

Developing Asia and the world

Developing Asia and the Pacific: Performance and prospects

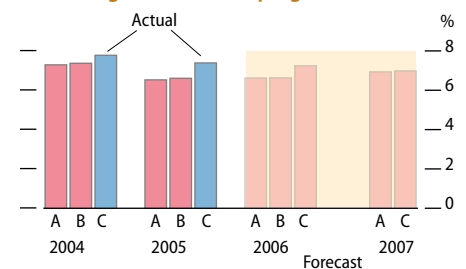
Economic growth in developing Asia and the Pacific surprised on the upside in 2005. In September last year, the *Asian Development Outlook (ADO) 2005 Update* forecast aggregate regional growth of 6.6%. The *ADO 2006's* estimate of growth is now 7.4%, well above the average rate of growth in the region since 2000. If purchasing power parity weights, rather than weights based on market exchange rates, are used to aggregate over countries, regional growth in 2005 is estimated to have been even faster, at 8.0%. With the release of revised gross domestic product estimates for 2004 in a number of countries, growth in 2004 has now been raised to 7.8%, from 7.4% in the *ADO 2005 Update*.

On the basis of a broadly favorable outlook for the international economy, the continuing trend toward improved economic management and performance, and apparent resilience to high oil prices, the *ADO 2006* revises up its aggregate growth projection for 2006, and, to a lesser extent, for 2007 (Figure 1.1.1). Aggregate regional growth of 7.2% is now expected in 2006, easing to 7.0% in 2007. But risks remain, and could yet unsettle a generally positive outlook. These risks include the possibility of a disorderly unraveling of global payments imbalances (which are still widening), heightened protectionist trade pressures, yet higher oil prices, and the possibility of an antigen shift of the avian flu virus into the human population.

Performance in 2005

Headline growth in developing Asia is heavily influenced by the performance of the People's Republic of China (PRC) (which carries a weight of about 37%), and by India and the Republic of Korea (Korea) (which have a combined weight of 30% of regional income) (Figure 1.1.2). In the PRC, following back-to-back years of double-digit expansion, growth dipped below 10% in 2005, but only fractionally. Booming exports and investment continued to propel demand, and growth of industrial output accelerated. In India, growth surged to 8.1%, underpinned by strong performances in industry and services, and a rebound in agriculture from a weak performance in 2004. Although Korean growth slipped in 2005, consumption demand recovered in the latter part of the year to lift the annual average to 4%.

1.1.1 GDP growth, developing Asia



Note: A = Asian Development Outlook 2005; B = Asian Development Outlook 2005 Update; C = Asian Development Outlook 2006.

Sources: Asian Development Outlook database; staff estimates.

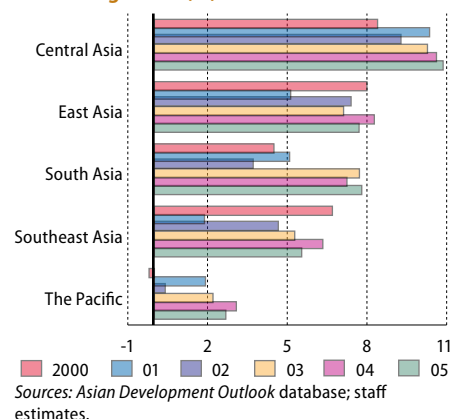
Other countries, too, saw positive developments. In 2005, Pakistan grew faster than at any time in the past two decades (its fiscal year ended on 30 June 2005). Its performance was helped by an exceptional agricultural harvest, but the industry and services sectors also showed some vigor. In 2005, growth once again climbed in Cambodia, Lao People's Democratic Republic, and Viet Nam, and was faster than at any point since 1999 in all three countries. In Central Asia—a net oil and gas exporter—high oil prices supported double-digit economic expansion. Although growth in the Pacific remains seriously constrained, 2005 was better than most recent years. Solomon Islands consolidated its recovery process, and Samoa enjoyed its fastest growth in 4 years. The benefits of high oil prices enjoyed by Papua New Guinea and Timor-Leste, both net exporters of oil, buttressed the Pacific average.

Resilience was another theme in 2005. The impact of high oil prices on growth appears to have been muted. Developing Asia is not only a large net oil importer, it is also a comparatively energy inefficient region (*ADO 2005 Update*). In 2005, oil prices were on average about 42% higher than in 2004, yet regional growth slowed by just 0.4 of a percentage point. And despite the horrific loss of life caused by the December 2004 tsunami, economic growth in Indonesia and Sri Lanka in 2005 improved on 2004's performance. Pakistan's tragic earthquake is unlikely to have much impact on its economic performance in FY2006. Across the region, the number of human deaths from avian flu has now risen to 103 (as of 17 March), but the main economic impact of the virus has so far been confined to the poultry sector. Although this sector is small in most countries, poor farmers are the people bearing the brunt of income losses.

Various factors help explain why oil prices did not make a large dent on regional growth in 2005. To the extent that fuel prices are either directly or indirectly subsidized, as they still are in many Asian developing countries, producers and consumers have been shielded from the need to make adjustments. In both the PRC and India, and in a majority of other countries, the pass-through of higher border prices to retail fuel prices was far from complete (Box 1.1.1). Unrelated factors that supported growth in 2005, such as better agricultural harvests in some countries, also helped mask the impact of higher oil prices. In countries that allowed faster and fuller pass-through, such as Indonesia and Thailand, there is clearer evidence that rising oil prices did in fact pinch growth. But the resources released by reduced subsidies are now available for programs that can sustain growth over the longer run, including investments in health, education, and physical infrastructure.

For some countries, 2005 proved a difficult year. The Maldives economy contracted. This small island's tourist industry was laid low by the destruction caused by the tsunami, and has yet to recover fully. The economy of the Kyrgyz Republic also contracted. Political dislocation and production difficulties at a large gold mine took their toll on aggregate income. In other countries, growth slowed. In Thailand, the conjunction of the tsunami, an unusually poor agricultural harvest, and political uncertainty linked to disruption in the south slowed growth. In the Philippines, too, bad weather hit agricultural growth and political uncertainty cramped investment. Toward the end of 2005, growth slowed

1.1.2 GDP growth (%)



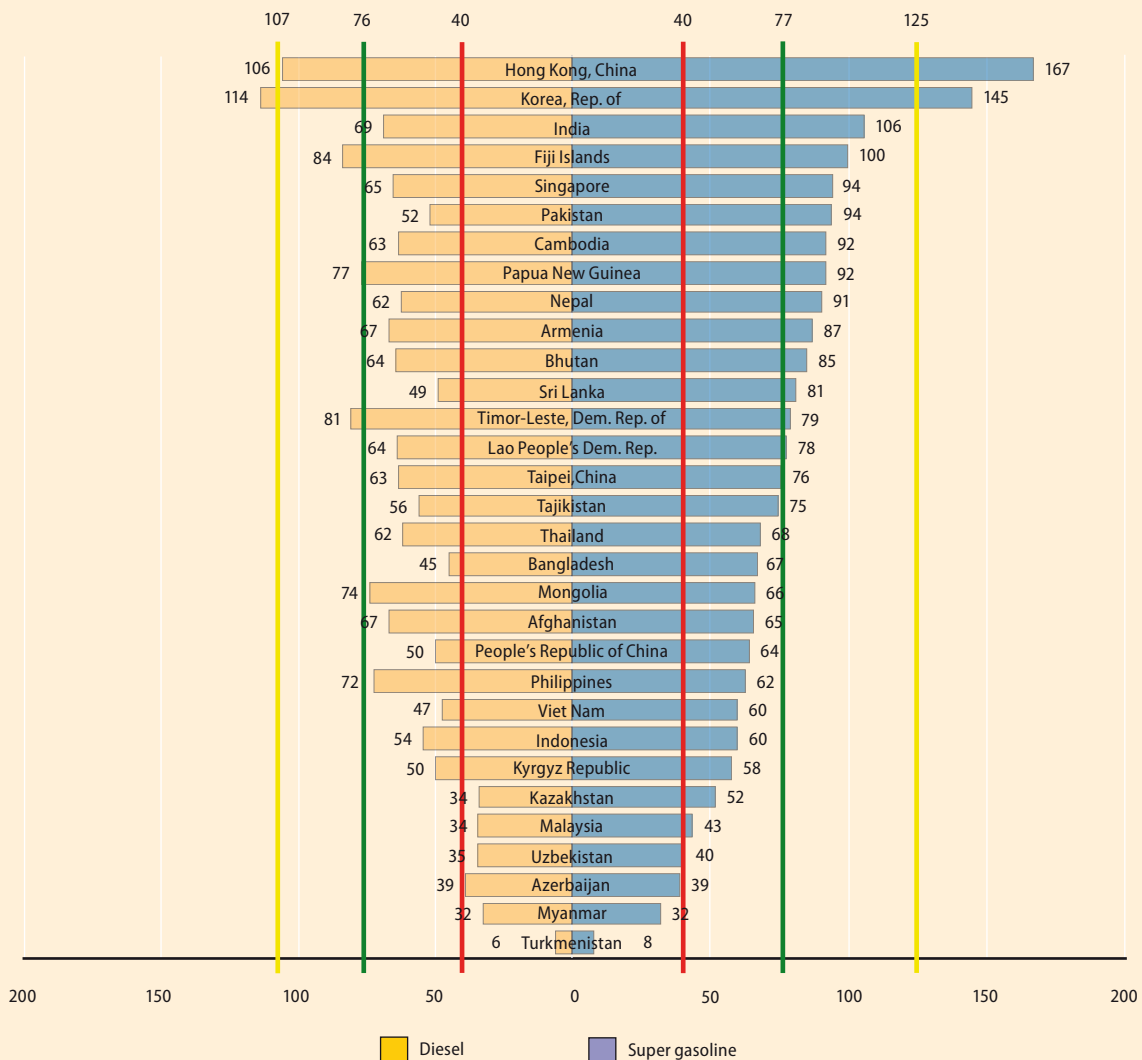
1.1.1 Retail fuel prices in Asia

Since 2002, international fuel prices have been on an uptrend, cumulatively rising by close to 150%. The average price of Brent crude has climbed from \$25 per barrel in 2002 to \$62 per barrel in 2006 (as of 15 March). Average prices of diesel and kerosene in the New York market have soared higher than that of Brent crude, increasing from about \$0.18 per liter to \$0.48 per liter over that period. Meanwhile, the hike in prices of unleaded gasoline, both regular and premium, has been much less than that of Brent crude. Average unleaded gasoline prices

are now \$0.42–0.46 per liter, compared with \$0.18–0.21 per liter in 2002.

