RICHARD KOSOBUD AND HOUSTON STOKES

Trade Peace in the Pacific Through a Free Trade Area?*

What must be done is to build a political framework with the allies in which economic relationships no longer produce the tensions they have in the past.

Henry A. Kissinger, January 1973

By and large, a pattern of beneficial economic relations was maintained by the major developed trading partners of the Pacific Basin during the 1950s and 1960s. The region's international trade volume more than doubled and its share of world trade rose to over 10 percent.[1] During that period, a framework of generally fixed exchange rates and a reduction in barriers to trade characterized international trade and monetary policies in the Pacific, as among free economies elsewhere. Several underlying objectives on the part of the U.S. and Japan, which we shall discuss shortly, enabled the trading partners to manage economic conflicts arising within this framework. Currently, however, a series of events has put strong pressure on these objectives, resulting in more difficult management of economic conflicts.

Unless new institutional arrangements are developed to deal with the increasing U.S. imbalance of payments on the one hand and the growing importance of Japanese goods in the world markets on the other, there is a serious possibility that the future will evolve into a situation of economic conflict not unlike the 1920s and 1930s. Among the unfortunate features of this interwar period was the destructive use of protectionist trade policies. In this paper we attempt to trace the origin of the present-day problems and to consider proposed solutions, including a free trade area. First, a background discussion is in order.

During the immediate post-World War II period, the U.S. government was largely preoccupied with policies toward a perceived monolithic communist threat. The

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[1] United Nations Yearbook of National Account Statistics and the Growth of World Industry (New York: U.N. Statistical Office, various dates).

effective reason for increasing trade among the "free" economies appears to have been the belief that such trade would serve to strengthen the democratic institutions of trading partners. Within this general policy framework, the U.S. took the lead in transferring technology to countries such as Japan. Because of the diversity and sheer size of the United States economy relative to the level of U.S. imports and exports and the dollar's position as a reserve asset in central banks of the world, this policy was not constrained by anxieties about moderate deficits on the balance of trade. Further, the U.S. was in the rather unique position of not having to heed the impact of domestic policies on either wage and price movements or the balance of payments.

The Japanese government gave overriding priority to the rebuilding and redesigning of an economy that up to 1950 gave little indication of a capacity for rapid economic growth. This objective appears to have been guided by market calculations with respect to exports. Japanese business and government leaders appear to have rather skillfully estimated the potential export commodities in which they had a comparative advantage. Less use was made of the price mechanism in determining the composition of imports and capital flows. Tariff and non-tariff restrictions as well as very tight control on foreign direct and equity investment in Japan largely denied both cheap food and, to some extent, cheap capital to Japanese consumers and enterprises.[2]

A number of developments have altered the support obtainable for these priorities. The U.S. military disentanglement from Southeast Asia and the attitudes preceding this move presage much more cautious views about military and economic commitments. The domestic price and wage trends set in motion by the U.S. fiscal and monetary management of the economy during the war are among the factors which have raised anxieties about the effectiveness of the balance-of-payments adjustment processes. These are likely to remain at a much higher level in the future than in the past. Related to the military disentanglement is the remarkable change toward greater flexibility in the relations between China and the U.S. The number of policies which can be considered by China, the U.S., and the U.S.S.R. toward one another have recently been enlarged. There are increased opportunities for trade and investment that previously were precluded from consideration.

Although there is considerable agreement that the economy of Japan has been successfully rebuilt and redesigned, the appropriate response of Japan's trading partners to the emergence of this major economic power has yet to be fully exhibited. In the past, the Pacific trading partners of the United States have been virtually excluded from the European Economic Community. The growing size of this economic union, now that the United Kingdom, Ireland, and Denmark have joined, will not, in all likelihood, change this. Hence, opportunities for increased trade within the Pacific region assume greater importance.

