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Paths and Strategies towards the FTAAP: Linking Integration and Inclusive Growth

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EXECUTIVE SUMMARY

While the pathway to the Free Trade Area of the Asia-Pacific (FTAAP) has been intensely discussed with a focus on its architecture, something has been missing: how to link trade and investment liberalization with inclusive growth of the APEC economies. The APEC economies have been increasingly open to trade and investment, but domestic distortions persist. The consequences have been less beneficial effects of trade and investment liberalization to domestic stakeholders. In particular, less-advantageous minorities have become more vulnerable to external economic shocks. If these failures are not urgently and seriously addressed, political support for further integration towards the FTAAP will continue to weaken. This reckoning has led to this paper.

This paper offers policy options to make the FTAAP more conducive to inclusive growth of the APEC economies. Policy proposals are offered in two fronts. At negotiations, a grand compromise between advanced and developing economies should be sought to make negotiations agenda more comprehensive and balanced. Under this grand bargain, protected sectors in advanced economies – potential exporting sectors for developing economies – would be opened in exchange for more commitment in new rules by developing economies. To make this grand bargain politically possible, each side should do its homework domestically. Empowering human capital and skill upgrading programs will be urgent and imperative, along with designing more effective trade adjustment assistance programs. To enhance the possibility of achieving this comprehensive and balanced agenda, and to ensure all are on board, a two-track commitment should be designed. At the domestic front, major distortions which have obstructed a more inclusive integration in the past should be urgently corrected. Specifically, policy preference for incumbents should be removed; labor markets should become less rigid; capital markets should be accessible to all; and social safety nets should be strengthened.

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Paths and Strategies towards the FTAAP: Linking Integration and Inclusive Growth

CHOI Byung-il

I. Introduction

While the pathway to the Free Trade Area of the Asia-Pacific (FTAAP) has been intensely discussed with a focus on its architecture (APEC 2014, 2015a), something has been missing: how to link trade and investment liberalization with quality growth of the APEC member economies. In the early days of the APEC, the prevailing assumption was that trade and investment liberalization would benefit all the economies involved by providing the parties with more trade opportunities and competition, ultimately leading to job creation, income generation, the rise of middle class and so on (APEC 1989a, 1989b).

However, the outbreak of the 1997 Asian financial crisis and the 2008 global economic crisis weakened such presumptions. Despite greater liberalization, inequality and unemployment still remain unresolved. People have begun to mount their opposition against trade, although the jury is still out to establish the causality between trade and growth, and between trade and distribution (OECD 2011). Yet, one thing certain is that any future discussion or negotiation towards the FTAAP should involve this missing piece of dimension on ‘inclusive integration’ - how trade and investment liberalization would promote

inclusive growth, which would enhance living standards of all stakeholders more fairly.

The current discussion on the FTAAP is too overly focused on external integration, forgetting the main reason for pursuing integration – promoting an environment that is mutually advantageous granting equal economic opportunities for all the stakeholders. Hence, the linkage between external integration and inclusive growth is still yet to be found. In the light of the Bogor Goal of “2010/2020 trade and investment liberalization” (APEC 1994), the most important guiding principles of the APEC, and the two pillars of the APEC – Trade and Investment Liberalization (TILF) and Economic and Technical Cooperation (ECOTECH) – the linkage between trade-driven integration and inclusive growth has become an issue of significant concern. In particular, considering the onset of ‘new normal’ in the aftermath of the 2008 financial crisis, and the growing suspicion about trade liberalization in relation to inequality and unemployment, this missing link is in urgent need of being discovered.

What has been missing in many studies of the APEC economic integration is the absent-minded focus on the virtue of the external integration, while not paying attention to the market and government failures within the domestic economy. While the APEC economies are increasingly open to trade and investment, domestic distortions (e.g. noncompetitive markets favoring incumbents and penalizing new comers, lowering consumer wealth, hindering innovation) and the inadequate levels of social safety-nets persist. The consequences have been less beneficial effects of external integration to domestic stakeholders. In particular, less-advantageous minorities have become more vulnerable to external economic shocks. If these failures are not urgently and seriously addressed, political support for further integration, such as through the FTAAP, will continue to weaken. This reckoning has led to this paper. This paper takes the linkage between trade liberalization and inclusive growth seriously, and aims to derive policy proposals to make the FTAAP more inclusive to growth of the APEC economies.

This paper is organized as follows. The next section explores the concept of inclusive integration and discusses the cost of non-inclusive integration. Section III analyzes the current state of play on pathways towards the FTAAP. The analysis in section III will reveal how miserably the current debate on the FTAAP misses the point, when it comes to the theme of inclusive integration. Section IV offers policy proposals to make the FTAAP more inductive to inclusive integration. Section V concludes the paper.

II. Why ‘Inclusive Integration’?

1. What is ‘Inclusive Integration’?

After decades of globalization where products, money, information and ideas move across national borders more freely due to liberalization, the very basic premise that globalization benefits all is being challenged. In advanced and developing economies alike, middle and lower-class people have not seen their real incomes rise for years. The gap between rich and poor has widened, with those at the top capturing an ever-increasing share of growth. (OECD 2011, 2015; Dabla-Norris *et al.* 2015) Inequality¹ in income and wealth has become a major concern of our time.²

Whereas globalization has brought more growth to society, economic growth has not benefited all people in the society in an even manner. Milanovic and Lakner (2013) show that, during the time period of 1988 to 2008, the largest gains from globalization went to the global median income (50th percentile) earners and to the top 1%. Within countries, widening income inequality is prevalent. In 2010, the richest 1% earned at least 10% of total national gross incomes in 9 out of 18 OECD countries (around 20% in the US), while back in 1980 the corresponding figure did not exceed 8% (OECD 2015, pp. 17-18).³ Income gaps between top and bottom, rich and poor have not narrowed much. The average income of the richest 10% in the OECD is around 9.5 times that of the poorest 10%, up from 7 times 25 years ago (OECD 2015, pp. 17-18).