While fuel prices in the international market are continuing to move up, governments in many parts of developing Asia have limited the rises in domestic retail fuel prices, shielding domestic consumers from higher costs. As a result, many Asian governments are facing increasing fiscal stresses brought about by direct or indirect subsidy provision. Bangladesh, India, Nepal, and Sri Lanka all adjusted retail prices upward in 2005.

Box figure Comparison of retail fuel prices in Asia (as of February 2006, US cents per liter)



— Retail fuel prices of Luxembourg = approximate minimum entrance level for 10 European Union accession countries.

— Retail fuel prices in the United States = average cost-covering retail prices including industry margin, VAT, and approximately 10 US cents for the two road funds (federal and state). This fuel price, as it has no other specific fuel taxes, may be considered the international minimum benchmark for a nonsubsidized road transport policy.

— Crude oil prices on the world market (Brent at Rotterdam).

Sources: National press reports; surveys by ADB resident missions; *Fuel Price Report*, February 2006, available:

<http://www.theaa.com/onlinenews/allaboutcars/fuel/2006/February2006.doc>; Energy Information Administration, available:

<http://www.eia.doe.gov>, downloaded 22 March 2006.

Nevertheless, these countries continue to have relatively large direct or indirect subsidies (in relation to gross domestic product), mainly due to large subsidization of household-use products such as kerosene and liquefied petroleum gas. Governments have indicated that subsidies will be reduced in 2006 and 2007. The PRC raised gasoline and diesel ex-refinery prices in March 2006.

The box figure, which provides an indication of the extent of government subsidies, shows retail prices of transportation fuels—super gasoline and diesel—during the first 2 weeks of February 2006 for selected developing Asian economies. Following the methodology adopted by the German Technical Cooperation (GTZ), the box figure shows three sets of colored vertical lines defining benchmark prices (see Box 3.4 of the *Asian Development Outlook 2005 Update*). The red lines (40 US cents per liter) indicate the cost per liter of crude oil, which was \$63 per barrel at that time. The green lines are the US retail prices plus 10 US cents per liter of taxation for road infrastructure (77 US cents per liter for gasoline and 76 US cents per liter for diesel). The yellow lines represent Luxembourg product prices (125 US cents for gasoline and 107 US cents for diesel). Only Hong Kong, China and the Republic of Korea priced their gasoline and diesel close to the yellow benchmark lines of Luxembourg.

For gasoline, a large number of economies (14) in developing Asia charged the US retail price benchmark or more, while a smaller number (5) charged the US retail price benchmark net of the 10 US cents allowance for taxation. This does not necessarily indicate that full cost recovery was practiced in these countries' pricing mechanisms, as cost recovery depends on refining and distribution efficiency as well as on infrastructure maintenance costs. Economies pricing up to the green benchmark line likely recovered at least their crude and refining costs.

Indonesia used to cover only crude costs, but even as gasoline prices were put up by 149% since February 2005, retail prices remained below the green benchmark line. In Turkmenistan, which is one of the net oil and gas exporters of Central Asia, retail prices covered a very

small fraction of crude costs. Azerbaijan priced almost up to the red benchmark line. Malaysia and Uzbekistan covered crude oil costs, but retail prices remained heavily subsidized. In late February 2006, gasoline prices were raised by 19% in Malaysia, but the Government estimates that the new prices would be 28% higher still if subsidies were removed. Retail prices in Myanmar fell short of crude oil costs, even as gasoline prices were raised more than eightfold in October 2005 to curb a thriving trade in the black market.

For diesel, several countries—Azerbaijan, Kazakhstan, Malaysia, Myanmar, Turkmenistan, and Uzbekistan—charged less than the indicative crude costs. As with gasoline, most of the countries that did not charge up to the red benchmark line are oil producers and net oil exporters. Myanmar, despite having lifted diesel prices more than ninefold in the last quarter of 2005, still has heavily subsidized retail prices. Malaysia estimates that domestic retail prices of diesel would be 25% higher if government subsidies were removed. Still, another 19 countries did not price up to the US retail price benchmark.

More economies provided greater subsidies for diesel than for gasoline. This is because diesel is commonly used by public utility vehicles, and the poor stand to benefit from the subsidy by way of lower transport fares. However, an unintended effect is that private car owners who use diesel-run vehicles also benefit from the government subsidy.

Since 15 February 2006, crude oil prices have risen further, but these increases have not been fully reflected in domestic retail prices of most developing Asian economies. Instead, subsidy bills continue to grow, fuel tax revenues are generally on the slide, and losses of state owned and controlled petroleum distribution companies continue to rise.

Sources: Surveys by ADB resident missions; *Fuel Price Report*, February 2006, available: <http://www.theaa.com/onlinenews/allaboutcars/fuel/2006/February2006.doc>; Datastream; Energy Information Administration, available: <http://www.eia.doe.gov>; national press reports.

sharply in Indonesia as the impact of reductions in fuel subsidies caused inflation to jump and rising interest rates sapped domestic demand.

Inflation in developing Asia moderated a little in 2005, but the picture varied across subregions and countries (Figure 1.1.3). Inflation eased in both East Asia and South Asia, largely as a result of favorable agricultural developments that subdued rises in food prices. But it accelerated in Southeast Asia and in Central Asia on account of higher oil prices, though for different reasons. In Southeast Asia, higher oil prices added to costs that percolated through to prices, while in Central Asia inflation was spurred by the impact of a booming oil sector on demand, as

government spending expanded and oil wealth filtered through to other parts of the economy.

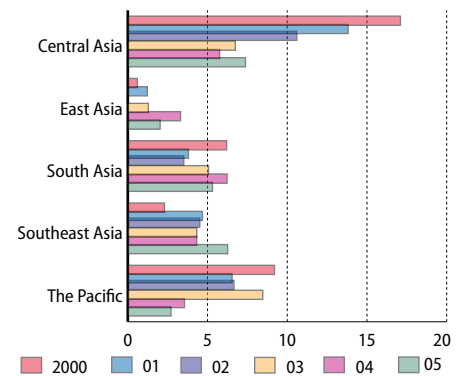
Across the region, the monetary authorities took steps to respond to the threat of heightened inflationary expectations. Policy interest rates were raised in quite a few economies, including Azerbaijan; Bangladesh; India; Indonesia; Kazakhstan; Korea; Malaysia; Pakistan; Philippines; Sri Lanka; Taipei, China; and Thailand. Nevertheless, real interest rates remained quite low.

In most countries, fiscal positions in 2005 remained little changed relative to 2004. However, measures to limit growth of expenditure helped reduce the deficit in the Philippines, and in India fast growth helped buoy fiscal revenues. In Indonesia and Malaysia, public expenditure targets were missed because of slow disbursements on planned investments. In Pakistan, a larger deficit reflected a sharp increase in development expenditures aimed at sustaining growth. In some countries, the fiscal cost of fuel subsidies have triggered cuts in their levels, with subsidies on gasoline reduced the most and those on diesel and kerosene less so. Thailand moved to eliminate gasoline and diesel subsidies altogether. In October, the Indonesian Government slashed subsidies. Other countries have moved more slowly. In Bangladesh, PRC, and India, liabilities accumulated on the balance sheets of state-owned oil distribution companies that purchase fuel at world prices but that are compelled to sell in domestic markets cheaply. These losses must eventually be met by taxpayers.

Developing Asia's trade surplus with the rest of the world widened by \$52 billion in 2005 to \$192 billion; the PRC's trade surplus alone widened by about \$74 billion. Had oil prices not risen, Asia's trade surplus would have been much larger. Although the growth of merchandise exports from the PRC tailed off a little in 2005, imports grew at only half of their 2004 pace. Slower import growth in 2005 reflected an expansion of domestic capacity that replaced imports of some commodities and, possibly, a drawdown of inventories of imported commodities that had been accumulated in earlier years. Korea's trade surplus in 2005 almost matched 2004's as large-scale enterprises continued to perform strongly in overseas markets. In Southeast Asia, an overall rise in the current account surplus disguised a widening trade deficit in both the Philippines and Thailand. Central Asia posted a 75% increase in its trade surplus as a result of higher oil prices. In South Asia, trade deficits widened in all countries but Bangladesh and Nepal (Figure 1.1.4).