That the existing agreements on economic relations in the Pacific are coming under growing strain is apparent from the increase in the number of open, unresolved

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[2] For examples of these non-tariff restrictions, see K. Kojima, Japan and a Pacific Free Trade Area (Berkeley: University of California Press, 1971), pp. 42-7.

conflicts. It is not difficult to discern dissatisfaction in Japan and occasionally other Pacific trading partners such as Australia, Canada, and New Zealand, with the U.S. "voluntary" import quota agreements which have recently tended to grow in scope and number. The proper yen-dollar exchange rate has surfaced since the New Economic Policy of 15 August 1971 as a major bone of contention. It seems clear that the arguments for fixed versus more flexible exchange rates are given different weight by the region's major economies. The threat of protectionist measures within the U.S. appears to be doubly irritating to her trading partners; they seem designed to restore balance of trade surpluses no longer believed appropriate to the mature U.S. economy. Further, they discriminate in many instances by falling unevenly on different trading partners.[3] Possibilities of conflict over oil shortages brought about by policies of the Organization of Arab Petroleum Exporting Countries appear to be more numerous than opportunities for cooperation. From U.S. quarters have come a series of complaints about the lack of access to the Japanese market. It is argued that tariff and non-tariff barriers effectively prohibit trade in many agricultural products such as rice. Tight exchange controls and other measures have prevented direct and equity investment in Japan. Liberalization of tariff and quota measures which have occurred in Japan are not always accompanied by additional measures facilitating imports (such as removal of sales taxes, changes in administrative practices favoring Japanese products, and the like).[4]

These economic problems are not new, though their magnitude in recent years has increased. However, their management has undoubtedly deteriorated. On the horizon is a new problem which may add yet another conflict to Japanese-U.S. economic relations. Any extensive reconstruction in Southeast Asia is likely to stimulate trade flows between that area and the major suppliers of reconstruction aid. A clash of particular industry interests could arise from the fact that for a number of commodities, especially more sophisticated consumer goods and capital equipment, the U.S. and Japanese economies are competitive sources of supply.

Our cursory survey of these problems leads to the natural question of what approach should be adopted to handle these economic conflicts when the prior framework proves unworkable. If the countries in the Pacific region can gain access to larger markets without the disrupting effects of inflation or imbalance of payments, the gains from economies of scale in the production of many traded goods will accrue to the citizens of the respective countries in the form of increased welfare. Possibly more significant in the long run may be the "non-economic gains" of increased trade—the interdependence of national economies would reduce the risk of war and encourage international cultural contacts.

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[3] The United States has traditionally run a balance-of-trade surplus that was more than offset by a large capital outflow. This "excessive" capital outflow and the degree of foreign ownership (as well as possible inflation) it ultimately implies has set the stage for the growing anti-U.S. feeling that is a fact of life in many foreign countries.

[4] A discussion of these issues is to be found in E. H. Preeg, Traders and Diplomats (Washington, D.C.: Brookings Institute, 1970).

Alternative Approaches

Both the system of fixed exchange rates established at Bretton Woods and the gradual reduction of tariffs under the General Agreement on Tariffs and Trade (GATT) led to an increase in international trade after World War II. The Kennedy Round of GATT talks in the 1960s further reduced tariffs significantly and international trade again increased. While progress might not have been faster if the ill-fated International Trading Organization had not been blocked in the United States Congress in the late 1940s, the developments since the war suggest that increased trade liberalization benefited all parties concerned. The crucial consideration is that such a liberalization be orderly. That is, balance of payments of the respective countries must not be unduly disturbed and the production dislocation within the countries must be kept within reasonable (politically feasible) magnitudes. Economically, the gains from such trade liberalization derive from specialization. Trade allows a country to move beyond the restraints of its own production possibilities and achieve a higher level of welfare than could be achieved without trade. While dynamic changes in technology, concentrations of economic power, and the distribution of gains from trade among various groups modify the case for freer trade, it is arguable whether these modifications currently override the free trade argument. However, trade liberalization entails both a realignment of production in the countries concerned and painful short-term adjustment costs for particular industries. For this reason as well as lessening U.S. pressure for freer trade due to her balance-of-payments considerations. another round of across-the-board liberalization in the medium-term future seems unlikely.