¹ Inequality is typically measured by the Gini coefficient (gross income or disposal income), and by tracing changes in the income shares of the population (for example, top 10% vs bottom 10%, top 20% vs bottom 20%, top 1% vs other 99% and so on). In the analysis of the stagnant disparity among the upper and the lower, the latter method is more intensely used.

² Calling attention to inequality has become trendy at any major international occasion. For instance, refer to Furman (2014).

³ In the US 47% of total income growth over 1976-2007 went to the top 1%, in Canada it was 37% (OECD 2015, p. 17).

Due to globalization, astonishing numbers of people have escaped from poverty. Just witness China and India. While absolute poverty has been dramatically declining on the global scale, however, inequality has not much decreased, but rather risen in the advanced world, and many parts of the developing economies (Figure 2, 3, 4 from Dabla-Norris *et al.* 2015).

International organizations, once unashamed cheerleaders of globalization, are now turning their back on the relentless pace of globalization. The World Bank, IMF, and OECD have, one after another, started to look at the shadow of globalization.⁴ Recently, IMF has released a series of studies in inequality. Its renewed focus is on the significance of decreasing inequality for the society. Ostry, Berg, and Tsangarides (2014) argued for no stark trade-off between efficiency and equity, shaking the long-held mainstream view, from their observation that for many countries redistribution through the tax and transfer system was positively related to growth.⁵ Another work from the IMF argues for more focus on the income growth of the poor and no hollowing out of the middle class (Dabla-Norris *et al.* 2015).

Interestingly, the IMF turned its conviction about neo-liberalism upside down, by saying, “Instead of delivering growth, some neoliberal policies have increased inequality, in turn jeopardizing durable expansion” (Ostry, Loungani, and Furceri 2016). In the context of Asia, Jain-Chandra *et al.* (2016) find that recently fast-growing Asian economies have been unable to replicate the “growth with equity” miracle, while the rapid growth in Asia in the 20 century has come with equitable distribution of the gains.

If this high level of inequality is not mitigated, there is danger of hampering social cohesion and making growth unsustainable. Hence, a strong case has

⁴ As a point of reflection, it is noteworthy to recall how stubborn IMF was in sticking to the ‘neoliberal’ doctrine of the Washington Consensus during its bailout operation in crisis-stricken Asian economies in the 1997 Asian financial crisis.

⁵ Debate has focused on the effect of such a transfer on economic incentive versus providing more opportunities for the lower-income class and social solidarity.

been made for inclusive growth. In this paper, inclusive growth is defined as economic growth that distributes dividends of the growth to all stakeholders of the society in an equitable manner, and thereby decreases inequality.⁶ In the literature, inclusive growth is often interchangeably used with shared growth, pro-poor growth. The common denominator for these terms is the equality of opportunity, as noted in Ianchovichina and Lundstrom (2009). The concept of inclusive growth as used in this paper goes beyond the equality of opportunity. In the light of stagnant and widespread inequality, providing equal opportunity alone may not be sufficient.

When trade liberalization leads to a country on the path toward ‘inclusive growth’, we call such trade liberalization ‘inclusive integration’. More precisely, the term of inclusive integration means trade and investment liberalization which promotes inclusive growth – enhancing the living standards of all stakeholders more fairly.⁷ In other words, inclusive integration is trade liberalization which helps to achieve inclusive growth. Inclusive integration is trade liberalization which lifts all boats, not just yachts.

2. Trade Liberalization and Inequality

Experts have been investigating what factors were behind inequality. Technology and globalization – trade liberalization – are presumed as the two main drivers. Identifying which factor is more responsible, and how much, is not an easy task, because often technology and globalization reinforce each

⁶ There is no rigorous definition on inclusive growth. The concept as defined in this paper is in line with many international organizations, including the OECD (2015). According to OECD (2015), ‘Inclusive Growth’ is economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society. The ADB has been active in the research of inclusive growth in the context of Asia and Pacific (ADB 2010, 2011). In particular, strengthening and sustaining the growth of small and medium-sized enterprises (SME) is highlighted (ADB 2012).

⁷ The concept of ‘fairness’ does not mean the equal outcome to all. It means that dividends of growth go more to the middle and lower class, compared to the status quo.

other and, thereby, the effect is mixed. Conventional wisdom has been that it is technology, not globalization, which drove increased inequality (Hicks and Devaraj 2015; Gordon 2016).

Technological advances have been found to have contributed the most to rising income inequality in OECD countries, accounting for nearly a third of the widening gap between the 90th and the 10th percentile earners over the last 25 years (OECD 2011). It is notable that the similar trend – the growing income gap between the high-skill and the low-skill – is also found in larger developing economies. This trend is easily explained by economic logic: the increasing global demand for the high-skilled, which are scarce, and such a fierce competition among the low-skilled across the countries, which are abundant.

The link from trade liberalization to inequality is not obvious, compared to the adverse effect of technological advances on inequality. Trade liberalization may be a mixed blessing for the unskilled in advanced economies. Those in import-competing sectors would find their wage stagnating in the face of a flood of low-priced imports from developing economies (substitution effect). At the same time, their real wages may be increasing due to lowered prices on many products (income effect).⁸ Offshoring of assembly lines to developing economies has long been accused as the main culprit of decline in manufacturing and rising skill premium, which eventually causes inequality (Feenstra and Hanson 1996, 2003).⁹ The jury is still out in examining whether or not offshoring is the true culprit. As a matter of fact, a lot of offshoring has taken place in the context of mapping the global production network (now called the ‘global value chain’) irrespective of trade liberalization.¹⁰

⁸ Net effect would be decided between the size of substitution effect and income effect.