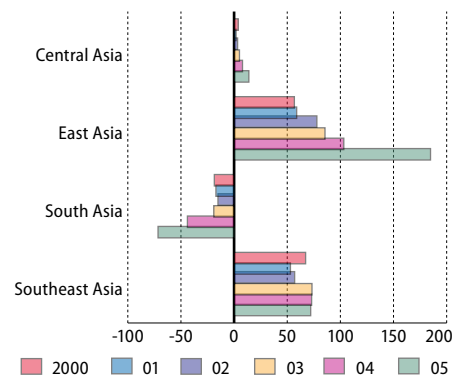
Generally, current account movements in 2005 tracked closely those of the trade balance. But strong remittance inflows in Bangladesh, Pakistan, and Philippines in 2005 either offset or reversed trade deficits. To some degree, remittances were buoyed by strong oil revenues in the Middle East, which is host to many immigrant workers from Asia. As a percentage of gross domestic product (GDP), the current account surplus widened in East Asia, and narrowed in Southeast Asia (Figure 1.1.5). In Central Asia, the deficit switched to a surplus. South Asia's current account deficit widened substantially. Largely as a consequence of current account surpluses, developing Asia's foreign exchange reserves increased in 2005 to around \$1.86 trillion (Box 1.1.2). Foreign direct investment (FDI) inflows in 2005 remained brisk but were a little less than in 2004,

1.1.3 Inflation (%)



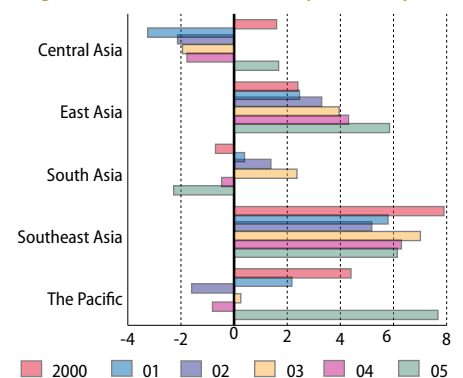
Sources: Asian Development Outlook database; staff estimates.

1.1.4 Trade balance (\$ billion)



Sources: Asian Development Outlook database; staff estimates.

1.1.5 Current account balance (% of GDP)

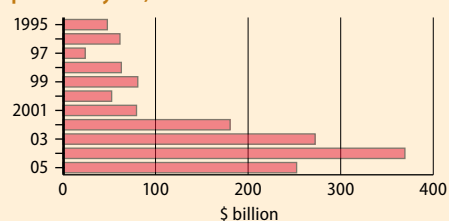


Sources: Asian Development Outlook database; staff estimates.

1.1.2 Developing Asia's foreign exchange reserves and the United States trade deficit

Developing Asia's foreign exchange reserves rose by about \$252.4 billion during 2005 to \$1.86 trillion at year-end, according to preliminary data (Box table). Despite its size, the advance was much lower than the \$369.4 billion seen in 2004, and represented a break in the increasingly outsized gains made by the region since 2001 (Box figure 1). Only a handful of countries recorded declines in reserves in either year and they were marginal. The lower accumulation in 2005 was due mainly

1 Foreign exchange reserves (change from previous year)



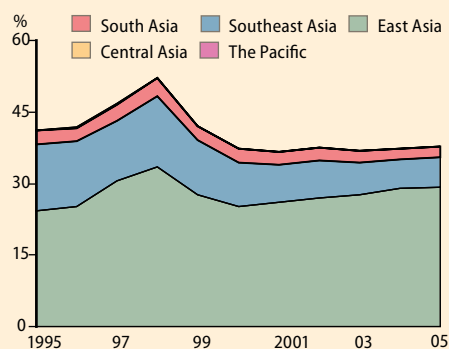
Note: Data for 2005 are preliminary.

Sources: International Monetary Fund, International Financial Statistics online database, available: <http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT>; Central Bank of China, available: <http://www.cbc.gov.tw/EngHome/Economic/Statistics/FS/history/ERESERVE-H.xls>, downloaded 15 March 2006; staff estimates.

to smaller reserve increases among large holders such as India; Republic of Korea; Malaysia; Singapore; and Taipei, China. Early balance-of-payments data suggest that these smaller gains reflect developments in the capital and financial accounts rather than in the current account surplus for the year. At \$819 million, the PRC accounted for about 44% of developing Asia's stock of foreign exchange reserves at end-2005, up from about 27% at end-2001, accumulating about 56% of the region's increase in reserves over this period.

Box figure 2 indicates that the region's share in the United States (US) merchandise trade deficit remained essentially stable in 2005—as it has since 2000. Within this trend, the PRC has gained share. This

2 Share in total US trade deficit



Source: US Census Bureau, available: www.census.gov, downloaded 27 March 2006.

In 2005, developing Asia's trade deficit with the US amounted to \$289.6 billion, or 37.8% of the total US trade deficit, up by 0.6 percentage points from 2004. In East Asia, the PRC accounted for \$201.6 billion, or 26.3% of the total deficit, up by 1.4 percentage points, while the share of Korea and Taipei, China fell by a combined 1.2 percentage points, to produce a net 0.2 percentage point increase for the subregion. A deeper US trade deficit with Southeast Asia accounted for nearly all the balance (0.4 percentage points) of 2005's increase.

Foreign exchange reserves (\$ billion)

	Stock end-2005	Change over the year 2005	2004
Central Asia	8.7	-2.0	4.9
Armenia	0.7	0.2	0.1
Azerbaijan	1.2	0.1	0.4
Kazakhstan	6.1	-2.4	4.2
Kyrgyz Republic	0.6	0.1	0.2
Tajikistan	0.2	0.0	0.0
East Asia	1,406.8	233.2	290.6
China, People's Rep. of	818.9	208.9	206.7
Hong Kong, China	124.2	0.7	5.2
Korea, Rep. of	210.0	11.8	43.7
Mongolia	0.4	0.2	0.0
Taipei, China	253.3	11.6	35.1
South Asia	148.1	6.3	27.1
Bangladesh	2.8	-0.4	0.6
Bhutan	0.4	0.1	-0.1
India	131.0	5.9	27.5
Maldives	0.2	-0.0	0.0
Nepal	1.5	0.0	0.2
Pakistan	9.8	0.3	-1.1
Sri Lanka	2.5	0.4	-0.1
Southeast Asia	297.0	15.0	46.5
Cambodia	1.0	0.0	0.1
Indonesia	32.8	-1.9	-0.0
Lao People's Dem. Rep.	0.2	0.0	0.0
Malaysia	72.0	6.6	21.9
Myanmar	0.8	0.1	0.1
Philippines	15.8	2.8	-0.5
Singapore	115.3	3.8	16.5
Thailand	50.5	2.0	7.5
Viet Nam	8.6	1.6	0.8
The Pacific	1.4	-0.0	0.2
Fiji Islands	0.3	-0.1	0.1
Micronesia, Fed. States of	0.0	-0.0	-0.0
Papua New Guinea	0.7	0.1	0.1
Samoa	0.1	-0.0	0.0
Solomon Islands	0.1	0.0	0.0
Tonga	0.0	-0.0	0.0
Vanuatu	0.1	0.0	0.0
Developing Asia	1,862.0	252.4	369.4

Note: Foreign exchange reserves exclude gold, special drawing rights, and the reserve position in the International Monetary Fund.

Sources: International Monetary Fund, International Financial Statistics, and Asian Development Bank staff estimates.

while portfolio inflows climbed sharply. However, 2005 saw net credit outflows, prompted perhaps by revised expectations of the likelihood of regional currency appreciation.

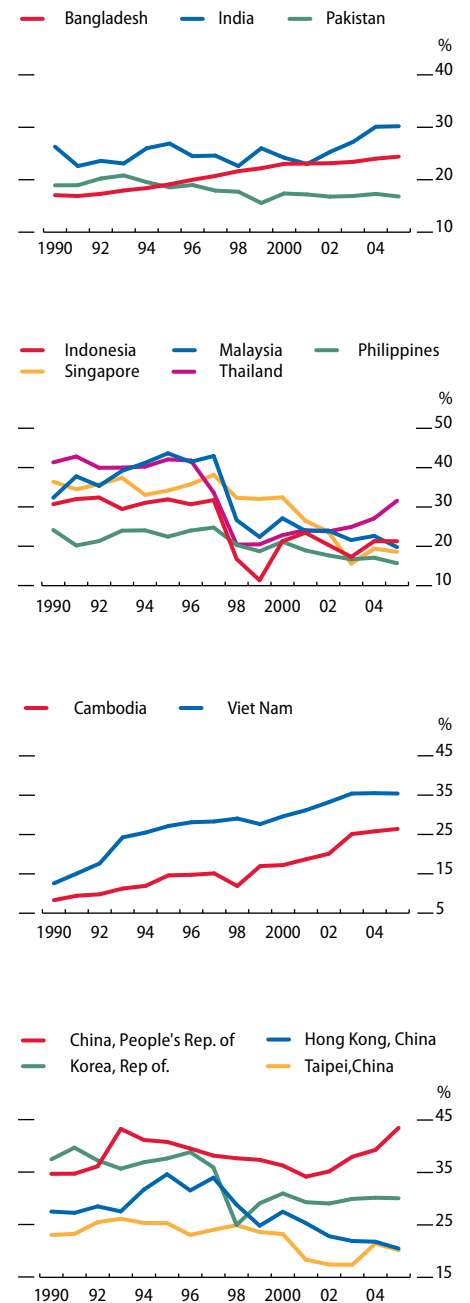
Developing Asia's aggregate current account surplus mirrors an excess of Asia's saving over investment. This has been referred to as a "savings glut," but as the *ADO 2005 Update* noted, outside the PRC, widening surpluses are more closely associated with stunted levels of investment. In 2004, evidence of a broad pickup in business investment was observed, particularly in South Asia and Southeast Asia. The PRC's investment rate, which has trended up for over two decades, also increased in 2004. But in 2005, investment performance was somewhat mixed. Yet again, the aggregate investment rate rose in the PRC, despite the presence of substantial excess capacity in some sectors. In South Asia, investment rates remained largely unchanged on 2004. In Southeast Asia, investment spurred in Thailand and its ratio to GDP increased by 4.5 percentage points. In Indonesia, the investment rate held steady. Investment rates fell in Malaysia, Philippines, and Singapore. With the exception of Cambodia, PRC, and Viet Nam, investment rates in East Asia and Southeast Asia are still well below their average precrisis levels (Figure 1.1.6).