Turning to the international monetary system, one of the advantages of fixed exchange rates seems to have been a reduction in the costs of uncertainty which thus tended to stimulate commercial transactions. In the latter part of the 1960s the major weakness of fixed exchange rates and the inability to adjust the balance of payments began to be felt. Major industrial countries were increasingly unable or unwilling to use monetary and fiscal policy in controlling prices sufficiently to maintain the balance of payments because they feared the domestic repercussions of possible unemployment. As a consequence, the alternative of flexible exchange rates began to attract increasing attention, since under this system all countries will be in balance-of-payments equilibrium (assuming trade elasticities yielding stability in the exchange markets). In restoring the balance of payments there is an inevitable trade-off between the use of fixed exchange rates, where internal adjustments are made at the expense of domestic employment and growth goals, and flexible exchange rates, where the price is paid in terms of international trade and capital flow. This problem is unlikely to be resolved by either rigidly fixed or freely floating rates. It is possible that the international monetary system will undergo a rather long transition period with the final result being an exchange rate system of greater flexibility tempered by nervous governments and central bankers.

If freer trade is not generally obtainable by methods previously employed, some gains may be secured by means of a regional framework. An element of discrimination is introduced, but this is allowed under GATT provisions on the grounds that it is a step toward multilateral and nondiscriminatory trade. A movement toward a second best solution is better than none at all. Fairly sizable transfers of national sovereignty to a regional unit such as a common market, whose members adopt common tariffs and permit free movement of labor and capital, are unlikely to coincide with the preferences of Pacific Basin trading partners in the foreseeable future. We believe that a free trade area which permits independent tariff policies toward nonmembers but reduces tariffs for members could be a more acceptable alternative.[5] Provided that a balance-of-payments equilibrium is maintained, the implementation of such an arrangement on a commodity by commodity basis, with comparative costs being used to determine agreed specialization, may diminish protectionist counterarguments. A free trade area would likely require new regional institutions including a trade and development organization, a currency or reserve facility, and an investment agency, all of which could contribute to a more orderly handling of the increasing economic conflicts of the Pacific Basin.[6]

Continuing to survey alternative approaches, we next consider a bilateral approach to economic problems. One interpretation of this approach has been put forth by George Meany in the following words: "If any nation closes the door on us–on our products–then we should turn around and close the door on them; just as simple as that."[7] It is possible to build an argument for such an approach on the grounds that it could tend to correct the asymmetrical pressures on trade deficit and trade surplus economies. Countries running surpluses in the trade account are not under the same pressure to adopt different policies, say further liberalization of barriers to trade, as are those experiencing trade deficits. However, a nation to nation framework tends to focus attention on bilateral surpluses and deficits rather than more appropriate measures such as a country's multilateral balance of payments. For example, in the Pacific Basin a triangular flow of trade is discernible in which the U.S. buys more manufactured goods from Japan, which buys more raw materials from Australia, which in turn buys more manufactured goods from the U.S. It is easy to show that requiring bilateral balance would result in each country achieving a lower welfare potential. A serious disadvantage of the bilateral framework is that it invites economic warfare of the worst sort. For example, such a policy on the part of the U.S. directed

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[5] It is important to distinguish between a free trade area which allows free trade between countries while permitting each country to maintain its own individual tariff with nonmember countries, a customs union which is a free trade area with the additional (and often difficult to implement) provision that all countries in the union must agree on a common tariff for the union, and an economic union which is a customs union with the additional feature that factors of production such as labor are mobile between countries. We have drawn on studies by K. Kojima, Pacific Free Trade Area, op. cit. and H. Shibata, "The Theory of Economic Unions," Fiscal Harmonization in Common Markets, ed. C. S. Shoup (New York: Columbia University Press, 1967).