⁹ Studies on the effect of offshoring on inequality are few, while some efforts were made to figure out the effect of offshoring on employment in home country. Choi (2014) reports that during 2000-2009 the outsourcing of the Korean firms decreased employment by 0.13%.

¹⁰ Examples abound: the relocation of semiconductor and electronics assembly lines to South East Asian countries in the 1970s where these economies had higher tariffs, Japanese auto plants in the US where the US maintained its tariffs on Japanese imports.

Increased trade could decrease income inequality in developing countries through a demand hike and subsequent wages for their lower-skilled workers, who are plenty and abundant. In this regard, if data reveals non-decreasing inequality after trade liberalization, it may be reasonable to be suspicious about non-trade factors or working mechanisms where trade opening can be beneficial to the unskilled.

Financial liberalization may generate another channel for causing inequality. Some studies (e.g. Freeman 2010)¹¹ have shown that in advanced and developing economies alike, increased financial flows – foreign direct investment (FDI) and portfolio capital – cause income inequality. (Dabla-Norris *et al.* 2015, p. 20) An explanation is the concentration of foreign assets in skilled and technology-intensive sectors, which increases the demand for those working in such sectors, and hence their wages. Sweeping generalization from a few cases, however, would be premature and mistaken. It is equally plausible that FDI may help to establish and develop labor-intensive industry in developing economies. In the process, those who were jobless or in another economic sector would get new jobs and continually upgrade their skill in their new jobs. This dynamic process may decrease income inequality. The very nature of financial liberalization matters, when it comes to its effect on inequality.

As we discussed, the effect of trade liberalization on inequality is not unambiguous, often mixed with positive and negative effect.¹² Freer trade may lead to more jobs in the society as a whole, meaning more winners than losers, or the mere re-composition of jobs among different sectors. Moreover, the linkage between job and income growth is getting weaker due to productivity enhancement through technology. It would be reasonable to say that causality from trade liberalization to inequality is not strong, compared to causality from

¹¹ Freeman 2010 is requoted from Dabla-Norris *et al.* 2015.

¹² Through this paper, the term of trade liberalization includes financial liberalization as well, unless noted otherwise.

technological advance to inequality.¹³ Then, why are people more upset about trade liberalization than about technological advances in their misfortune? One clue is that trade liberalization is driven by a government chosen by people, hence people believe it is something stoppable, while technological advance is driven by the free will and incentives of people, and thereby something unstoppable.

This perception is well reflected in political developments these days. The on-going US presidential election has seen both parties lambasting free trade as a bad thing, causing job loss and unfair treatment of the American people (Democratic Party 2016; Republican Party 2016). In the parlance of this paper, they perceive trade liberalization as not inclusive. While recognizing the rather complicated causality from trade to inequality and not agreeing with the rise of new protectionist sentiment, the approach in this paper is to take the link from trade liberalization to inequality more seriously. On this premise, we set to explore how to promote and achieve more 'inclusive growth' through trade liberalization.

3. Cost of Less-Inclusive Integration

If trade liberalization is inclusive, it would help facilitate the transition from less-trade (prior to opening) equilibrium to more-trade (post opening) equilibrium. However, if growth fails to be inclusive, there will be stubborn resistance to market opening, which would create substantial cost to the society. Each layer of these costs deserves careful scrutiny.

First, the political cost spent on blocking trade liberalization attempts. This cost is pure waste, because it fails to create any net value to the society. As long as further liberalization is being delayed due to political outcry and the society is

¹³ In the case of the US, Hicks and Devaraj (2015) estimate that the US manufacturing job loss during 2000 to 2010 is largely accountable for by technology (85%) rather than by trade (13.4%).

stuck in the status quo, the society would suffer net loss. Second, the opportunity cost from status quo: cost from sticking to an inefficient allocation of resources. There are other costs associated with opening without reform. This is related to the situation where a society decides to open further *despite strong opposition*, but without any reform of domestic distortions *due to strong opposition*. More often than not, this situation is remarkably familiar in many countries. Trade officials, afraid of domestic opposition, fail to link the opportunity of external opening to much-needed internal reform. They even find solace from the excuse that they are simply in charge of trade, not domestic economic affairs. Precisely this is the crux of the matter, the core of the problems.

So far, research has been mainly preoccupied by these layers of cost. The first and the second aspects of these costs were given primary research attention. What makes trade liberalization less inclusive is accounted for by the third cost. This third cost gives rise to the vicious circle of trade liberalization: trade liberalization becomes half-way house, without correcting domestic distortions, which in turn makes further trade liberalization more difficult because of the ‘non-inclusive’ outcome of previous trade liberalization. This analysis illustrates the prime significance of addressing domestic distortion in the context of trade liberalization.¹⁴ In this regard, it is proper to ask: Why do domestic distortions stand in the way of fully reaping the benefits of trade liberalization?

Trade liberalization always entails two dimensions: efficiency and distribution. The conventional theory of comparative advantage argues that trade liberalization enhances the efficiency of the economy, compared to pre-liberalization, while there are winners and losers.¹⁵ Assuming that the system would take care

¹⁴ For some developing economies, external pressure for trade liberalization was often used to undertake domestic reform, which would be daunting, if not impossible, without external pressure. Choi (2015) offers the case of China in its long negotiating process of acceding to the WTO. This strategic approach to trade liberalization is meeting more resistance, as economies grow and create their own establishment.