On the eve of the abolition of quotas on textiles and clothing on 31 December 2004, concerns had been expressed that some countries in developing Asia could lose significantly (for example, Mlachila and Yang 2004). The textile and clothing industry is an important source of foreign exchange revenue, income, and employment in many of Asia's developing countries. A detailed examination of the impact of the end of the quota regime is provided in *Textiles and clothing in the post-quota era: The outlook for Asian suppliers*, later in Part 1, drawing on recent European Union (EU) and United States (US) customs data on the quantity and value of imports from exporting countries. This analysis suggests that for competitive, well-positioned Asian suppliers, such as Bangladesh, Cambodia, India, Indonesia, and Pakistan, the end of quotas has, overall, resulted in expansion and increased market shares, despite reversals in some market segments. But for smaller, marginal producers, such as Fiji Islands, Mongolia, and Nepal, the end of quotas has meant that it is no longer profitable to produce readymade clothes for distant markets in Europe and America, and has led to factory closures and downsizing. For those countries where unit labor costs are comparatively high, such as Malaysia, Philippines, and Thailand, some reductions in market share have occurred but prospects have been helped by the reintroduction of "safeguard" quotas on the PRC's textile and clothing exports in the latter part of 2005. Viet Nam's market share also held up in the EU and US. That country's prospects will depend on its World Trade Organization (WTO) accession and the development of its intermediate textiles industry.

Outlook for 2006 and 2007

The outlook for developing Asia in 2006 and 2007 will clearly depend on global economic prospects (Table 1.1.1). As explained in *Prospects for the World Economy in 2006–2007*, below, these are seen as remaining broadly favorable and supportive of growth in the region. Collectively,

1.1.6 Investment rates



Sources: Asian Development Outlook database; staff estimates.

the major industrial economies are forecast to grow close to their potential, and global trade is expected to expand at about its recent historical average. The upswing in the global electronics cycle, which began in 2005, should continue through most of 2006, supporting growth in a number of regional economies, in East Asia and Southeast Asia especially. Fast growth is again expected in the PRC and India. Risks to the regional outlook would, however, be mitigated if domestic demand were to play a more supportive role going forward.

The baseline assumptions on which the country projections rest are set out in each of the country chapters (see Part 2). Although it is difficult to generalize across such an expansive and diverse region, it seems reasonable to expect that macroeconomic policy settings will remain broadly neutral in terms of their impact on demand. In a number of countries, interest rates are likely to continue to climb in a context where global interest rates are also likely to rise. The room for fiscal maneuver is limited in many countries of developing Asia. Indeed, in a number of countries, it is expected that governments will take measures to rein in deficits. In those countries where fuel subsidies are directly or indirectly adding to fiscal burdens, subsidies are likely to be gradually rolled back and retail prices brought more closely into line with border prices. Hidden subsidies to other energy prices, such as electricity, may also be gradually removed as the cost of fuel inputs rises.

Against a backdrop of favorable global conditions, of marginally less accommodative macroeconomic policy settings, and of continued adjustments to high oil prices, aggregate growth in 2006 is expected to soften a little to 7.2%, and by some more in 2007 to 7.0%. By historical standards, these growth rates in developing Asia are robust (Figure 1.1.7).

In the PRC, growth is set to ease in 2006. In its recently announced 11th Five-Year Program (2006–2010), the Government has set its sights on a lower growth trajectory for the economy. The Government now intends to pay more attention to some of the social and environmental stresses that have emerged as a consequence of the prolonged rapid growth that has largely been concentrated in urban and coastal areas. However, given the existence of gaps in market institutions and signaling processes, and the difficulties in changing incentives and reining in spending at the local level, it is unlikely that the momentum of growth can be slowed quickly. Growth of about 9.5% is forecast for 2006, softening to about 8.8% in 2007. In Korea, growth in 2006 is expected to accelerate to 5.1%, supported by a continued recovery in consumption demand, and strong investment demand by large-scale enterprises. A combination of slower growth in the PRC and an acceleration of growth in Korea should just about cancel each other out, leaving the average for East Asia at about 7.7%, matching 2005's performance.

India has ambitions to lift its growth rate to over 9% in the medium term. This is likely to require that it increase the ratio of its investment to GDP and that it raise capital productivity. Both will need determined

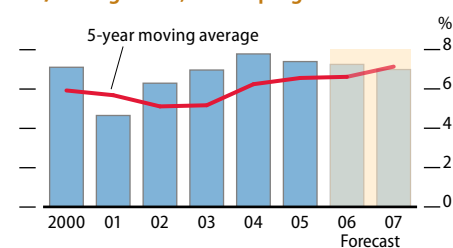
1.1.1 Selected economic indicators, developing Asia, 2004–2007

	2004	2005	2006	2007
Gross domestic product (annual % change)				
Developing Asia	7.8	7.4	7.2	7.0
Central Asia	10.6	10.9	10.3	9.8
East Asia	8.3	7.7	7.7	7.1
South Asia	7.2	7.8	7.3	7.5
Southeast Asia	6.3	5.5	5.5	5.7
The Pacific	3.1	2.7	2.9	3.0
Consumer price index (annual % change)				
Developing Asia	4.1	3.4	4.0	3.7
Central Asia	5.8	7.4	7.9	6.3
East Asia	3.3	2.0	2.4	2.7
South Asia ^a	6.2	5.3	6.1	5.4
Southeast Asia	4.3	6.3	7.3	4.9
The Pacific	3.4	2.6	2.9	2.8
Current account balance (% of GDP)				
Developing Asia	3.6	4.3	3.9	3.4
Central Asia	-1.8	1.7	2.9	4.8
East Asia	4.3	5.8	5.5	4.8
South Asia	-0.5	-2.3	-3.0	-3.1
Southeast Asia	6.3	6.1	5.6	5.2
The Pacific	-0.8	-0.6	-	-

^a India reports on a wholesale price index basis.

Sources: Asian Development Outlook database; staff estimates.

1.1.7 GDP growth, developing Asia



Sources: Asian Development Outlook database; staff estimates.

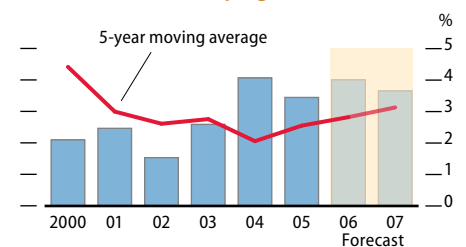
reform efforts. However, it is unlikely that growth in 2006 can match 2005's strong performance. The base effect that lifted agricultural growth in 2005 will be removed, the Reserve Bank of India is likely to continue to nudge interest rates up over the next 12 months, and the program of fiscal consolidation that is now under way is set to continue. As part of this program, the economy will likely have to adjust to the effects of higher global oil prices so that subsidies can be reduced. In Pakistan too, growth is expected to soften as agricultural conditions revert to normal. Outside agriculture, particularly in the large-scale industrial sector and in services, Pakistan's economy should continue to perform strongly. Softer growth in India and Pakistan will clip the average for South Asia, which is put at about 7.3% in 2006, but with some upside potential in 2007 as investment expands to relieve infrastructure bottlenecks.

The performance of Southeast Asia in 2006 and 2007 is likely to change little from recent economic performance, with growth projected at 5.5% in 2006 and rising marginally to 5.7% in 2007. Until there are clear signals that inflationary threats have abated, domestic demand in Indonesia will probably be contained by high interest rates. Thereafter, possibly in the second half of 2006, growth should begin to pick up. Medium-term prospects will hinge on an improvement in the business investment climate, and on an easing of infrastructure bottlenecks. In Malaysia and Thailand, it is expected that public sector investment programs will address critical bottlenecks and support growth. Both economies may also benefit from the current upswing in the electronics cycle. Over the near term, growth in the Philippines is expected to stay largely unchanged. The Philippines faces a difficult reform agenda, which has upfront costs but which should deliver durable benefits over the longer term.

As a net oil exporter, Central Asia will continue to benefit from high oil prices. Robust growth in Kazakhstan should continue. Azerbaijan in 2005 became one of the fastest-growing economies in the world, with momentum set to build further as new investments in oil and gas fields and export pipelines come into full operation. An important challenge in Azerbaijan and in other oil-exporting countries is to manage windfall gains in a way that provides a basis for balanced and sustainable growth over the long term. Uzbekistan has enjoyed strong growth in the past 2 years and this momentum will likely be carried forward, aided by greater FDI. Growth in the Kyrgyz Republic, which is a net oil importer, should bounce back after 2005's difficulties. In both 2006 and 2007, growth in Central Asia is expected to remain close to 10%.

In the Pacific, high oil prices will help sustain subregional growth in 2006 as both Papua New Guinea and Timor-Leste are comparatively large economies and net oil exporters. Timor-Leste will see growth boosted by higher public investment financed by petroleum revenues. In contrast, Papua New Guinea's growth prospects remain hobbled by a difficult law-and-order situation. The small economies, which are entirely dependent on fuel imports, will continue to face pressures, but Solomon Islands is expected to consolidate its recovery. In the Fiji Islands, growth of tourism and opportunities in some niche sectors will help offset difficulties created through the loss of clothing quotas and reductions in sugar subsidies by the EU. Growth in the Pacific is predicted to remain at about 3.0% in 2006 and 2007.

1.1.8 Inflation, developing Asia



Sources: Asian Development Outlook database; staff estimates.