[6] Johnson argues that with a free trade area the degree of policy harmonization is much less than has usually been emphasized. He makes the additional point that capital mobility can be a substitute for harmonization. Thus our proposal for a regional free trade area bypasses many of the coordination problems associated with customs unions and economic unions. See H. G. Johnson, Aspects of the Theory of Tariffs (Cambridge, Mass.: Harvard University Press, 1972).

[7] Mr. George Meany, president, AFL-CIO, quoted in the New York Times, 20 February 1973.

against Japan raises the possibility of Japan's turning to the Soviet Union or China for trade and investment transactions on terms disadvantageous to both Japan and the U.S.

A final alternative we wish to present is the possible withdrawal of the U.S. from an active role in the Pacific Basin coupled with a turn toward protectionist levels of tariffs, quotas, and restrictions on capital flows except for selected areas of interest such as South America. In our opinion, such a policy would adversely affect the level of consumer welfare in the United States and would in addition remove a competitive stimulus to the performance of U.S. industry. This would impair United States capacity to compete in the international economy, further fueling protectionist sentiments. Perhaps the major risk involved in this framework is that it promotes a tendency toward north-south alignments between developed and developing countries and a concomitant breakup of the world economy into unpromising regional blocs. Such alignments can be dimly perceived: the EEC and the Mediterranean-African bloc as well as the U.S. and Latin America. Presumably Japan would be forced to turn increasingly to Southeast Asia. Such bloc-arrangements are unlikely to be greeted with enthusiasm by the governments of many developing economies and would, in all probability, be unacceptable to China and the U.S.S.R.

This survey of alternatives leads us to the conclusion that it would be highly desirable to look further into a Pacific Basin regional framework as an attractive medium-term approach to trade and investment problems.

A Regional Framework for Trade in the Pacific Basin

If our belief is correct that multilateral, nondiscriminatory steps toward freer trade are unlikely in the near or medium-term future, then the idea of a free trade area becomes worthy of a closer look. The economic and political implications of such a step do not all point in the same direction. A free trade area providing for removal of barriers among members and yet allowing for independent tariff policies toward nonmembers (and probably requiring anti-trade deflection measures) entails trade discrimination among countries.[8] Therefore, it has a potential for harm as well as good. We shall have to consider the economics of such a proposal in more detail. It ought to be mentioned at this point that countries at similar stages of economic development are most likely to find economic and political gains in such an arrangement. Thus, we follow Kojima in considering the following countries as candidates for membership: Australia, Canada, Japan, the U.S., and New Zealand. This is what we mean by a Pacific Area Free Trade Area (PAFTA).

It is usually argued that if the countries are initially similar in the range of goods produced, then the appropriate trade organization is a customs union (or possibly an

[8] Under a free trade area there is no common tariff on countries outside the area. As a consequence measures must be taken to prevent goods from being taken around the tariff barriers of one of the countries by being "imported" from the partner when in fact the goods were actually from some country outside the free trade area. This problem is usually handled by some type of certificate of origin.

economic union if labor mobility is desired) since all member countries will have an easier time agreeing on a common external tariff. When countries are dissimilar in the sense that they have comparative advantage in different areas, the formation of a free trade area is the most likely prospect. In this case, the member countries are spared the task of agreeing on a common external tariff. If countries are all in equal stages of economic development, then presumably their growth rates are more compatible. In the case of PAFTA, the fact that the Japanese economy is growing faster than those of other prospective members implies that unless some adjustment is made, the establishment of a free trade area will result in sharp changes in the balance of payments among the member countries. In order to overcome this potential difficulty, we propose that the free trade area be implemented in a step by step manner so as to maintain the balance of trade of each country.[9] It is likely that governments of less developed economies will be more reluctant to expose their developing (infant) industries to the vigorous pressures of such competition at too early a stage. We shall have more to say about the possible relations of developing economies to a free trade area below.

