US diplomatic setback regarding the AIIB. Infrastructure development is a top priority for most nations in the region, and a key to long-term economic growth. Strong US participation in Asian infrastructure serves to strengthen US ties generally with nations of the region and creates bonds of partnership and a storehouse of goodwill serving broader American interests. It also opens the door to wider participation of American firms in the economies of the region, and boosting global growth will increase opportunities for US exports and investment. The United States cannot rely solely on military strength as the basis for its regional position.

Certainly, budgetary and political constraints have placed some limits on US initiatives, but there are compelling elements of leadership that do not require large government appropriations. There is room for more creative use of the existing institutions and for mobilizing the strengths of other major like-minded countries, such as Japan, South Korea, and Australia. The role of the private sector could also be more skillfully enhanced.

Moreover, if American leadership is not more active, there is risk that the region will evolve in the direction of spheres of influence—one built around Chinese efforts to gain influence through use of parallel institutions and bilateral investment support. The interests of the United States and the region will be best served by a common set of standards and practices. Existing global and regional institutions, with new reform dimensions, are well positioned to provide leadership, and to integrate new regional efforts as complementary components of a global institutional architecture.

From the outset, the United States has raised legitimate concerns as to whether the AIIB would operate on the basis of long-accepted standards, governance, safeguards, and transparency. It should continue to do so, and should work constructively with like-minded founding shareholders. However, US diplomatic efforts have been badly flawed. Despite legitimate policy concerns, the United States stood flatfooted in terms of adjusting to the political realities of the region. The United States failed to appreciate the strength of regional demand for new sources of financing for infrastructure, and the desire of nations globally to respond constructively to this need. In April, the United States modified its stance on the AIIB, and added to its messaging that it supported other multilateral institutions collaborating with the AIIB.

The United States and its allies should seek to ensure that China's stated intentions are more than rhetoric. There should be no expectation that the United States will join the AIIB, though it might be useful to seek observer status. Indeed, as a Pacific power, the United States does not need to be part of every multilateral institution in the region. In fact, it might in the future serve as opposition if the initiative clearly and seriously undermines established standards and norms. However, the United States—directly and in coordination with like-minded partners—should seek to encourage the AIIB to be a complementary component of the existing system, and one that operates on the basis of time-tested and high-quality norms and standards.

The United States should welcome constructive initiatives that enhance infrastructure development in the region and strengthen the regional financing architecture—provided they operate on the basis of high standards, are inclusive, and are connected cooperatively to global and regional institutions. An example of this would be urging that other financing initiatives recently announced by China, such as the Silk Road Fund and the New Development Bank (BRICS Bank), also operate on the basis of accepted standards and norms, including transparency and open procurement.

The United States needs an approach that plays to its strengths: capacity in existing institutions, broad support for time-tested norms, innovative private sector, and strong allies and friends in the region.

## Recommendations

- *The United States Should Advocate a Strong Development Agenda for the Asia-Pacific Region, Including Infrastructure, alongside its Open Market Trade Agenda.* This is a top priority for most nations in the region and a key to their long-term economic growth. There are compelling elements of US leadership that do not require large US budgetary appropriations, including stronger support for local governance reforms, more effective delivery by existing multilateral institution, leveraging private sector resources, and encouraging larger resource contributions from like-minded partners in the region.
- *Launch a New Initiative to Enhance the Asian Development Bank*: The United States, Japan, and other like-minded ADB shareholders should launch a new

initiative to further enhance the lending capacity of the ADB and to improve the speed and efficiency of infrastructure project development and decision-making. The United States and Japan should take the lead in supporting a capital increase for the ADB in the 2016-18 timeframe. Over the past two years, the Asian Development Bank, under the leadership of President Nakao, has undertaken a number of significant initiatives to elevate its capacity and effectiveness. These have been pursued in steady fashion, without the drama accorded the AIIB. They address many of the criticisms the ADB has faced in recent times. However, the United States, Japan, and other like-minded ADB shareholders should launch a new initiative to further enhance the effectiveness of the ADB.