¹⁵ ‘Winners’ are those in exporting sectors, who stand to gain from trade liberalization. ‘Losers’ are those whose welfare or living standards are declining due to trade liberalization. ‘Often losers’ are

of losers in one way or another,¹⁶ the standard argument goes, trade liberalization will make a society better off. Those in less competitive sectors would be given compensation and adjustment assistance and/or migrate to more competitive sectors. As a result, trade liberalization will enhance the production capacity and consumption possibilities of the society bigger, with no one being left behind.

As it turns out, assuming the system was working its course was a big ‘if’. For trade liberalization to achieve a win-win situation for the winners and the losers, the losers should be able to enjoy at least the same level of living standards after trade liberalization. Non-market and market mechanisms may attain this outcome. The losers may find new jobs in competitive sectors easily. Lump sum transfer or redistributive tax to the losers may make them not worse off. For the first type of market solution to work, the economy must be working under full-employment and it must be a flexible economy with flexible prices.¹⁷

The realities are far from this theoretical construct. Many economies are not fully employing their inputs and prices are sticky. For the second type of non-market solution, goodwill collides with moral hazard. In the name of TAA (Trade Adjustment Assistance), the US has operated a program of assisting those in trade-distressed sectors, dating back to the mid-1960s. Its economic effectiveness has been challenged, but it has been an indispensable element for getting fast-track authority without which the US could not pursue meaningful trade negotiations with other countries (Hornbeck 2013). In Korea, a similar program has been designed in the ratification process of FTAs. Starting from the Korea-Chile FTA, the government has offered various programs of cash and non-cash assistance to farmers and non-farmers (Choi and Lee 2005). This process has become, unfortunately, a familiar ritual in most trade liberalization

those in an import-competing sector, facing intensifying competitive pressures from trade liberalization.

¹⁶ As explained in the next sentences.

¹⁷ The economy is working not inside of the production possibility frontier, but along the frontier.

efforts. A huge sum was offered during the ratification process of the Korea-US FTA and the Korea-China FTA. The essential purpose of this program was less to facilitate their migration to more productive sectors, and more to alleviate opposition.

When domestic distortions are severe, trade liberalization is less likely to lead to inclusive outcome. This observation implies that the society with stronger resistance against domestic reform is less prone to fully enjoy the benefits of trade liberalization. The subject of inclusive liberalization brings home the issue of domestic distortion.

III. FTAAP: Current State of Play and Missing Link

1. Pathway to the FTAAP

The FTAAP (Free Trade Area of Asia Pacific) has been intensively debated in the APEC. Since the 2014 Beijing APEC Leaders Meeting, rivalry between the US and China on taking the initiative in the designing and implementation of the FTAAP has intensified. Three perspectives or scenarios contend for mapping out the pathway to the FTAAP. The first perspective (“TPP-based approach”) is to have the TPP as the basic platform for further expansion to non-TPP APEC members to join and expand. The second perspective (“RCEP-based approach”) is to have the RCEP as the basic platform. Finally, the third perspective (“Third way”) is to develop a multitrack framework: a comprehensive and high-level agreement for advanced economies and a less comprehensive and not-so-high-level agreement for developing ones. The “hybrid” approach suggested by Schott (2014) and the umbrella agreement idea suggested by Petri and Abdul- Raheem (2014) belong to this third way.

At present, only the TPP has been concluded and we know what is in it. On the contrary, the RCEP talks are moving at a slow pace with a modest level of ambition, having not much of a high hurdle for investment and services. The third perspective is only on the mindset of some policy makers and scholars, but not yet linked to any of the significant negotiating efforts.

To put these approaches in the proper context, we need to understand the current state of play. When China was the APEC host economy in 2014, it strongly promoted the realization of the FTAAP, driven by its political desire to develop something against the US initiative of the TPP. It managed to secure agreement from the APEC leaders in regard to a roadmap to the FTAAP (APEC 2014). The roadmap includes “Collective Strategic Study” on issues relating to the realization of the FTAAP. This study is scheduled for completion in 2016 (i.e. Peru’s APEC year). It is worthwhile to note that in Beijing the

APEC Leaders agreed on the following common views on the FTAAP, which are considered as the Guiding Principles for the FTAAP (APEC 2014). According to the Guiding Principles, the FTAAP should

- support and complement the multilateral trading system
- be comprehensive, high quality and incorporate and address “next generation” trade and investment issues
- build on APEC’s progress toward achieving the Bogor goals
- be negotiated and realized outside of APEC, in parallel with the APEC process
- aim to minimize any negative effects resulting from the proliferation of regional and bilateral RTAs/FTAs
- be pursued by building on current and developing regional architectures, with emphasis on TPP and RCEP as “pathways”

The Guiding principles require that APEC should

- maintain its non-binding, voluntary cooperation character
- continue to play a role as incubator of the FTAAP and provide leadership and intellectual input to its realization.

Noticeably, the TPP-based approach alone qualifies the condition of “comprehensive, high quality and incorporates and addresses the ‘next generation’ trade and investment issues.” This is because the RCEP is still yet to be completed and the current direction of the RCEP talks is not comprehensive enough and not advanced enough in the “next generation” trade and investment issues. Although one cannot rule out the possibility that the RCEP may incorporate advanced and comprehensive agreements in trade and investment issues, this would be an unrealistically optimistic wish. Nonetheless, considering the non-binding and voluntary nature of the APEC process, all the three approaches are worth considering.

The biggest strength of the TPP-based approach is the presence of the text.

The TPP was concluded last year and 12 participating countries signed the agreement. It is now waiting for ratification. There is a strong concern about whether the TPP would survive the US domestic politics at the ratification stage. Various scenarios are proposed for the ratification, including the lame duck session. Some argue that the TPP would be eventually ratified even with some modification. Some argue otherwise.¹⁸ If Obama leaves his office without getting ratification of the TPP from the Congress, then 2017 will prove a testing time – the first year after President Obama, who negotiated the TPP against the unwillingness of his own party, is succeeded by the new president.