The Simple Economics of a Free Trade Area

The static economic gains from a free trade area arise from reductions in tariffs which lead to trade creation. From this must be subtracted trade diversion.[10] The net effect is not a proposition to be stated with certainty; it all depends. We can say that if member economies are generally competitive before the free market is formed (with differences in costs existing for the same commodity) and are generally complementary after the market is formed (indicating that inefficient industries have yielded to imports and efficient industries have expanded through exports), then member economies will have gained overall from the free trade market. Economies that are already completely specialized in different commodities that are not found in more than one economy are unlikely to achieve a static gain from specialization after the formation of a free trade area. The fact that Australia, Canada, and New Zealand have commodities with a high raw material content, Japan with a high labor content, and the U.S. with a high technology content is less promising from the standpoint of such static gains than from the fact that they all have manufacturing and service industries

[9] The term step-by-step means that not all goods are in the free trade area at the beginning. New goods are added to the list of those goods covered in a manner such that the multilateral balance of trade of each country is maintained. We envisage that the selection of goods to be added to the free trade area will be decided by some multinational regional organization where both political and commercial interests in all the member countries have representation.

[10] If after the formation of a free trade area trade creation occurs, there is a reduction in the supply price of the good and a reduction in the tariff revenue collected. If we assume that initially the tariff revenue was distributed uniformly, there is a net gain to the country. Trade diversion in a free trade area arises from the fact that consumers within the free trade area may now be able to buy the good from another member at a lower price than from a nonmember country, even though the latter is in fact the lowest cost producer. Although the net effect may appear to be a gain to the consumer of that good, the country is actually worse off since the pre-tariff price is now higher than in the previous case. Whether a free trade area results in an increase in welfare depends on whether the trade creation effect is greater or less than the trade diversion effect.

of varying degrees of competitiveness. Potential gains from a free trade area imply potential adjustment costs to inefficient industries.[11]

Though they may be the most important ones of all, the dynamic economic gains from a free trade area are somewhat more elusive to describe. If industry supply curves in any country are falling, an enlargement of the market will create an opportunity for a reduction in unit costs. Although it may be assumed that the size of the U.S. economy has already brought about the realization of such gains, this conclusion may be based on too broad a definition of commodity. A related gain is connected to the diffusion of technology among member countries. It has been observed that comparative advantage has frequently changed from country to country during the "product cycle" of a commodity; that is, from the first stage of highly specialized use of a new commodity to the last stage of standardization for mass consumption.[12] This diffusion of technology within and among economies is a process not yet clearly understood, but it has been thought to account for an important share of total factor productivity growth and thus a welfare gain. It is quite likely that reductions in trade barriers facilitate this process. Finally, it should be noted that formation of a free trade area is likely to act as a competitive spur to any lethargic firms that would now be exposed to another source of competition. The consequences for new investment expenditures to modernize plant and equipment, for example, are likely to be enhanced within each member country as the potential market expands.

A free trade area is compatible with a flexible exchange rate system or a fixed exchange rate system using either a nonmember's currency, a member's currency, or the currencies of all members of the free trade area. In the following comments, the merits and disadvantages of these systems will be compared simply to show that while a bad monetary system can cause havoc to trade, a number of monetary options are available.

Under a system of flexible exchange rates, the major advantage is that exchange stability encourages an equilibrium in the balance of payments for all members. In a world of perfect capital mobility, only under a system of flexible exchange rates will all countries be able to have an independent monetary policy. The basic disadvantage of such a system is the cost of uncertainty about the exchange rate. Many countries view movements of their exchange rates as a sign of "weakness" and resent the fact that these fluctuations are not under their control. Although some of these costs can be reduced by forward covering, the possibility of a free trade area with flexible exchange rates between countries is not likely to gather much support, especially from

[11] In the Trade Act of 1962 a program was established whereby workers who lost their jobs as a consequence of lowering tariffs would be given the opportunity for government-financed retraining. Although this program was very farsighted, administrative difficulties which included long delays in identifying people who qualified, hampered the program in reaching its full potential.