- *Strengthen the Foundations of Private Sector Participation in Infrastructure Projects*: The United States should back an initiative, probably within the G20, on creating a more welcoming regulatory, legal and market environment for infrastructure financing by private investors and on supporting development of an infrastructure asset class to support private institutional investment. The G20 has a number of initiatives underway that focus on creating a more welcoming regulatory, legal, and market environment for private capital. These include the Global Infrastructure Facility and Infrastructure Hub, announced at last year's Brisbane Summit. While the United States was supportive of these initiatives, there is room for enhanced US leadership in this field, including funding for more technical assistance on project design and preparation and on building government capacity to handle complex infrastructure projects. However, more significant than funding would be US backing for an initiative on rules of governance and steps to support creation of an infrastructure asset class to support private institutional investment. The rule of law, independent and non-corrupt regulators and judiciaries, and political stability are integral to raising large institutional capital.
- *World Bank Reform in Support of Infrastructure Development in the Asia-Pacific Region*: The United States should consider placing greater reliance on guaranteed instruments, including consolidation of the private sector guarantee operations of MIGA and IFC. In addition, the World Bank should consider increasing its lending capacity through leverage of IDA resources.
- *The United States Should be Prepared to Collaborate with New Multilateral Financing Institutions and Arrangements that Are Committed in Practice to High International Standards on Governance and Operations*. This principle should be applied to the AIIB.
- *Use Existing Global Mechanisms More Proactively and Creatively to Frame Behavior in the Asia-Pacific*: The United States should take the position that there is no effective regionalism in isolation from the global framework, or in operating on a contrary basis to it. Strong US leadership in the Asia-Pacific region flows from strong global leadership. Where it can, the United States should seek to use global institutions to frame the agenda at the regional level. It has successfully done this over the years through the G20 and the Bretton Woods institutions. The G20 is accorded legitimacy by its members, and is seen as a forum for addressing global concerns and regional concerns with global implications. The G20 includes most of the United States' European and Asian allies and partners. It should be utilized to address economic development and infrastructure issues of vital importance to the Asia-Pacific region.
- *Develop More Comprehensive and Effective Arrangements on Official Export Credits*: The OECD Arrangement today is ineffective, and should be replaced by a new, stronger set of disciplines that should be inclusive of all major countries providing export financing support. The playing field for major official providers of export credits, much of which support infrastructure development, should be leveled. In 2012, Presidents Barack Obama and Xi Jinping announced the creation of an international working group outside the OECD (as China is not an OECD member), to develop a new arrangement that would be more comprehensive and more effective. The group, which now includes sixteen nations, has made little progress to date in developing a comprehensive set of transparent, responsible international guidelines for the regulation of export credits. The United States should elevate the priority it gives to a new arrangement, and should place it squarely on the G20 agenda. Regardless, Congress should continue authorization of the US Export-Import Bank, an important tool for ensuring that US firms are not competitively disadvantaged globally.

# CHAPTER 7

# EVOLVING TRADE ARCHITECTURE—PILLAR OF GLOBAL GROWTH

For the past seven decades, international trade has been the engine of world growth and global integration. It was governed by the companion to the Bretton Woods financial institutions, the General Agreement on Trade and Tariffs (GATT), succeeded in 1995 by the World Trade Organization and led by the United States. International capital flows and investment, along with an open trade system, led to what is now viewed as the "golden age" of trade—1950-73, when trade grew by 8.2 percent per year, nearly double that of global economic growth.[37] Worldwide, global trade in goods and services grew from $2.7 trillion in 1980 to $23 trillion by 2011.[38]

The United States saw its reliance on global exports and imports of goods and services grow from 10 percent of GDP in 1960 to more than 30 percent by 2014.[39] Continual advances in transportation (e.g., shipping containerization), communications, productivity, and especially information technology (IT) have shrunk time and distance, reduced costs, and digitized many services. The US-China bilateral trade relationship totaled $592 billion in 2014.[40]

As trade agreements have evolved, they have addressed overall tariffs for manufactured goods, with a worldwide average of about 5 percent.[41] Key 1990s WTO agreements on financial services and IT set the stage for freer trade in the services sector, an area where the United States is very competitive globally and regularly runs a large trade surplus. As tariffs have diminished, more forward-looking trade agreements have set the trade agenda. These agreements reduced non-tariff barriers such as regulatory standards, investment and competition polices, intellectual property, state-owned enterprises, and dispute-settlement mechanisms.

Burgeoning foreign direct investment (FDI) has fueled the growth of global production chains since the 1980s, and these economic networks have fostered an increasingly integrated and interdependent world economy. In the process, Asia became a global production hub. Today, there are more than eighty-two thousand multinational firms, with some eight hundred thousand subsidiaries worldwide. They account for more than two-thirds of world trade, much of it with or between multinationals and/or their suppliers. The close relationship between FDI and trade is one reason why the United States has made an effort to protect US companies by negotiating bilateral investment treaties (BITs) that create more predictable investment environments, often gain reciprocal treatment, and include dispute settlement mechanisms. A centerpiece on the agenda of the US-China economic relationship is a BIT currently being negotiated.