Hilary Clinton, the Democratic candidate for US President in the 2016 presidential race, campaigned that she was against the TPP (in fact, she supported the TPP when she was the Secretary of State) (CNN 2015). Donald Trump, the Republican candidate, vowed to disapprove any further free trade deals, and even to renegotiate existing deals (The Washington Times 2016). Whether these positions taken by the two main contenders are only in the sake of disguised protectionism, only for the campaign, or actual convictions held by the candidates on protectionism, will have to wait the test of time. The cost of non-ratification of the TPP would be too much to assume for the US. The US' leadership and credibility in the international community would be gravely damaged, and such a development would make the US unreliable to its allies in the era of US-China contest in the Asia Pacific.

While the future of the TPP is being tested in the realm of US politics, the RCEP is moving too slow and does not have much momentum to get it going. The ASEAN, which is the backbone of the membership formation of the RCEP, has failed to lead the talks up to now. The same is true for China. China, with its desire to exert its influence, displays a strong enthusiasm in the FTAAP, whereas such leadership is missing when it comes to the RCEP. This remarka-

¹⁸ Choi (2016) offers in-depth analysis of the ratification of the TPP in the US and its strategic implications.

ble absence of the Chinese leadership in the RCEP raises questions about its true intentions regarding the FTAAP.

In terms of the negotiating agenda, the TPP and the RCEP have common elements in Market access for goods (TPP aimed at 100%, RCEP aiming for 90%), Rules of origin, Trade facilitation, Services (TPP adopted “negative list”, RCEP adopted “positive list”), Investment, Competition, Intellectual Property, Development. There are a wide range of issues included only in the TPP, but not in the RCEP. These are Government Procurement, SOE, E-Commerce, Environment, Labour, Trade Remedies, Textiles and Apparel, Temporary Entry, Horizontal Issues like SME, Supply Chain Facilitation, and Regulatory Coherence. These issues exclusive to the TPP are often called ‘21st Century Issues’.

Table 1. TPP and RCEP: Common Elements and Differences in Agenda

Common Elements	TPP Only
Market access for goods - TPP aimed at 100%, RCEP aiming for 90%	Government Procurement
Rules of origin	SOEs - unless included in RCEP under Competition
Trade facilitation - Customs - SPS - TBT	E-Commerce
Services - TPP adopted “negative list”, RCEP adopted “positive list”	Environment
Investment	Labour
Competition	Trade Remedies
Intellectual Property	Textiles and Apparel
Development - Horizontal issue in TPP	Temporary Entry
Dispute Settlement	Horizontal Issues - SMEs - Supply Chain Facilitation - Regulatory Coherence
“Other Issues” (RCEP)	Separate Chapters in TPP - Telecommunications - Financial Services

Source: Scollay (2016); USRT (2016).

2. Assessment of Scenarios

Considering its negotiations agenda, comparison with the RCEP, and the achievement, the TPP is a “high standard”, “21st century”, “comprehensive” agreement. On the other hand, it is also true that the TPP represents, to a large extent, the US priorities and interests, even though close scrutiny to the negotiating process reveals that the outcome reflects compromise among the 12 participating countries. The concern is that some elements of the TPP may prove too much for several APEC economies, which are outside of the TPP for now but considering to join it in the future. Specifically, the issues like SOE, Environment, Labor, ISDS, IPR, cross-border Data Flow may be a cause of concern for them.

It is undeniable that some APEC economies are sensitive to these issues. Some of these concerns may be too over-blown, though. In the TPP, there is no presumption of privatisation of SOE. Sovereignty and policy space are preserved with modest commitments to specific actions in Environment and Labor. In the area of ISDS, a more balancing act is made between investor certainty and host government policy autonomy. As for intellectual property and access to medicines, the US’ initial position was substantially modified (Headlines and Global News 2016).¹⁹

Notwithstanding these fine details, embracing the TPP will still be a tough act to follow for several APEC economies. The critical litmus test for the TPP-based pathway toward the FTAAP is whether China can join the TPP. In the early days of the TPP, Beijing criticized the TPP as a US conspiracy to block China. With the change of Chinese leadership to Xi, Beijing has also changed its rhetoric about the TPP. At least on the surface, Beijing became somewhat more flexible: for instance, some Chinese policymakers began to show more

¹⁹ Precisely because of this, the TPP is being severely criticized in the US pharmaceutical sector. Perhaps the internal dissatisfaction within the US proves the point.

positive attitudes toward China's eventually joining the TPP. Yet, some insiders still remain doubtful and critical, hinting that such an event would be a long and winding road. China will make sure that no stones are unturned until it can possibly imagine its place in the TPP. On the other hand, the possibility of the US joining the RCEP is less plausible. The US has never negotiated a low-level international trade agreement, whether bilateral, regional or multilateral.

All considered, China may regard the third scenario as a more palpable multi-track framework: comprehensive and high-level agreement for advanced economies and less comprehensive and not-so-high-level agreement for developing ones (Li 2016). The problem is which text they would use. At least two texts will be available for the effective implementation of the third scenario. If not, China will have to rely on the TPP. Yet, the more likely text alongside the TPP agreement is the RCEP, in case of the successful completion of the RCEP. As pointed out before, the RCEP is silent on many of the so-called "21st Century Issues" like SOE, Trade and Labor, Trade and Environment and so on. Which means, non-12 initial members to the TPP, including China, would find themselves still in the universe of the TPP in those issues in their "opting out" decision.