[12] One clear example has been electronics. Many products such as color TV that were first invented in the U.S. now are made in Japan. There is increasing evidence that this process will not necessarily stop here. Possibly, a lower cost location of production will be found somewhere else in Asia. A classic discussion of this topic is to be found in R. Vernon, "International Investment and International Trade in the Product Cycle," Quarterly Journal of Economics, 80 (May 1966), pp. 190-207.

central bankers.[13] An alternative to flexible exchange rates within the free trade area is the formation of a currency area. While this issue is outside the scope of our study, we wish to note that the formation of a free trade area is not inconsistent with the major proposals for reform of the international monetary system.

Because much of the analysis dealing with economic gains to be realized from a free trade area is inconclusive, we should attempt some estimate of PAFTA's quantitative impact. Ideally, we should have a detailed quantitative model for the region which would enable us to forecast the direct and indirect effects of reductions in tariffs. Lacking such a model to deal with the matter *mutatis mutandis,* we shall have to make the estimates on a static basis *ceteris paribus.* It may be noted for comparison that some estimates of the static gains from trade due to the enlargement of the EEC for countries such as England have been on the order of one percent.[14]

If we assume unchanged export prices and competition in the supply of commodities outside the free trade area, we can calculate the quantitative impact of a free trade area. Our results are based on estimates of import demand elasticities and a (1965) trade matrix among member economies. One set of previously prepared estimates, based on optimistic assumptions about these elasticities, provides a maximum projection of trade gains.[15] Using more pessimistic assumptions (essentially scaling down the import demand elasticities for manufactured products), we have obtained an estimate of minimum gains from trade creation. These estimates are given for each of the member countries in the table below.

Estimates of Annual Increases in Exports and Imports After Establishment of a Free Trade Area (1965 = base year: Billions of U.S. Dollars)

	U.S.	Japan	Canada	Australia	New Zealand	Total (rounded)
Optimistic Assumption						
(a) Increase in exports	2.30	1.74	.86	.06	.02	5.98
(b) Increase in imports	2.28	.43	1.48	.65	.14	5.98
(a)–(b)	.02	1.31	–.62	–.59	–.12	
Pessimistic Assumption						
(c) Increase in exports	1.20	.90	.80	.06	.02	3.98
(d) Increase in imports	1.18	.30	1.12	.30	.08	3.98
(c)–(d)	.02	.60	–.32	–.24	–.06	

Source: Selected data adapted from K. Kojima, *Japan and a Pacific Free Trade Area* (Berkeley: University of California Press, 1971), Table 3.6, p. 91.

Averaging the estimates, our calculations indicate approximately a 5 percent increase in exports among PAFTA members—a figure above estimates we have seen for the EEC. Exports and imports do not increase proportionately for all members, mainly

[13] Forward covering refers to the practice of buying currency today for delivery at a fixed exchange rate sometime in the future (usually 90 to 180 days). A good book on the subject is P. Einzig, A Dynamic Theory of Forward Exchange (London: Macmillan, 1962).

[14] H. G. Johnson, "An Economic Theory of Protectionism, Tariff Bargaining, and the Formation of Customs Unions," Journal of Political Economy, 73, no. 3 (June 1965), pp. 256-83.

[15] Kojima, Pacific Free Trade, op. cit., p. 34.