Yet for all its success, the future of the global and Asia-Pacific regional trade system is clouded by uncertainty. US economic leadership is increasingly challenged. Globalization, seen in the 1990s as an engine of prosperity, is increasingly viewed as a source of inequality within and between nations. Unlike the previous eight global trade liberalization rounds, the Doha Round, begun in 2001, remains unfinished. Unlike during previous trade liberalization talks, which were dominated by the G7 nations, the new political weight of emerging economies—China, India, Brazil, Turkey, etc.,—made the talks more polycentric, complex, and politically unwieldy.

It is probably not a coincidence that the regional and global exponential increase in FTAs has occurred as the WTO's Doha Global Round of Trade negotiations has ended inconclusively after an effort that lasted more than a decade. As global trade liberalization has stalled, there has been a proliferation of bilateral, regional, and interregional free trade agreements since 1990, reflecting market-driven trade. According to the WTO, hundreds of FTAs are either in force or in various stages of negotiation.[42]

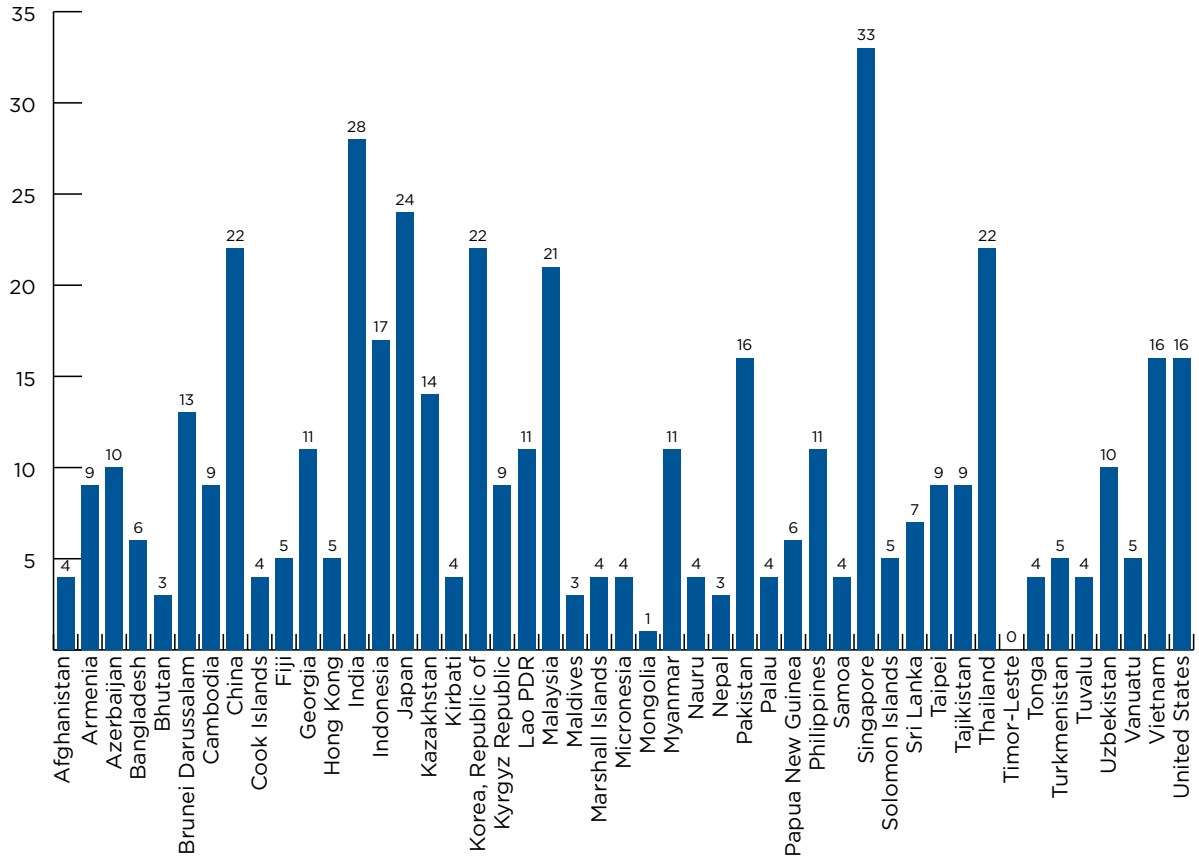
## The Asian FTAs "Noodle Bowl"

Driven by Asian-centric global supply chains, an explosion of bilateral and multilateral FTAs has occurred in the region over the past two decades. ASEAN has been at the forefront of this frenzy of overlapping Asia-Pacific bilateral

37 World Trade Organization, *World Trade Report 2013*, https://www.wto.org/english/res_e/booksp_e/wtr13-2b_e.pdf.
38 Ibid.
39 Ibid.
40 Wayne M. Morrison, "China-U.S. Trade Issues," Congressional Research Service, March 17, 2015, https://fas.org/sgp/crs/row/RL33536.pdf.
41 UNCTAD, Key Statistics and Trends in Trade Policy (New York and Geneva: UN, 2013), http://unctad.org/en/PublicationsLibrary/ditctab20132_en.pdf.