The inflation outlook for developing Asia in 2006 and 2007 is generally favorable (Figure 1.1.8). In most countries, authorities are expected to respond adroitly to inflationary threats. Slowing price inflation—or even declining prices—for commodities, a mild appreciation of regional currencies, and stiff competition in the market for manufactured goods are all likely to help keep price rises in check. However, a gradual pass-through of earlier oil price rises seems set to continue in 2006 and will seep into inflation numbers. Food prices may also rise if agricultural conditions turn out to be less favorable than in the recent past. For these reasons, inflation is expected to edge up in some countries, but should pose little threat to overall prospects. As the impact of earlier oil price rises should have largely faded by 2007, and higher interest rates will have had more time to work on demand, it is envisaged that inflationary pressures will subsequently recede. Further sharp rises in oil prices would, of course, pose a risk to the outlook for inflation.

Developing Asia is expected to continue to run a substantial current account surplus over the next 2 years (Figure 1.1.9). As a proportion of GDP, though, it is likely that the current account surplus will begin to edge down (Figure 1.1.10). In the PRC, measures to support domestic demand and greater exchange rate flexibility should start to narrow its trade and current account surpluses. Korea's current account surplus may also close as domestic demand plays a stronger role in supporting growth. In South Asia, deficits are likely to persist or may even widen as large infrastructure projects get under way. Thailand, which ran a current account deficit in 2005 for the first time since 1997, is expected to maintain deficits in 2006 and 2007 as domestic investment picks up further.

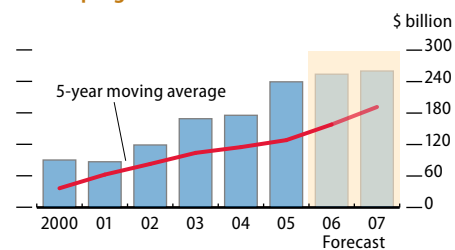
A narrowing current account surplus suggests that, on average, domestic demand will play a more important role in supporting growth in developing Asia in 2006 and 2007. In some countries, the growth of consumption spending is set to pick up and, in others, there is greater optimism about investment. Public investment programs will be ramped up in some countries to address deficits in areas such as roads, ports, power, and the environment. Ongoing efforts to improve the business climate for private investment, and improved corporate balance sheets, should also contribute to capital spending.

The moves toward greater currency flexibility against the US dollar taken by the PRC and Malaysia in 2005 have so far resulted in only small appreciations of the dollar value of their currencies. In recent months, the Korean won and the Singapore dollar have appreciated by more. The likelihood of continued current account surpluses, robust FDI inflows, and—possibly—sustained portfolio interest in developing Asia is likely to keep exerting pressures for an appreciation of many regional currencies through 2006. Additional exchange rate flexibility of key currencies would help adjustments and could give a fillip to domestic demand.

Medium-term prospects and challenges

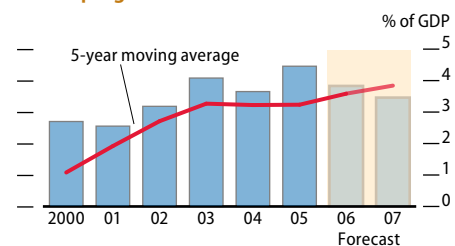
The medium-term outlook (2006–2010) for developing Asia is broadly favorable. The region benefits from its geography and demographics, and from the conviction among leading policy makers that integration with the global economy will be beneficial. Nevertheless, further progress

1.1.9 Current account balance, developing Asia



Sources: Asian Development Outlook database; staff estimates.

1.1.10 Current account balance, developing Asia



Sources: Asian Development Outlook database; staff estimates.

cannot be taken for granted and, in many countries, sustaining growth will require a concerted effort on reforms. Not only will reforms expand opportunities, but they should also help economies better cope with any future turbulence and shocks that they may have to face.

Part 2 of *ADO 2006* notes that a key challenge (outside the PRC) is to raise investment rates to sustain or accelerate growth. More public sector resources will be needed to help close gaps in physical and social infrastructure provision. This is likely to require taxation and other revenue reforms, as well as closer scrutiny of what governments spend public money on. Closer partnerships will also be needed between the private and public sectors to meet burgeoning infrastructure needs, though the private sector will not find partnerships attractive if they entail unreasonable risks. At one level, risks can emanate from macroeconomic instability. At another, inadequate legal and regulatory provision, and unreliable enforcement, represent a deterrent to private investment. The absence of markets in long-term debt and in instruments for hedging and managing risk also impede private investments in projects where revenue streams extend far into the future. And there is still much that can be done to improve the climate for small domestic private entrepreneurs, including simplifying business registration processes (Table 1.1.2).

A later section in Part 1, *The Doha Development Agenda*, asks: What is at stake for developing Asia in the Doha Round trade talks? It makes the point that the region has a strong interest in a positive conclusion to the Doha Round, and that developing countries in Asia can contribute to this. This is likely to require them to trade off concessions on liberalization in “sensitive” sectors for expanded market access in other sectors, special assistance to support structural adjustment, and measures to ensure that poor countries can actually get their exports to market. The benefits of trade liberalization will be maximized where complementary domestic reforms ensure positive supply responses to changes in relative prices. The idea that there can be a “round for free” for least-developed countries is misplaced. These countries will only benefit from the Doha Round if they take an active part in the talks. Although meaningful trade liberalization, particularly in agriculture, can do much to help expand opportunities for the poor, in some cases safety nets may be needed to provide social protection and mitigate adjustment costs.

Part 3 of *ADO 2006* looks beyond the Doha Round and examines the opportunities offered by possible multilateral, regional, and bilateral routes to trade liberalization in Asia (see also Box 1.1.3 in this section). There has been a close association between burgeoning trade, FDI, and deepening regional trade integration, particularly in East Asia and Southeast Asia. The evidence, however, suggests that these processes are being driven more by technology, markets, and the private sector than by formal preferential trading agreements such as the Association of Southeast Asian Nations (ASEAN) Free Trade Area (AFTA). Looking to the future, opportunities for trade creation in Asia as well as in the rest of the world would be maximized by a multilateral approach to liberalization, especially one that includes low-income Asian countries that are currently outside the WTO framework.

Developing countries in Asia are now, though, being swept along on

1.1.2 Ease of doing business

Rank	Economy
2	Singapore
7	Hong Kong, China
20	Thailand
21	Malaysia
27	Korea, Rep. of
31	Maldives
34	Fiji Islands
35	Taipei, China
36	Tonga
39	Samoa
45	Kiribati
46	Armenia
48	Marshall Islands, Rep. of
49	Vanuatu
50	Palau, Rep. of
53	Solomon Islands
55	Nepal
56	Micronesia, Fed. States of
60	Pakistan
61	Mongolia
64	Papua New Guinea
65	Bangladesh
75	Sri Lanka
84	Kyrgyz Republic
86	Kazakhstan
91	China, People's Rep. of
98	Azerbaijan
99	Viet Nam
104	Bhutan
113	Philippines
115	Indonesia
116	India
122	Afghanistan
133	Cambodia
138	Uzbekistan
142	Timor-Leste, Dem. Rep. of
147	Lao People's Dem. Rep.

Note: The ease of doing business index ranks economies from 1 to 155 and is calculated as the ranking on the simple average of country percentile rankings in each of the following indicators (covered in *Doing Business in 2006*): (i) starting a business, (ii) dealing with licenses, (iii) hiring and firing workers, (iv) registering property, (v) getting credit, (vi) protecting investors, (vii) paying taxes, (viii) trading across borders, (ix) enforcing contracts, and (x) closing a business.

Source: Doing business web site, available: <http://www.doingbusiness.org/EconomyRankings/>, downloaded 24 March 2006.

1.1.3 Routes for Asia's trade

Developing Asia's trade in goods and services has grown at an unrivalled rate. Between 1984 and 2004, the region's exports expanded almost 10-fold. Over the same period, it enjoyed rapid growth of income, and made significant gains in terms of poverty reduction and other social objectives. Of course, aggregate regional trends mask considerable geographic diversity. East Asia led the way and began experimenting with trade liberalization in the 1960s. Gradually, these experiments were broadened, and East Asia was followed by Southeast Asia and more recently by the People's Republic of China. These experiences have had a powerful demonstration effect and South Asia is now embarking on its own liberalization agenda. In Central Asia, trade has grown from a low base, after a virtual dissolving of economic structures at the breakup of the Soviet Union. In the small Pacific states, location and size have been an impediment to deeper integration.

It would be naïve to suggest that trade liberalization can of itself ignite and sustain growth, but the balance of evidence (Winters 2004) provides a strong "presumption" that trade liberalization has been an important element in a broader package of factors that has helped lift productivity and incomes in developing Asia. One reason for this is, perhaps, that trade openness stimulates investment by expanding markets abroad and by reducing the cost of imported machinery. Another is that trade liberalization may help trigger or "lock in" other beneficial institutional and policy changes. In contrast, significant trade protection has never been associated with fast economic growth for extended periods of time.

Part 3 develops the point that growing trade integration within Asia, and between Asia and the rest of the world, reflects a confluence of factors. Trade integration has been driven both by multilateral and unilateral liberalization initiatives, on the one hand, and by technological changes and market opportunities that have created new avenues for trade, on the other. Developing Asia benefited from expanded market access for manufactured goods that resulted from multilateral trade liberalization under the sponsorship of the General Agreement on Tariffs and Trade and then the World Trade Organization (WTO). But in East and Southeast Asia, unilateral efforts to liberalize trade were critical and helped pave the way for foreign direct investment looking for low-cost, export-production platforms. These trends were apparent before the establishment of preferential trade agreements, such as the Association of Southeast Asian Nations Free Trade Area. Other evidence (ADB 2002) suggests that, unlike in North America and Europe, preferential agreements in developing Asia have had little impact on trade integration.