because manufactured products exhibit the largest increase. Thus, Australia, Canada, and New Zealand experience, in our mental experiment, a larger increase in imports than exports, reflecting their relatively smaller manufacturing sectors. In order to make a free trade area more attractive to these countries, certain preferential arrangements regarding their manufacturing sectors may have to be established.[16] These considerations affecting Australia, Canada, and New Zealand provide another reason why we are prepared to argue that the best way to implement our proposal for a PAFTA is in a step by step manner. It is our view that initially it would not be desirable for all commodities in all partner countries to be in the free trade area. Implementing the free trade area in this manner will have two major advantages over opening it immediately to all goods. In the first place, the "burden" of adjustment in the partner countries will be minimized. In the second place, it will maintain the balance-of-payments equilibrium in all countries. Thus, if it is assumed that all goods are placed initially in the free trade area, the data suggests that Australia, Canada, and New Zealand might suffer some decrease in their balance of payments; this is not the case if the free trade area is implemented in a stepwise manner. To illustrate, Japan once maintained high tariffs on U.S.-grown grapefruit while the U.S. maintained tight restrictions on the importation of fresh Mandarin oranges grown in Japan. The traveler between the two countries, having acquired a taste for both fruits, could well complain that his welfare was reduced by these restrictions. We argue there has been an increase in welfare in both countries now that such restrictions have been reduced. The balance of trade for both countries has not suffered from this specific step.

The Simple Politics of a Free Trade Area

Since the formation of a free trade area for all goods would be an initial shock to the economies of all countries concerned, it is worth repeating that such a move should proceed in a stepwise manner. In addition to limiting the short-run effects on the balance of payments, such a course of action will reduce the rate of the production adjustment in each country that must eventually accompany the greater specialization implicit in a free trade area. Such a stepwise introduction procedure on a commodity by commodity basis is not only sound economically, but politically as well. The countries concerned may wish for reasons of security or prestige to limit the trade of some goods, and the infant industry argument provides a rationale for certain exceptions. This latter point, which is recognized by GATT, states that a country can give protection to an industry in the short run if: (a) it eventually will grow up and no longer require protection to survive; (b) if the resulting gains outweigh the short-run welfare costs of protection; and (c) if the industry's gains are not fully captured by the

[16] This is one of the reasons for some negative attitudes in H. W. Arndt, "PAFTA: An Australian Assessment," Intereconomics 10 (Hamburg: October 1967). A more favorable view of prospects is to be found in the Australian economist's (Peter Drysdale) article, "Pacific Economic Integration: An Australian View," in Kojima, Pacific Free Trade, op. cit. Canadian responses, cautious but positive, may be found in such publications as A New Trade Strategy for Canada and the United States (Ottawa: C. D. Howe Research Associates, Inc., 1966).

firms concerned, so that the private market will not find it possible to support the industry during the "infant period." Problems such as these undoubtedly have limited the implementation of the Free Trade Agreement of 1966 signed by Australia and New Zealand.[17] Our proposals for a stepwise procedure and regional institutions to provide a forum for continuing discussion of these problems could help to maintain progress.

It may be giving away too much to the protectionist argument, but the trade diversion which enables member countries' industries to displace some volume of trade from nonmember industries may ease resistance to the free trade area idea among potential member countries. However, to the extent that trade diversion occurs, it implies damage to economic interests both outside and inside the free trade area. Among the interests likely to suffer will be those of developing economies. For example, the countries of Southeast Asia may view the formation of a free trade area as not only a "rich man's club" but also an arrangement which threatens their economic interests. We believe that any free trade area with good chances of survival will have to work out arrangements with developing economies which entail preferential access to the free trade area market. By providing a framework within which the U.S., Japan, and other member nations can develop common policies toward developing economies, especially those in Southeast Asia, possible economic rivalries may be diminished.[18]

The formation of a free trade area would have implications beyond Southeast Asia. It clearly would be of interest to China. The evolution of China's economic policies with respect to international trade is not yet discernible, but it is probable that trade will largely be subordinated to political objectives. A free trade area would provide a means for the more capitalistic trading partners of the Pacific area to withstand any attempts by China to divide them through the creation of economic rivalries. On the other hand, the use of a free trade area as a threat to China's interests will work against opportunities to draw China into fruitful economic relations. It would seem plausible to think of offering China associate member status in any free trade area institutions. To the extent that conflicting interests between China and the U.S.S.R. cause China to fear isolation, this status would have some attraction. With the increased penetration of U.S. companies into the U.S.S.R., we foresee efforts on the part of China to establish meaningful trade relations with the West. It should not be assumed, therefore, that China will not want to participate in a regional arrangement.