42 World Trade Organization, *World Trade Report 2013,* op. cit.

**Figure 3. Number of FTAs in the Asia-Pacific vs Number of US FTAs**




*Source*: Asia Regional Integration Center, ADB; Office of the United States Trade Representative.

and multilateral trade arrangements, which have grown from 6 in 1991 to 257 either currently ratified or in various stages of development. These FTAs are so complex that they have come to be known as the "noodle bowl."[43]

This web of FTA activity stems from—and comprises—a large portion of the global supply chains and trade and financial flows that define globalization. In 2013, intra-Asian trade exceeded 53 percent of the region's total trade.[44] Interregional trade and investment between emerging economies—evident in China's booming trade and investment with Africa and Latin America, and a robust energy nexus between Asian consuming nations and the Middle Eastern suppliers—continue to grow.

While there is a growing sense that these overlapping FTAs, with varying rules and sectors covered, need to be consolidated, none of these arrangements are necessarily problematic for the international system or inimical to US interests in Asia. They should be viewed in the same context as other regional pacts like the North American Free Trade Agreement (NAFTA), the EU, or Mercosur in Latin America. Indeed, the flurry of intra-Asian FTAs since the 1990s can be viewed, in part, as an Asian response to the creation of NAFTA and the EU, which solidified two major trading blocs. In addition, the trauma of Asia's 1997-98 financial crisis fostered a greater sense among Asians that they had to create their own regional institutions to protect themselves from external shocks.

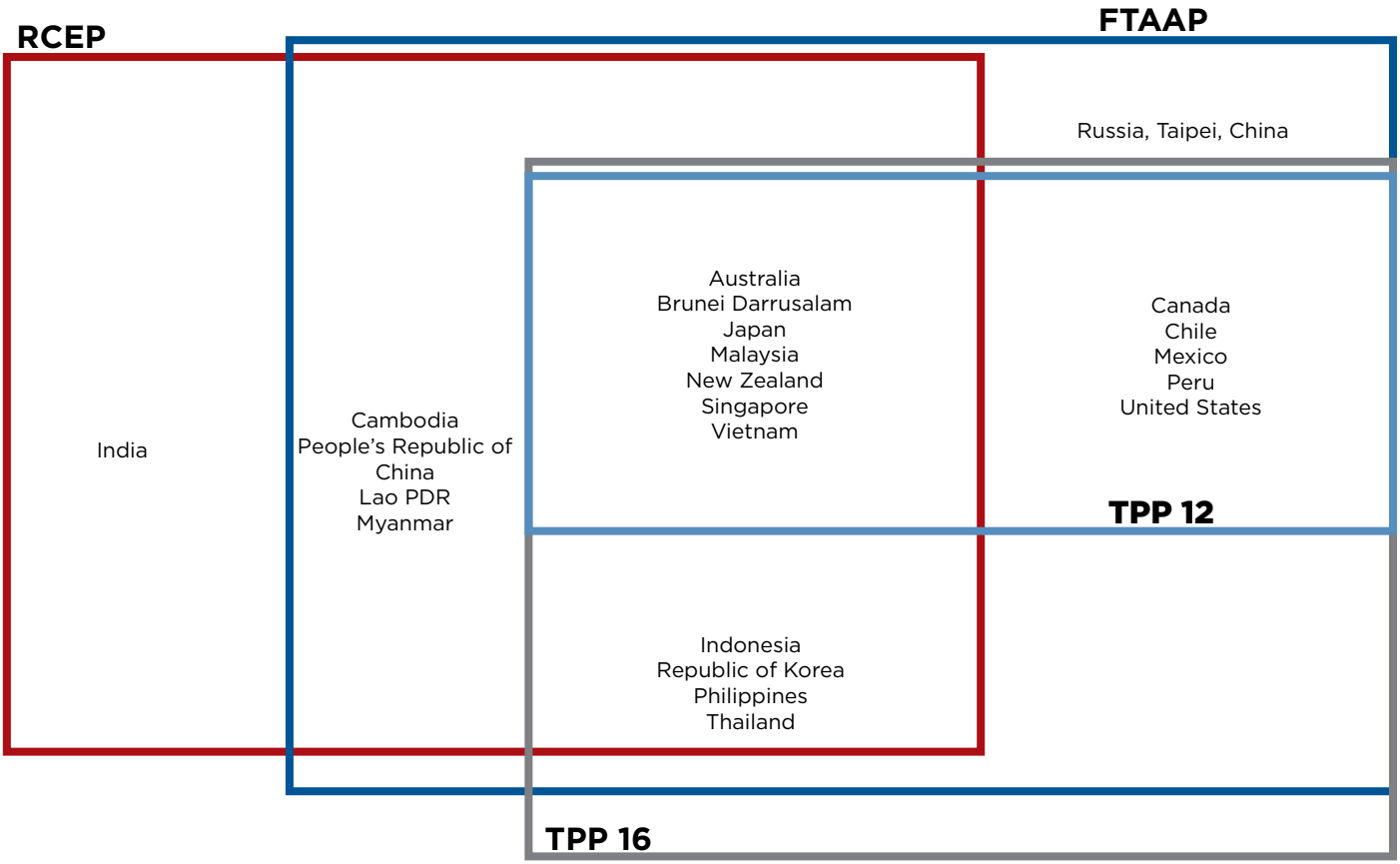
This process has evolved since 2012. ASEAN has been the driver of the Regional Economic Comprehensive Economic Partnership (RCEP), a trade arrangement that would involve ASEAN along with China, India, Japan, South Korea, Australia, and New Zealand, and which is still in the early stages of negotiation.[45] In Northeast Asia, a trilateral trade agreement between China, Japan, and the Republic of