In a nutshell, there are two potential structures for the FTAAP. One is the single agreement with "single undertaking". If the TPP goes into force, the momentum will increase for other APEC economies to join the TPP. Then, the TPP will become the "de facto" FTAAP. This pathway looks challenging at the moment and will take time even in an optimistic scenario. The other path is the "Two-speed" FTAAP, with the FTAAP as an "umbrella agreement" with common commitments linked to two further agreements: the TPP or "TPP-style" agreement with a higher level of commitments and benefits, and the RCEP or "RCEP-style" agreement with a lower level of commitments and correspondingly a lower level of benefits (Schott 2014; Petri and Abdul-Raheem 2014).

3. Missing Link in the Current Scenarios

While the pathway to the FTAAP has been much discussed with a focus on its architecture, something has been missing: how to link trade and investment liberalization with quality growth of the APEC member economies. In fact, the APEC is well aware of this issue. In 2010, APEC adopted “The APEC Leaders’ Growth Strategy”, in which APEC Leaders called for the necessity of promoting the broadest participation in the global economy with the aim of sharing the benefits of economic integration with all the parties involved, from the recognition of side effect of the imbalance and disparity between and within the APEC economies (APEC 2010).

The APEC Growth Strategy identified the five key attributes for economic growth: 1) Balanced Growth, 2) Inclusive Growth, 3) Sustainable Growth, 4) Innovative Growth, and 5) Secure Growth (APEC 2010). The APEC Leaders have continued to care about growth. In 2015, they proclaimed the APEC Strategy for Strengthening Quality Growth (APEC 2015b). Notwithstanding this policy awareness, the current discussion on the FTAAP is too overly focused on external integration, without carefully considering the effect of external integration on the domestic economy.²⁰ The Guiding Principles for FTAAP (APEC 2014) are also silent on this dimension.

As stressed in the preceding section, external integration in the midst of domestic distortion would be likely to increase inequality. If growth is inclusive, it would help facilitate economic transition from less-trade (prior to opening) equilibrium to more-trade (post opening) equilibrium. However, if growth fails to be inclusive, there will be sub-

²⁰ For instance, recent big-scale international conference on the FTAPP, titled as “the FTAAP: Asia-Pacific Economic Integration by 2020 and Beyond”, held in Beijing during October 15-16, 2015, had no session on the question of linking the FTAAP with domestic inclusive growth. The two-day conference solely focused on technical issues related to the negotiations. The conference program is available at <https://www.pecc.org/event-calendar/past-events/event/458-ftaap-asia-pacific-economic-integration-by-2020-and-beyond> (PECC 2015).

stantial resistance and opposition to market opening, generating a huge cost – the cost of adhering to inefficient resource allocation, the political cost spent on opening markets and so on.

IV. Strategy for Realizing Inclusive Integration with the FTAAP

The strategy for linking APEC's move towards the FTAAP with inclusive growth requires an approach from two fronts: the negotiations front and domestic policy front.

1. Negotiations Front

As discussed in the previous section, contending scenarios for the FTAAP revolve around the TPP, RCEP or a variant of the RCEP. Salient differences among them are the scope of market access and rule making. Developing economies in the APEC are reluctant to embrace the idea of 'deep integration'. Not only are they concerned about opening up their service sector, but also about making 'new' rules on state-owned enterprises, environment and labour, ISDS, intellectual property, access to medicines, and digital trade. Some of these concerns are legitimate and reasonable. As for some developing economies, they may not have any specific policy directions on these issues. Hence, these issues are mainly the subject of interest for the US. If the US insists on these issues and other economies – mainly non-TPP APEC members – resist, it will be difficult for the FTAAP to materialize. How to avoid such a deadlock?

To make progress towards a more-inclusive FTAAP, mistrust on each side should be dealt with. Developing economies have been suspicious about the case of 'deep integration'. They have taken a view that 'deep integration' is mainly for the interests of the advanced economies and a remote concern for themselves. In the eyes of developing economies, the advanced economies have always wanted to have all to their liking, while not opening up their politically sensitive and unproductive sectors, which are main exports targets for developing economies. In the view of advanced economies, developing economies repeat the predictable pattern of making concessions but not fully implementing.

To make progress, this undesirable ‘stylized’ pattern will have to stop. Each side should earn trust from the other side.

Advanced economies should correct their double standard by doing their homework – opening up their entrenched sectors, which have been immune from the discipline of trade liberalization, and showing more flexibility in advancing ‘new’ issues to developing economies. At the same time, developing economies should engage in service and rule making negotiations with a forward-looking attitude, instead of hiding behind the APEC way of non-binding and voluntary, and take their liberalization commitments seriously. And both advanced and developing economies should work together on non-tariff measures (NTM) and investment with a view to creating an effective and sustainable rule in these agenda. Table 2 shows the summary of a grand bargain as argued.

Table 2. Grand Bargain

	<i>Commitment</i>
Advanced Economies	<i>Market access in protected sectors</i>
Developing Economies	<i>New (21st Century) Issues</i>
Advanced and Developing Economies together	<i>NTM Investment Rule</i>

Source: Table by the author.

Under this grand bargain between advanced and developing economies, the negotiations agenda for the FTAAP would be more comprehensive and balanced for all concerned. What is remarkable is that this grand bargain will make the FTAAP more inductive to inclusive integration. Under the grand bargain, protected sectors in advanced economies (for instance, textile in the US, farming in Japan) – potential exporting sectors for developing economies – would be opened in exchange for more commitment to new rules by developing economies.

To make this grand bargain politically possible, each side should do its

homework domestically. Empowering human capital and skill upgrading programs, among others, will be urgent and imperative. Otherwise, the demand for protection will be loud and noisy. Designing a more effective trade adjustment assistance program is also an important priority.