Yet the landscape of preferential trade agreements is changing globally and in Asia. Perhaps disillusioned by the slow pace of progress on multilateral liberalization trade talks, policy makers in recent years have generated an avalanche of bilateral trade agreements that have been notified to WTO. Increasingly, these bilateral agreements will influence the volume and pattern of trade and investment flows, globally and within Asia. Such agreements liberalize trade on a reciprocal basis between two countries and their scope can go beyond WTO mandates to include investment, trade in services, and other issues, including trade facilitation. Essentially, like-minded partners can agree on anything they would like to, provided that this does not abrogate their WTO obligations. The potential that bilateral agreements have to expand into areas not yet covered in multilateral agreements holds promise for gains. But bilateral agreements are also inherently discriminatory, leaving countries that do not receive preferences at a disadvantage to those signing up to them.

Asia is well represented in the array of bilateral agreements that are now in force or are currently in negotiation. Many of these actual and potential agreements are between Asian countries and countries from other regions. Asia's "noodle bowl" is not only filling up quickly, it is spilling across regional boundaries. It seems unlikely that bilateralism is a route that will lead to a larger Asian free trade area (with or without extending benefits to third parties on a most-favored-nation basis). A more likely scenario is one in which large Asian trading "hubs" negotiate bilateral deals with smaller, isolated trading "spokes," but in which the spokes are not linked through reciprocal deals with each other.

In Part 3, a general equilibrium model of the global economy that focuses on Asia's trade (GEMAT) is used to compare and contrast the potential offered to Asia by multilateral, regional, and bilateral approaches to trade liberalization. The results are striking and illustrate the possibility of significant trade diversion under bilateralism, and a polarization of benefits favoring large trading hubs to the detriment of small Asian countries. Add to this the compliance costs entailed by the expanding noodle bowl of overlapping and inconsistent rules of origin, as well as the fact that bilateralism can deflect interest and energy from multilateral processes, then the potential for harm is clearly present.

However, the risk entailed by bilateral agreements depends on their intentions, their coverage, and their details. It also depends on the underlying political dynamics. It is conceivable that bilateral liberalization initiatives may move these dynamics in some countries

1.1.3 Routes for Asia's trade—*continued*

toward more expansive, multilateral liberalization efforts, but this is not guaranteed. A more purposeful approach may therefore be needed to limit damage and maximize opportunities. In Part 3, ways of mitigating the potentially damaging impacts of bilateral agreements and of leveraging their potential benefits are set out. These include assuring wide coverage in terms of goods and services, adopting harmonized rules, and leaving open the possibility of extending preferences to others. Calculations presented there suggest (i) that measures reducing trade costs and helping ensure that poorer countries can get their goods to market more cheaply—through simplification of customs procedures, for example—offer considerable benefits, and (ii) that these measures are inherently nondiscriminatory. As many poor countries do not have the capacity to negotiate and design “full-

blown” bilateral trade agreements, technical assistance and cooperation are likely to be needed as part of broader “aid-for-trade” approaches.

In the final analysis, significant progress on the multilateral liberalization of trade under the aegis of WTO could do much to reduce bilateralism's downside, through lowering potential margins of preference on a most-favored-nation basis.

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a rising tide of bilateralism in which countries extend preferences on a reciprocal basis, but do not extend liberalization on a most-favored-nation basis to others. Despite significant bilateral agreements between countries within the Asian region, such as the 2002 Economic Partnership Agreement between Japan and Singapore, agreements appear to be driven by a wide variety of interests and are not limited by geography. At this point, it would be difficult to conclude that bilateralism is a stepping stone to deeper integration within Asia or its subregions. Asia's “noodle bowl” is getting full, but it is also spilling across regional boundaries. Given the compelling political, strategic, and commercial interests that appear to be driving bilateralism, the challenge ahead is to ensure that crisscrossing bilateral agreements adhere as closely as possible to principles that avoid discrimination and that these agreements reduce trade frictions and (nontariff) costs, rather than increase them. Faster progress on multilateral liberalization, by narrowing potential margins of preference, would also help stem possible harm caused by discrimination and complex rules of origin.

Risks

This generally positive outlook for developing Asia could muddy for several reasons. Avian flu continues to spread in bird populations, and although it is difficult to quantify what the ultimate economic costs would be of a global pandemic among humans, the short-term costs are likely to be substantial (Box 1.1.4). Poor countries in Asia would face immense challenges in coping with the stresses that would be placed on health and social infrastructure and on public services.

Global payments imbalances are, if anything, likely to widen in 2006, and maybe beyond. But encouraging signs of a more balanced profile of growth are emerging among the major industrial economies and some narrowing of the savings and investment gap in Asia may be in prospect. Nevertheless, underlying structural imbalances are unlikely to correct

1.1.4 The economic risk of avian flu

The possibility of an influenza pandemic is a major uncertainty facing the region's economy. Since early 2004, the H5N1 influenza virus, commonly known as "avian flu," has been spreading quickly in poultry populations throughout the region. Avian flu has been detected in birds in more than 30 countries, from East Asia (where it originated) to Africa, Europe, and the Middle East. It has already severely curtailed the export of poultry products from a number of countries and has led to the deaths of millions of birds. In economic terms, estimated costs are in the range of \$10 billion–\$15 billion. Since backyard farming is a major source of income for many rural households in the region, avian flu has contributed to the already high level of rural poverty.

Public health experts fear that the H5N1 virus could mutate and become a human influenza. Around 200 people have caught avian flu directly from infected birds and more than half of them have died. Each animal-to-human infection raises the possibility that the virus will mutate. As humans have no natural immunity against this particular virus, it would spread quickly across the globe. What would the consequences of a human influenza pandemic be?

The world has little experience with flu pandemics. In the 20th century, there were only three. The first, in 1918, killed an estimated 2.5–5.0% of the world's population in a short period. It killed more people than the First World War. Two other pandemics were milder, although they did kill substantially more people than the normal seasonal flu.

One thing that all of these flu pandemics had in common was that they originated with a form of avian influenza that subsequently mutated. If the virus mutates, it will take a heavy human toll. The World Health Organization's most optimistic estimates are that it will lead to between 2 million and 7 million deaths. Other estimates are significantly higher. While the human cost would be substantial, it would also have important economic ramifications.

The severe acute respiratory syndrome (SARS) outbreak in 2003 caused a major, albeit short-term, economic shock localized in the affected economies. This highlighted the importance of psychology on the demand side.

The Asian Development Bank made projections of the impact of a SARS-like demand shock coupled with the epidemiological estimates of the World Health Organization (available at http://adb.org/Documents/EDRC/Policy_Briefs/PB042.pdf). These estimates suggest that avian flu would lead to a severe economic shock in the Asia and Pacific region, with economic consequences in the range of \$100 billion–\$300 billion. At its worse, this would essentially halt economic growth for 1 year and throw the world into an economic recession, the first global recession since 1982.

While the economic impact of avian flu would be severe, in all likelihood it would not be long lasting. Economic activity would likely return to "normal" within 1 year and reach pre-pandemic levels in 2–3 years. Although the aggregate impact of avian flu is likely to be brief, its impact would not be felt uniformly.

Services sectors would be severely affected, as people reduce their "face-to-face" contact. Internationally traded services, such as tourism, management consulting, and international banking, would be especially hard hit. Investment decisions would be delayed and trade would slow.

Economies that have a significant share of services in their economies would be the most affected—and the impact greater and longer lasting. This includes advanced economies, such as Hong Kong, China and Singapore, and countries that receive significant international tourism, such as Cambodia and Thailand. Larger economies, such as People's Republic of China, India, and Indonesia, are less dependent on international trade and so would feel a smaller economic impact.

themselves quickly and the possibility remains that a shift in investor preferences—which are, after all, volatile—will precipitate a sharp fall in the real value of the US dollar. Views about the extent of the required depreciation, its timing, and whether adjustments are likely to be smooth or sharp, vary widely. The most troubling scenario would be one in which the US dollar showed an abrupt and sharp depreciation. This would almost inevitably be accompanied by an increase in long-term US interest rates. Asia could then get caught in a double bind: not only would its exports to US markets become more expensive in US dollar terms, but domestic demand in the US could sag under the weight of higher market interest rates. As developing Asia is still highly dependent on the US as a market for its final goods, as seen in Part 3, this could stall an important engine of Asia's growth. In these circumstances, inflationary pressures in Asia would be tempered and monetary policy could be eased, but opportunities to support demand through fiscal expansion would

be constrained. Better coordination of macroeconomic policies at an international level could help mitigate this risk.

Looking further out, the quality of Asia's growth poses risks.

Economic growth has taken a high toll on the environment, to the point where threats to water and other resources could increasingly constrain growth. The incidence of environmental disasters appears to be increasing and this has now captured the attention of policy makers in the PRC and in other countries. As Asia continues to modernize and industrialize, it must find ways to promote cleaner production and technologies as well as greater energy efficiency. Markets and incentives, together with controls and regulations, have an important role to play.

Finally, the prospects for developing Asia will be imperiled if inequality continues to widen and growth does not provide jobs for its massive population. At least 500 million people in the region were either unemployed or underemployed in 2005, out of a total labor force of 1.75 billion. Between 2005 and 2015, another 245 million people will be added to the labor force. Developing Asia therefore needs to find almost three quarters of a billion new jobs in the next decade. If it fails to do this, its growth is unlikely to prove durable over the long run as social and other stresses—including badly overcrowded cities—increasingly consume resources and constrain opportunities. Ultimately, these jobs will not be provided if countries retreat into protectionism and turn their backs on trade liberalization, or fail to undertake other complementary reforms that will elicit the necessary supply responses.