43 Asian Development Bank, "Asian Free Trade Agreements: Untangling the Noodle Bowl," August 8, 2013, http://www.adb.org/features/free-trade-untangling-asia-s-noodle-bowl; Masahiro Kawai and Ganeshan Wignaraja, *Patterns of Free Trade Areas in Asia*, Policy Studies no.65 (Honolulu: East-West Center, 2013), http://www.eastwestcenter.org/publications/patterns-free-trade-areas-in-asia.

44 World Trade Organization, "International Trade Statistics 2014," https://www.wto.org/english/res_e/statis_e/its2014_e/its14_world_trade_dev_e.pdf.

45 For an overview of RCEP, see Australian Government Department of Foreign Affairs and Trade, "Regional Comprehensive Economic Partnerships," http://dfat.gov.au/trade/agreements/rcep/Pages/regional-comprehensive-economic-partnership.aspx.

**Figure 4. RCEP, TPP, and FTAAP Tracks**




*Source*: Peter A. Petri, Michael G. Plummer, and Fan Zhai, *The Transpacific Partnership and Asia-Pacific Integration: A Quantitative Assessment* (Washington; Peterson Institute for International Economics, 2012).

Korea (ROK) is also under discussion, buoyed by a 2012 trilateral investment treaty. These arrangements are potential competitors of the Trans-Pacific Partnership, a US-led effort that currently includes twelve countries, including several also involved in RCEP. While both are ambitious in scope, TPP is a higher-quality, more comprehensive accord including not only goods, but services, competition policy, intellectual property, government procurement, environment, and labor. Both claim an open regionalism and accessibility for other nations to join. At the November 2014 Asia Pacific Economic Cooperation (APEC) Summit, China called for a Free Trade Area of the Asia-Pacific (FTAAP), a still-vague idea originally put forward by the United States more than a decade earlier. However, this time around, the United States has appeared cautious toward the idea, fearing that a Chinese-backed version would complicate the TPP process.

## Whose Rules?

There are qualitative differences in both structure and content between RCEP and TPP, the two major efforts to reconfigure Asia-Pacific trade arrangements. RCEP is designed to expand its ASEAN Plus Three (South Korea, China, and Japan) to an ASEAN Plus Six (adding Australia, New Zealand, and India) and, in the process, to consolidate the "noodle bowl" of Asian FTAs. The TPP currently has twelve participating nations.

In regard to participants, the key distinctions are that the United States is not involved in RCEP negotiations, China is currently not involved in TPP negotiations, and India is in RCEP but is not an APEC member. With the largest and third largest world economies, the United States and Japan, a successful TPP would carry a lot of weight in determining the future of the global trade regime. Among other things, TPP is in effect a path to a US-Japanese FTA.

With regard to content, RCEP appears less ambitious about setting standards and more focused on harmonizing existing regional FTAs (e.g., differing rules of origin). Large, emerging economies such as China and India have tended to be cautious and limited in terms of the scope of their agreements. RCEP addresses tariffs, agriculture, and services in a more limited way than TPP, with an emphasis on "flexibility" in applying stricture and differentiation between more advanced and developing Asian members (e.g., exemptions in protected sectors). RCEP calls for "consul-

tations" to address disputes, rather than a binding arbitration mechanism.[46] RCEP will allow China to liberalize trade incrementally, at its own pace.