Advanced economies have been reluctant and hesitant in opening up their protected sectors. Rather than making efforts to reform and open their protected sectors, they turned to the ODA (Official Development Assistance) program for the developing economies. When it comes to efficiency and sustainability, providing market access to developing economies is a better policy than the ODA. The logic is that providing market access gives an incentive to people in developing economies to harness the competitiveness of their relative abundant factors (in the sense of comparative advantage) and develop these into exporting sectors. On the other hand, ODA requires cost from the giving end of transaction: an ODA-giving country needs to establish its office, staff and so on. Moreover, providing market access is more transparent, free from corruption, whereas ODA suffers from lack of transparency in delivery mechanisms and endless scandals of corruption. Providing market access is rule-based, but ODA is discretionary. Despite these obvious merits, advanced countries have consistently rejected the call for opening their entrenched markets to people in developing countries. Without doubt, this is a politically driven choice. Politicians are good at counting the number of votes. Entrenched sectors in advanced countries have been heavily defended by punitively high tariffs and glaringly protective logic for those unproductive workers. As an unintended consequence, developing countries have been deprived of opportunities for development. Generous ODA may be a kind of psychological consolation for advanced countries. It is time to stop this nonsense. Advanced economies should open up their last mile for trade liberalization. It is for them, and for the APEC community. That is what leadership is all about.

A grand bargain does not imply all APEC economies accepting the same text in rule-making, however. Here the focus is to ensure that all are on the same page

and make no lapse in implementation due to deficient domestic regulations. Some economies would require time to fully understand and digest the issues, and many would need time to make their domestic system consistent with new trade commitments. Hence, one size does not fit all. A ‘Two-speed’ FTAAP may be conceived, differentiating between economies in fast-track and those in slow-track. Under this scheme, fast-track economies would undertake a high-level commitment with larger benefits and slow-track ones would undertake a moderate-level commitment with moderate benefits. A transition from slow-track to fast-track may also be designed, with incentives offered for such transition.

2. Domestic Policy Front

Trade liberalization should be conducted and implemented in the broad context of the domestic economy, if trade liberalization is to be inductive to inclusive integration. The main reason why more liberalization has not led to more fruits to the less powerful, the less advantaged, is because many distortions in domestic markets have not been properly and timely dealt with. Prime examples of major distortions are as follow:

Policy preference for incumbents

- New entrants, sometimes more innovative or less powerful, cannot compete in the newly expanded market due to market opening. Then, the benefit of market opening squarely falls on the incumbents, who are often politically well-connected. This situation gives rise to well-documented ‘rent-seeking activity’, which is socially unproductive. Often these incumbent play the mantra of ‘promoting national champion’, and such a tactic finds familiar friends in media and politics. The losers are potential entrants and tax payers. If this situation is not improved, disparity between the top and the rest of the others in the society will widen.

Rigid labor market

- Market opening brings intensified competition in the domestic market. Unproductive sectors are often those with heavy import protection. With this protective shield gone, local firms face the test of survival and fit. Once in a while, these local firms effectively meet the challenge, but more often than not, they are not up to the test. The logic of the comparative advantage principle for mutual beneficial outcome precisely dictates their failure. When they fail, capital and labor in those firms find other places to relocate to. Through this reallocation process, an economy becomes more productive. If the labor market is too rigid – layoff and firing are overly difficult (not just because of workers’ resistance, but more because of institutional rigidities against layoff and firing) – then this reallocation process will not take place. Within a rigid labor market, workers in unproductive import competing sectors will continue to keep their jobs at the cost of potential job creation in more productive sectors.

Exclusive capital market

- The exclusive capital market refers to the financial sector not easily accessed by the less powerful. Only the powerful, politically well-connected, big business and state-owned sectors enjoy such exclusive access to finance. The less powerful, small business, young entrepreneurs and private sector are either blocked or pay a high premium for limited access. This sort of financial exclusion is not only inefficient, but also undemocratic. Without upending this exclusive capital market from the less powerful, newly created business opportunities due to market opening go only to those powerful.

Inadequate social safety net

- Market opening is bound to cause trouble to some. For those distressed from market opening, society must provide a safety net. Any decent society is expected to provide wage insurance, job training, job search assistance for those who have lost their jobs. Without sufficient social safety, people may not be ready to absorb trade disturbance. Usually, the people who are in dire necessity of this safety net are the less powerful.

When market opening is implemented with those distortions intact, disparity between the powerful top and the rest of the others in the society will continue to widen. This situation is not unfamiliar, actually. We witness several of such episodes in Latin American countries. Every time a pro-business regime opens the economy more and more to trade and investment, more fruits from liberalization are picked up by the powerful. The rest of the others were not part of the game. The consequence was backlash against liberalization: the next populist regime resorted to distribution, while turning its back on market opening. Redistribution without generating growth was not sustainable either. Hence, history records the continuous repetition of pro-business regimes and populist ones in Latin America. The Latin American tragedy would have been resolved if domestic distortions were seriously addressed and effectively removed, along with liberalization.

In a less dramatic episode, Korean consumers have not fully reaped the benefits of the FTAs. Prices of some imported wines from the EU in Korea were observed to be more expensive than those in Japan, although Korea had an FTA with the EU while Japan did not. Take, for instance, the Korean consumers' on-line shopping sprees from foreign retailers. The products they race to order are often those without tariffs due to FTAs! As it turns out, the benefits of tariff elimination are more captured by importers, not consumers. In many cases, these importers enjoy exclusive access to foreign imports because of their license. Tariffs are removed through trade negotiations, while this con-

sumer-unfriendly distribution system is not reformed. Again, opening up without fixing domestic distortion leads to less inclusive integration, more favorable to the establishment.