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Prospects for the world economy in 2006 and 2007

The world economy demonstrated great resilience in 2005, despite rising oil prices, multiple natural disasters, and tight commodity markets. Growth in the United States (US), Japan, and euro zone averaged 2.7%, slowing from 3.2% in 2004. These figures mask important divergences in growth performance—a rapid recovery in Japan, strong growth in the US, and a faltering recovery in the euro zone. This divergence in economic performance among industrial economies is likely to narrow somewhat in 2006 and 2007. Asia continued to grow rapidly.

Overall, the outlook for the world economy in 2006 and 2007 is positive, with annual growth in the US, euro zone, and Japan forecast to average 2.7%. Inflation in the Organisation for Economic Co-operation and Development (OECD) countries is projected to average approximately 2% over the same period, reflecting recent and ongoing monetary tightening in the largest industrial economies. The volume of trade is anticipated to grow by around 7% a year in 2006 and 2007. Demand for Asian output is therefore expected to remain healthy.

Despite the positive outlook, there are downside risks. These include higher energy prices, growing protectionist sentiment in the industrial world, avian flu crossing to humans, and the possibility of sharp adjustments in exchange and interest rates induced by widening international payments imbalances. The *Asian Development Outlook 2006* baseline scenario outlined below assumes that these risks do not eventuate over the forecast period.

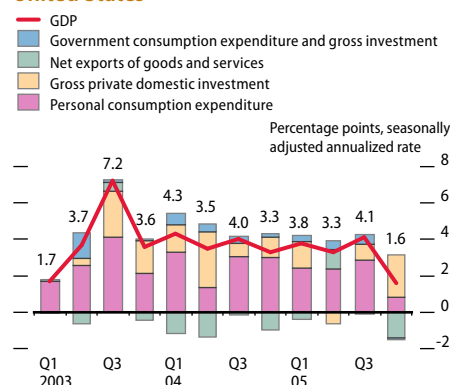
Outlook for major economies

United States

The US economy grew by 3.5% in real terms in 2005, down from 4.2% in 2004. Headline consumer price inflation was 3.4%, while prices exclusive of food and energy rose by 2.2%. Unemployment fell to 5.1% from 5.5% in 2004. Average real hourly earnings fell by 0.4%. Industrial capacity utilization rose by 1.5 percentage points year on year to December, to 81.2%, roughly its long-standing historical average rate from 1972 until now. Despite its robust performance, the US economy did not display signs of significant overheating. Policy interest rate increases (of which there were eight in 2005 and two in the first 3 months of 2006) mark a return to a more “neutral” monetary policy, and reflect the need to guard against energy price increases and strong demand being built into price expectations and wages. Inflationary pressures remain restrained.

Figure 1.2.1 shows the importance of consumer spending in driving US growth. US consumption growth has, at least until recently, been supported by the wealth effects of rapidly rising house prices. Consumption braked in the fourth quarter of 2005, slowing growth to 1.6% at a seasonally adjusted annualized rate. Rosier recent retail and production figures and tentative improvements in employment growth suggest that the fourth quarter results were a temporary dip,

1.2.1 Contributions to growth (demand), United States



Source: Bureau of Economic Analysis, US Department of Commerce, available: <http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N#S1>, downloaded 15 March 2006.

related to Hurricane Katrina. However, on the downside, tightening monetary policy and long-anticipated effects of higher energy prices are probably playing a role as well. The former appears to be contributing to a softening of the housing market, while the latter has crowded out nonenergy consumer spending from 57.5% of gross domestic product (GDP) in the second quarter of 2003 to 55.9% in the fourth quarter of 2005.

The US twin (fiscal and trade) deficits continue to cause concern. The fiscal deficit, exclusive of income on the social security trust fund, fell to 4.0% of GDP, as tax revenues outpaced spending growth, but the US Congressional Budget Office expects the deficit to widen slightly in 2006. The US trade deficit widened to 5.8% of GDP in 2005 from 5.3% in 2004, and continues to expand, reflecting faster growth of domestic spending over domestic output, and low savings. The US savings rate was 14.2% of GDP in nominal terms in 2005, roughly its average level of the past 3 years.

The baseline projection is for US real GDP growth of 3.3% in 2006 and 3.1% in 2007. This reflects gradually softening consumer demand as the effects of recent increases in oil prices and interest rates make themselves felt, and an assumption that government spending growth slows. This projection also assumes that policy interest rates will be raised once again in the first half of 2006. Significant downside risks remain if house prices weaken suddenly, oil prices rise much higher, or investor demands for dollar assets change in light of accumulating international imbalances.

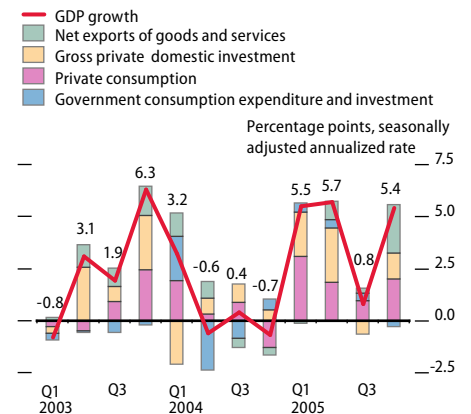
Japan

Japan's long-anticipated economic recovery took hold in 2005, strengthening rapidly in recent months. Real GDP grew by 2.7%, up from 2.3% in 2004 (Figure 1.2.2). Investment rebounded in 2005, growing by 4.3%. Providing further comfort, the unemployment rate fell to 4.4% in 2005 from 4.7%, and average real wages rose slightly. Consumer prices fell by 0.3% in 2005, but deflation seems to be coming to an end. In December, prices fell by an annualized rate of 0.1%, and in January 2006 inflation crossed the threshold into positive figures, rising to an annualized 0.5%.

The primary fiscal deficit (excluding surpluses on social security funds) is estimated by the Economist Intelligence Unit to have fallen from 4.8% of GDP in 2004 to 4.5% in 2005. The fiscal year 2006/07 budget has been passed, and envisages reduced spending and higher revenues as a result of renewed economic growth. Both these improvements are good news, as Japan's debt-to-GDP ratio was a striking 160% in the fourth quarter of 2005. Meanwhile, monetary policy, which has been extremely supportive of the recovery, is likely to tighten. The Bank of Japan ended its policy of "quantitative easing" in March 2006. The central bank is expected to raise nominal interest rates soon, in order to prevent real interest rates from turning negative as prices rise.

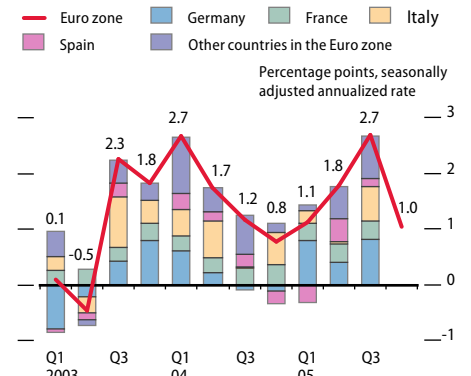
Given the strength of the recovery, a recent pickup in both domestic and external demand, and considerable pent-up consumer spending from the years of deflation, the Japanese economy is expected to grow by 2.9% in 2006. In 2007, as the momentum of the recovery begins to

1.2.2 Contributions to growth (demand), Japan



Source: Economic and Social Research Institute of Japan, available: <http://www.esri.cao.go.jp/en/sna/qe054-2/gdemenua.html>, downloaded 13 March 2006.

1.2.3 Contributions to growth, euro zone



Source: Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1996,45323734&_dad=portal&_sc_hema=PORTAL&screen=welcomeref&open=/economy/nation/quarter/qags_gdp&language=en&product=EU_MAIN_TREE&root=EU_MAIN_TREE&scrollto=294, downloaded 15 March 2006.

subside, the growth rate is projected to fall to 2.4%, closer to its long run potential growth rate of around 2.0%. The underlying trend rate reflects the maturity of both the economy and its workforce. The baseline forecast includes an end to deflation in Japan.

Euro zone

Euro zone GDP grew by only 1.3% in 2005. That said, the euro zone economy continues to produce signals that, while frequently mixed and interrupted, trend slowly positive. However, the contributions to growth of different countries and expenditure components remain in flux, as reflected in Figures 1.2.3 and 1.2.4. The external sector of the euro zone has performed erratically, and growth of consumption remains tentative. Though Spain has been a strong performer, France, Germany, and Italy have seen significant fluctuations, with France and Germany experiencing a slowdown in the last quarter of 2005. The fourth quarter of 2005 saw growth fall to 1% in the euro zone, as consumer and external demand contracted. Continued growth in investment supports cautious optimism.

All the major euro zone economies face significant fiscal problems. French, German, and Italian fiscal deficits have persistently exceeded the 3% of GDP targeted by the EU's stability and growth pact. Even with most of the smaller European economies within the target range, the scope for fiscal stimulus to support the recovery is sharply limited.

Monetary policy in the EU has tightened a little recently, with the European Central Bank (ECB) raising rates by a quarter percentage point to 2.25% in December. Despite firm handling by the ECB, inflation has slightly exceeded its target of 2% for 6 years in a row. In combination with the persistence of high unemployment in most of the euro zone (Figure 1.2.5), the tendency of the economy to register high inflation while showing disappointing growth reflects serious underlying structural problems. Until these are resolved, a convincing upswing in performance may be delayed.