In contrast, TPP is billed as a more comprehensive "twenty-first century" trade accord that goes well beyond WTO norms to what are called WTO-plus issues (competition policy, intellectual property, government procurement, and investment) and will deepen trade liberalization and expand rule-making to include technical barriers to trade, sanitary and phytosanitary standards, e-commerce, and environmental and labor standards. Services, increasingly digitized, already comprise a large and growing component of trade, and TPP covers the fastest growing services—banking and finance, engineering, architecture, legal, accounting—and the digitization of services is likely to expand exponentially as access to IT and IT capabilities continue to improve.

TPP also expands market access, and would eliminate tariffs and increase transparency on nontariff barriers. TPP includes an accession clause with the intention of drawing in other regional economies and major trading nations, particularly China, which, as it transforms its economic model and needs the access and protections in TPP, might find it in its best economic interests to adhere to TPP standards and rules. Beijing has expressed interest: Chinese Premier Li Keqiang recently told the *Financial Times* that, "China is open to TPP."[47] South Korea has already expressed a strong interest in joining TPP, and the US-ROK FTA, which has similarly high standards, should facilitate its accession. In addition, Thailand, the Philippines, Taiwan, and Indonesia are already examining the benefits from and adjustment required in TPP provisions. All are likely candidates to join TPP before the end of this decade.

For the United States itself, the economic benefits are likely to be modest in the near term, adding, by some estimates, less than 0.5 percent to its $17 trillion GDP.[48] But TPP has a strategic importance beyond the goal of Asia-Pacific trade liberalization and must be viewed in its larger geopolitical context. TPP is a central component of both US global economic statecraft and the US rebalance to Asia. For the United States, TPP is a key vehicle for reinforcing, deepening, and broadening the US presence in the Asia-Pacific economy. This would not only more firmly bind the US economy to the most dynamic region of the world, but also strengthen the reassurance role the US security presence in the region plays by demonstrating the United States is a central part of the Asia-Pacific economic fabric.

In this regard, the shale revolution and the emerging US role as the world's largest oil and gas producer is an important part of the policy equation. Asia includes the largest importers of petroleum products, and the biggest importers of liquefied natural gas (LNG). To the degree that the US is able to export LNG and oil to the region, becoming a provider of energy security, it would reinforce both its economic presence and its security role. Congressional efforts to revamp 1970s-era regulations constraining oil exports, likely to be finalized this year, will facilitate this energy provider role.

TPP should also be viewed in tandem with the Transatlantic Trade and Investment Partnership (TTIP), under negotiation with the European Union. The United States and EU comprise the two largest markets in the world, and 45 percent of global GDP. TTIP is more complicated than TPP. With traditional trade barriers already very low, the challenge is that breaking down remaining trade and investment impediments between the United States and EU involves harmonizing complex regulatory regimes. Eliminating or reducing conflicting or redundant US and EU regulatory measures is the knottiest aspect of TTIP, but would result in benefits to both economies and help shape global standards. The completion of TTIP, along with TPP, would likely ensure that the G7 nations would have much greater leverage in shaping global trade and investment rules than would otherwise be the case for a generation or more.

In addition, there are several sets of important multilateral initiatives underway—a Trade in Services Agreement, an Environmental Goods Agreement, and an expanded version of the existing Information Technology Agreement. These fit well with TPP and TTIP and hold the promise of bolstering the WTO. There is also a Government Procurement Agreement finalized by more than forty WTO members. All these efforts are more congruent with TPP than with RCEP.

## RCEP-TPP Rivalry or Stepping Stones to Regional or Global Regimes?

While RCEP and TPP are often viewed as rival, competing trade regimes, trade is not a zero-sum game. As these trade accords evolve, there is a regional interest in facilitating a scenario where they are supportive of either an Asia-Pacific-wide FTA—centered around the high standards of the TPP—or become stepping stones toward a revitalized global regime, building on the WTO.

46 Inter-American Development Bank, "Guiding Principles and Objectives for Negotiating the Regional Comprehensive Economic Partnership," http://www10.iadb.org/intal/intalcdi/PE/CM%202013/11581.pdf.
47 Lionel Barber, "Interview with Li Keqiang," *Financial Times*, op. cit.
48 Peter A. Petri and Michael G. Plummer, "The Trans-Pacific Partnership and Asia-Pacific Integration: Policy Implications," Peterson Institute for International Economics, June 2012, http://www.iie.com/publications/pb/pb12-16.pdf.