From the proceeding analysis, suggestions for policy reform are straightforward:

- Policy preference for incumbents should be removed
- Labor market should become less rigid
- Capital market should be accessible to all
- Social safety nets should be strengthened

The proposals in this paper should not be confused with the so-called Washington Consensus. What is being proposed in this paper is the minimum set of distortions which should not go hand in hand with market opening. As for the labor market, the paper does not make the case for an extremely flexible labor market like in the US. As for social safety nets, the recommendation is not merely praise for the Nordic model. For the Nordic model to work, three factors should work at the same time: social solidarity (strong sense of community), no corruption, and a competitive and vibrant economy. Those in the left forget that the Nordic people kicked many zombie firms from the market. Those in the right forget that the Nordic people do not inherit any notion of privilege, and the capitalists knew so well the sense of temperance, not being excessive.

The EU integration process best illustrates the significance of linking domestic reform with trade liberalization. For the accession of new members to the EU, the prospective member goes through a series of stress tests to identify their domestic distortions and is required to undertake reform of those distortions as a precondition for becoming a new member. A new prospective member is given time to revise its domestic policy and regulations pursuant to the EU guideline. This is precisely the exercise of correcting domestic distortions. Former Communist nations in the Central and Eastern Europe have gone through this exercise to be members in the EU!

V. Conclusion

This paper posed the question of how to make the FTAAP more inductive to inclusive integration. If it were the early days of the APEC, the theme of ‘inclusive integration’ would not have found serious research attention. In retrospect, those were times when belief in the sunny side of globalization ran wild, so much praise for the virtuous cycle of trade-growth-distribution. International organizations have been unashamed cheerleaders. Now, the tide has changed. Euphoria has markedly receded, mainly due to the decoupling of growth and distribution. Inequality has been stagnant in many countries. Trade has been blamed for causing inequality. This dramatic change of circumstances presents a strong case for taking inclusive integration seriously.

Policy proposals to achieve a more inclusive FTAAP are offered in two fronts. At negotiations, a grand compromise between advanced and developing economies should be sought to make negotiations agenda more comprehensive and balanced. Under such a grand bargain, protected sectors in advanced economies – potential exporting sectors for developing economies – would be opened in exchange for more commitment in new rules by developing economies. To make this grand bargain politically possible, each side should do its homework domestically. Empowering human capital and skill upgrading programs will be urgent and imperative, along with designing a more effective trade adjustment assistance program. To enhance the possibility of achieving this comprehensive and balanced agenda, and to ensure all are on board, a two-track commitment should be designed.

On the domestic front, major distortions which have obstructed a more inclusive integration in the past should be urgently corrected. Specifically, policy preference for incumbents should be removed; labor markets should become less rigid; capital markets should be accessible to all; and social safety nets should be strengthened.

The policy proposals offered in the paper are idealistic, yet realistic. They are idealistic, because some proposals require tough political decisions, and the idea of a grand bargain between advanced and developing economies may seem even naïve from the mindset of negotiation leverage. These proposals are not something to be pushed aside, though. The stakes are much higher. If these proposals are not taken seriously in the future discourse of the FTAAP, the consequences would be backlash to the progress towards the FTAAP. Failure to make a more-inclusive FTAAP would mainly serve the interest of the establishment. The cost of such a failure would make inequality worse. We cannot afford such a dismal outcome. For these reasons, these proposals are realistic. And the stakes are so high.

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국문요약

아태자유무역지대(FTAAP: Free Trade Area of the Asia-Pacific)를 달성하기 위한 다양한 청사진이 제시되고 있지만, 무역과 투자 자유화를 APEC 회원국들의 포용적 성장과 어떻게 연계할 수 있을지에 대한 연구는 부재한 상태이다. 무역과 투자에 대한 APEC 회원국들의 태도는 보다 더 개방적으로 변화했지만 국내적인 왜곡은 여전히, 포용적인 성장으로 연계되는 데 한계를 노정하고 있다. 특히 경제적 약자들은 외생적 충격에 취약한 상태로 노출되어 있다. 이러한 왜곡 상태에 신속하고 진지하게 대처하지 않는다면, FTAAP를 추진할 수 있는 정치적 추동력은 갈수록 약화될 것이다. 본 연구는 이러한 문제의식에서 시작되었다.

본 연구는 FTAAP 논의가 포용적인 경제성장과 연계되기 위한 협상과 국내개혁 두 가지 측면에서 정책방향을 제시한다. 첫째, 포괄적이고 균형 잡힌 협상의제를 만들기 위해 선진국과 개도국 간의 대타협이 필요하다. 선진국은 지금까지 정치적 반발을 이유로 개방의 예외 지대로 남겨두었던 분야 - 개도국의 수출가능 분야 - 를 개방하고, 개도국은 21세기 디지털 경제관련 무역쟁점 협상에 동의하며, 선진국과 개도국은 비관세 조치와 투자분야 협상에 동의할 필요가 있다. 대타협의 가능성을 구체화하기 위해, 각국은 국내적으로 인력개발과 숙련도 향상에 투자하고 무역조정지원제도를 현실적으로 손질해야 한다. 개방약속은 회원국의 역량에 맞게 2단계로 나누어 적용한다. 둘째, 지금까지 포용적 성장에 장애물이었던 심각한 주요 왜곡 - 신규진입자가 아닌 기존 시장참여자를 편드는 정책, 경직적인 노동시장, 일부 소수만 접근가능한 자본시장, 턱없이 취약한 사회안전망 - 을 신속하게 시정해야 한다.

핵심용어: 지역통합, 포용적 성장, 아시아태평양경제협력체, 아태자유무역지대, 환태평양경제동반자협정, 역내 포괄적 경제동반자협정

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