The U.S.S.R.'s interests in the Pacific Basin seem fairly diffuse at the moment. The ability of the free trade area partners to bargain more effectively with the other major trading interests of the world may prove to be one of the more lasting contributions of

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[17] An analysis of the problems of infant industries and a bibliography listing works discussing particular regions is available in R. E. Caves and R. W. Jones, World Trade and Payments (Boston: Little, Brown, 1973), pp. 556-66.

Even the sponsorship of joint studies (e.g., on commodity specialization and changes in the location of industries) would be valuable. This has been one of the gains of the Latin American Free Trade Area (LAFTA). ECIEL, Industrialization in a Latin American Common Market (Washington, D.C.: Brookings Institution, 1974).

a free trade area. It is not likely that the Soviet Union would welcome steps toward regional economic integration since such moves might reduce its bargaining power. It should not be overlooked that the U.S.S.R. might be drawn into valuable trading agreements involving raw materials (chrome, etc.) and fuel. Through a regional framework, these agreements might be carried out with fewer tensions.[19]

If the governments of Japan and the U.S. are to think seriously about proposals for regional integration in the Pacific, there must be a reconsideration of their global as well as regional economic interests. Both the U.S. and Japan have major global interests outside the Pacific Basin which would have to be reconciled with any trade diversion impact of a free trade area. In our opinion, this is the most serious drawback to the idea of a free trade area in the Pacific. The same reservation applies to Australia, Canada, and New Zealand although the formation of the enlarged EEC may make the Pacific concept more attractive to them. A Pacific Area Free Trade Area implies a significant commitment to managing economic events in the region. While such an involvement does not necessarily imply reduced commitments elsewhere, it would, for example, represent less preoccupation with the affairs of Europe, particularly on the part of the U.S.[20]

Granting the difficulties of taking meaningful steps toward regional integration in the near future, does this imply that less promising approaches to problems in the Pacific ought to be adopted? It seems to us that the regional institutions which would be required to make a free trade area work are worthy of consideration on their own merits, even though a formal free trade area will not immediately be established. It will be recalled that we proposed three institutions:

1. a regional trade and development organization
2. a regional currency or payments agency
3. a regional investment agency.

A regional trade and development agency could provide a means for discussing particular economic problems and trade liberalization measures among the major trading partners. It could also coordinate policy proposals with other agencies such as the Association of Southeast Asian Nations. At the present stage of economic relations in the Pacific, it would resemble the Organization for Economic Cooperation and Development although smaller, more flexible, and with a definite regional interest. A regional currency or payments agency could assist in formulating policies to deal with temporary balance-of-payments problems. A regional investment agency could consider the problems of direct and equity investment which now divide Japan and the U.S. as well as the problems of capital flows to developing economies. It need not

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[19] While it may seem unlikely that a highly planned economy would partipate fully in regional integration with capitalist economies, some sort of partial membership could be attractive from the viewpoints of both trade and reducing the threatening implications of non-inclusion.

[20] A similar point has been made by Rielly in discussing regional integration in Latin America. Robert E. Hunter and John E. Rielly, eds., Development Today (New York: Praeger, 1972).

conflict with existing agencies such as the Asian Development Bank, but it could focus on problems with special importance to the major trading partners. Formulation of such agencies would have the immediate merit of involving the Pacific trading partners in a process of understanding and managing economic events in the Pacific region.

Thus, while political realities in Asia rule out the formation of an Asian Common Market in the near future, they most certainly do not preclude the establishment of a free trade area in the Pacific if such formation is implemented in a stepwise manner so as to minimize the "problems of adjustment" in the economies of the prospective partner countries. Further, the increasing realignment of world economic power that reflects the Common Market's approach toward its full potential, as well as possible conflicts over access to resources such as oil, highlights the political wisdom of PAFTA.