The sequencing of the accords may have a significant influence on the evolution of the Asia-Pacific region to a more comprehensive free trade arrangement. Assuming that Republican-led bipartisan efforts to pass trade promotion authority succeed sometime this summer, the rhythm of TPP negotiations suggests the agreement could be finalized in 2015. At the same time, Japan is nearing completion of an EU-Japan FTA (an EU-ROK FTA entered in force in 2011). The US-EU TTIP negotiations would likely proceed beyond this timeframe. But, if concluded in 2017, for example, these two high standard accords will create momentum, and the reality of a substantial portion of global trade being governed by high quality trade and investment norms.

For its part, RCEP appears, by all indications, significantly behind TPP. A trilateral China-ROK-Japan trilateral FTA is a necessary intermediate step for RCEP to go forward, and those negotiations are still a considerable distance from completion. The 2012 trilateral investment accord set the stage for China-ROK-Japan FTA talks, which are hampered by problematic China-Japan and ROK-Japan diplomatic tensions. Overcoming differences between China, which has tended toward lowest-common dominator FTA commitments, and the ROK and Japan is likely to be an incremental, drawn-out process.

This timeline suggests that a successfully concluded TPP would enhance US leadership, positioning the United States and like-minded partners to pursue proactive economic diplomacy—within APEC, with ASEAN, and bilaterally with China—to explore ways and means to achieve a more inclusive TPP. To be sure, beyond content issues, there are significant procedural issues to be sorted out. For example, India is not a member of APEC, and thus not necessarily eligible to join TPP. However, post-conclusion of TTP, the following would be likely candidates to join the TPP within a year or two: South Korea, the Philippines, Thailand, Indonesia, and Taiwan.

Substantively, accession by China to the TPP would be a challenging prospect, even over the medium term. Differences on key provisions of the TPP are currently significant. However, the United States should make clear its desire to include China in the TPP, but on the same terms as other members. Chinese commentators often point to Beijing's exclusion from TPP as part of a narrative of US "containment." Such a stance would undermine the Chinese containment narrative, as well as strengthen the economic dimension of the US rebalance to the Asia-Pacific. Such moves would also have the effect of tilting US-China relations more toward the cooperative than the competitive.

Over time, China may also have special reasons for joining the TPP, related to its domestic reform agenda. When China acceded to the WTO in the late 1990s, China used the necessity of compliance with its WTO commitments as political leverage to implement certain market-oriented reforms. It is possible that the same logic would apply—and this might help explain Beijing's interest in TPP. Chinese accession to TPP would complement a more globally competitive, demand-driven Chinese economy than would RCEP and other regional trade arrangements in which China is a participant.

A Free Trade Area in the Asia-Pacific is a long-term objective currently on the agenda of APEC, but there is no agreed-upon pathway to an FTAAP. That pathway is complicated, both substantively and in terms of melding the variant FTAs in the region. The United States should be open to the FTAAP concept, but should make its top trade priority building the TPP into as large a membership as possible. Over time, the United States should also open other pathways to a strengthened, open, and high quality trading regime, both regionally and globally. However, it is not clear at this point that an FTAAP would be a stronger stepping stone to an enhanced WTO-type regime than would a pathway that centered on TTP and subsequent accessions by numerous other countries in the Asia-Pacific region, followed by a Japan-EU FTA and TTIP.

## Recommendations

- *Pass "Fast Track" Trade Promotion Authority and Conclude the Trans-Pacific Partnership in 2015:* The TPP represents the kind of forward-looking leadership the United States must exert in the region. The TPP is strategically important because it frames high standards of market openness among countries comprising 40 percent of the world economy and incentivizes countries outside to join. If TPA and TPP are not achievable in 2015, they should remain on the US agenda as a top economic priority, even into the next administration.
- *US Diplomacy Should Reach Beyond the Original Twelve Countries of the TPP:* The original twelve countries of the TPP should be the foundation on which to build an even broader Asia-Pacific trade partnership. Once TPP is concluded, the United States should begin immediately to seek to incorporate other countries of the region into TPP. It should give priority to the Republic of Korea, Taiwan, and ASEAN countries, including, in particular, the Philippines, Thailand, and Indonesia. The United States should make it clear that it welcomes China's accession to the TPP.
- *Conclude BIT with China*: The administration should highlight the Bilateral Investment Treaty (BIT) with China as a key agenda item during Xi Jinping's Septem-

ber 2015 state visit. Washington and Beijing should have high-level envoys advance negotiations to reach a robust, comprehensive BIT.

- *Accelerate New Agreements with Like-Minded Partners*: The United States should step up efforts to conclude sector-focused agreements, such as Trade in Services Agreement, Information Technology Agreement, Government Procurement Agreement, and bilateral investment agreements. These sector-focused agreements can facilitate inclusion of such provisions into regional FTAs.
- *The United States Should Be Open to Dialogue on the Pathway to a Free Trade Agreement for the Asia-Pacific, While Giving Priority to TPP Enlargement*: The United States should indicate openness to dialogue in APEC to develop a roadmap for the long-term goal of an FTAAP. However, assuming TPP is in place, the United States should recognize that concluding an FTAAP is a long-term challenge and give priority to extending participation in TPP. Moreover, from a US perspective, the pace of a FTAAP roadmap should be sensitive to progress on a Japan-EU FTA and TTIP, as the triangular configuration of TPP, Japan-EU, and TTIP could form the basis for a new global enhancement of the WTO regime.
- *Re-establishing in the United States a More Unified Direction on Trade Liberalization Will Require Politically Addressing the Effects of Globalization on Workers*. The recent debate on Trade Promotion Authority and Trade Adjustment Assistance laid bare the wide political divide on trade policy in the United States. It seems clear that re-establishing a bipartisan consensus favoring trade liberalization necessitates that those seeking to extend trade liberalization must at the same time address the effects of competitive dislocations and unfair foreign practices on American workers and firms.

# CHAPTER 8

# CONCLUSION: SHAPING THE ASIAN FUTURE

US leadership in a world in the midst of historic transformation is no easy task. However, it is both necessary and possible. Americans tend to view the past seventy years of US predominance in Asia as the norm, the natural state of things. However, Asians see the post-World War II period as a serendipitous happenstance of history. They well understand and appreciate that the US security guarantee has underpinned stability, and that US leadership of an open trade and financial system, US investment, and relatively open markets have facilitated the Asian economic miracle.

Yet, Asians are fearful that the wheels of history are turning, and that the US role is unlikely to continue—at least in its current form. They are concerned about safeguarding their interests and avoiding future shocks like the 1997-98 financial crisis that rocked Asia. Over the coming decade, Asia will likely continue to be the most dynamic region of the world and an engine of global growth. The Asia-Pacific will be no less important to the future of American prosperity and security than it has been over the past two generations. However, the US ability to determine outcomes in Asia has eroded. Even as US trade and investment in the Asia-Pacific continue to rise in *absolute* terms, they continue to decline in *relative* terms, as China, India, and other Asian nations grow more quickly.

This is not an argument for disengagement. US leadership is widely desired and, in the authors' view, necessary for shaping the Asia-Pacific future. Sustaining a leadership role requires the foresight to anticipate and stay ahead of the curve. That requires the United States getting its own house in order and taking steps to ensure it remains globally competitive (e.g., refurbishing infrastructure, reforming corporate tax policy, and improving education). It requires that US leaders understand the difference between what they would like to have and what they need to have. The same is true of Chinese leadership. To date, this has not been the case. For the United States, one causal factor is a dysfunctional political system. Another is a conceit that US preeminence is preordained. The United States also needs to foster a sense of inclusion and a larger voice in reformed regional and global institutions. An open regional and global trade and financial system in the twenty-first century also requires policies responsive to the developmental requirements of emerging economies. In the Asia-Pacific region, shaping the economic architecture of the future similarly requires foresight and creativity. With the exception of North Korea, all countries in the region understand that they have benefited from the liberal, open regional order. While Asians seek to reconfigure the system to better reflect regional interdependence, and China may hedge its position by supporting new institutions, there is little appetite to overturn the system and roll the dice with an alternative economic system. Nor do Asians want to be forced to choose between the United States and China.

The US diplomatic setback regarding the Asian Infrastructure Investment Bank (AIIB) should be a wake-up call regarding the need for adroit statecraft with key partners, such as Japan, South Korea, Singapore, and Australia, not to mention European G7 allies, as well as a keener appreciation for regional economic priorities. US policy concerns on AIIB governance standards was right policy, but poorly executed (though there were internal differences on strategy). After all, there is no dispute that Asia has enormous infrastructure investment needs, and neither the Asian Development Bank nor the World Bank has ample resources to meet them. It is in China's interest that its sojourn into international financial leadership be credible, and that the AIIB can obtain cofinancing from the private sector, the ADB, and others.

If the United States is to succeed in strengthening the regional commitment to an open, rules-based economic order, it must engage more robustly, nimbly, and assertively in the Asia-Pacific. It is difficult to see any actor other than the United States providing the stewardship necessary to achieve such an outcome. China can and should become a partner in such efforts. This report has sought to offer some guidelines for attaining desired outcomes in a world in flux, in the hope that policymakers find them useful.

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