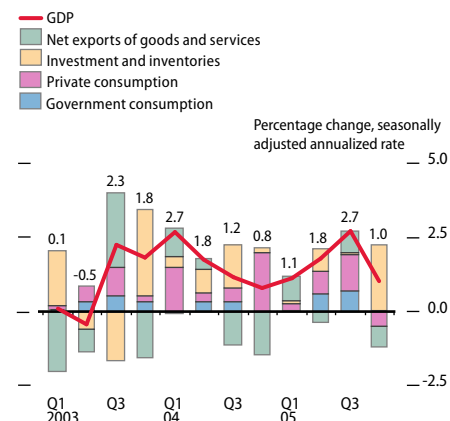
Growth in the euro zone is forecast at 2.1% in 2006, reflecting expectations of somewhat stronger performance in the larger economies, and the related modest growth in investment. Little change is expected in 2007.

World trade and commodity prices

The volume of world trade grew at a healthy 6.2% in 2005. The data reflect further shifts in geographic patterns of trade during 2005 as industrial-country exports posted small gains, while the share of the People's Republic of China in world trade continued to grow steadily, to an estimated 7% of world exports in 2005, compared with 4.3% in 2001. In keeping with the expected rate of global output growth in 2006, and a recovery in electronics demand, world trade is expected to grow at around 7% in 2006 and 2007.

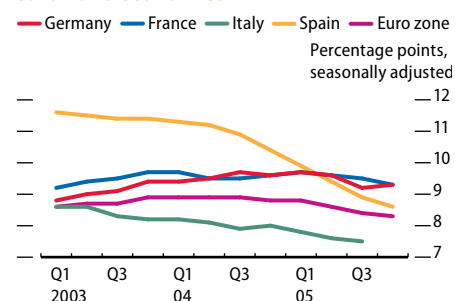
In 2002, the Brent crude oil price averaged \$25 per barrel. Prices began to increase in 2003, and have trended ever upward, if at times spasmodically, reaching \$62 per barrel as of 15 March 2006. Higher prices and slower worldwide growth appear to have damped oil demand

1.2.4 Contributions to growth (demand), euro zone



Source: Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1996,45323734&_dad=portal&_sc_hema=PORTAL&screen=welcomeref&open=/economy/nation/quarter/qags_gdp&language=en&product=EU_MAIN_TREE&root=EU_MAIN_TREE&scrollto=264, downloaded 15 March 2006.

1.2.5 Unemployment rate, selected euro zone economies



Source: Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1996,45323734&_dad=portal&_sch_ema=PORTAL&screen=welcomeref&open=/popul/labour/employ/lfsi/unemploy&language=en&product=EU_MAIN_TREE&root=EU_MAIN_TREE&scrollto=493, downloaded 15 March 2006.

growth, which fell from a high 3.8% in 2004 to 1.3% in 2005. Price increases are widely regarded to reflect increasingly tight capacity constraints and expected escalation in oil-field development and extraction costs.

There is significant uncertainty regarding future oil prices, as evident from the extent to which futures prices, for delivery up to 7 years from now, move in tandem with spot prices (Figure 1.2.6). If futures prices were based on long-run fundamentals, they would be more stable than spot prices, which reflect short-run shifts in demand and supply. Futures and spot prices moving in tandem strongly suggests that expectations of long-term fundamentals are not well anchored.

Despite this uncertainty, cheap oil may be a thing of the past. Even the most optimistic forecasts have prices falling at most to around \$40 per barrel by 2010. The baseline assumes that average oil prices will change little from their current levels (Table 1.2.1). However, because production constraints will bind tighter and more frequently, continued oil price volatility is expected.

Semiconductor sales grew by 6.8% in 2005, according to data from the World Semiconductor Trade Statistics organization. Semiconductor and wider electronics demand are volatile, as they are influenced by the development of new end-user products, and by the business cycle in consuming countries. Demand in 2005 was supported by strong sales of

1.2.1 Baseline assumptions for external conditions

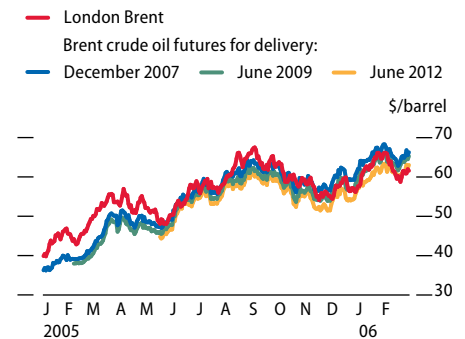
	2004	2005	2006	2007	2006–2010
	Actual	Preliminary	ADO projection	ADO projection	Annual trend rates
GDP growth (%)					
Industrial countries ^a	3.2	2.7	2.9	2.6	2.7
United States	4.2	3.5	3.3	3.1	3.3
Euro zone	2.1	1.3	2.1	2.0	2.0
Japan	2.3	2.7	2.9	2.4	2.4
Memorandum items					
US Federal Funds rate (average, %)	1.35	3.22	4.75	4.75	4.50
Brent crude oil spot prices (\$ per barrel) (annual average)	38.3	54.4	62.0	60.0	57.0
Nonfuel commodity prices (% increase)	17.4	13.5	-5.9	-6.3	0.3
CPI inflation (OECD) (annual average) ^b	1.9	2.7	2.1	2.0	2.0
World trade volume (% change)	10.3	6.2	7.0	6.8	6.3

^a Growth rates for industrial countries are a GDP weighted average for the US, EU, and Japan.

^b All consumer price index inflation data and forecasts for the OECD are from the Economist Intelligence Unit.

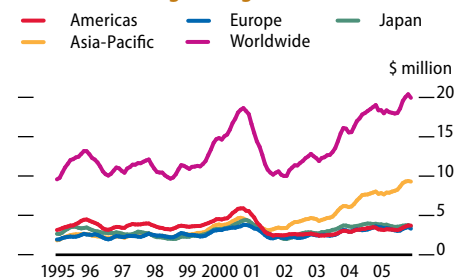
Sources: US Department of Commerce, Bureau of Economic Analysis, available: <http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N#51>; Economic and Social Research Institute of Japan, available: <http://www.esri.cao.go.jp/en/sna/qe054-2/gdemenuub.html>; Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1996,45323734&_dad=portal&_schema=PORTAL&screen=welcomeref&open=/economy/nation/quart/qags_gdp&language=en&product=EU_MAIN_TREE&root=EU_MAIN_TREE&scrollto=294; Federal Reserve Board, available: http://www.federalreserve.gov/releases/h15/data/Annual/H15_FF_O.txt; Datastream; Commodity Price Data (Pink Sheet), The World Bank, available: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:20268484~menuPK:556802~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html>; *Prospects for the World Economy*, World Bank, available: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGBLPROSPECTS/0,,contentMDK:20675180~menuPK:612509~pagePK:64218950~piPK:64218883~theSitePK:612501,00.html>; OECD, available: <http://www.oecd.org/dataoecd/42/36/18628078.pdf>; staff estimates.

1.2.6 Brent spot price and futures



Source: Datastream, downloaded 9 March 2006.

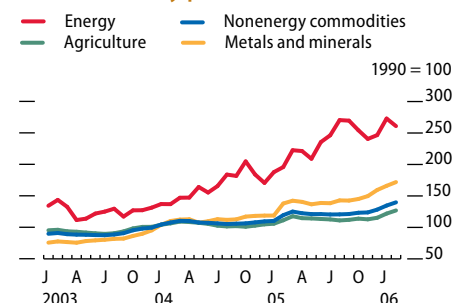
1.2.7 Global semiconductor billings, 3-month moving average



Note: The SIA's Global Sales Report is tabulated by the World Semiconductor Trade Statistics organization, which represents approximately 66 companies. The figures represent 3-month dollar amounts of shipments from manufacturers in source countries.

Source: Semiconductor Industry Association, available: <http://www.sia-online.org/downloads/GSR1976-present.xls>, downloaded 9 February 2006.

1.2.8 Commodity prices



Source: Commodity Price Data (Pink Sheet), World Bank, available: <http://www.worldbank.org/>, downloaded 6 March 2006.

MP3 music players and mobile phones. Demand is expected to be robust in 2006 and 2007, with industry estimates of billing growth ranging from 8% to about 20%. This wide range reflects differing expectations of the likely success of new products, especially those not yet widely used in emerging markets. Diversity of forecasts also stems from uncertainty regarding the future replacement schedules for notebook computers and mobile phones in more mature markets. These schedules are susceptible to cyclical effects. The expected buoyancy in several electronics markets therefore contributes to the bright outlook for electronics exports in 2006.

On the supply side, industry analyses forecast semiconductor production capacity constraints. Because manufacturers place semiconductor orders with reasonably long lags (up to 1 year), such forecasts are taken seriously. Given tight supply and demand conditions, electronics prices are expected to strengthen in 2006, and significant investments are anticipated in component-manufacturing countries. As Figure 1.2.7 shows, semiconductor export revenues do not rise every year, so despite the wide range of forecasts, 2006 is clearly expected to be a strong year. The figure also illustrates the emergence of demand for semiconductors in Asia (excluding Japan). This is due to outsourcing of electronics manufacturing from industrial countries, and to rapid growth in demand for consumer electronics in emerging Asia.

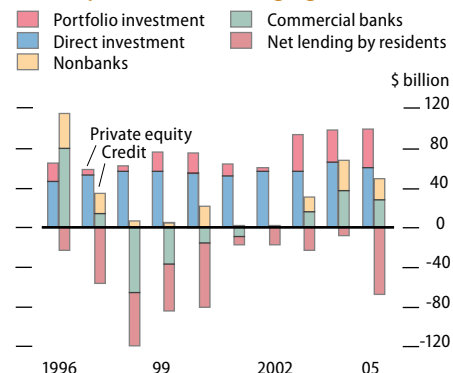
Agricultural price rises in 2005 slowed somewhat on strength of supply improvements (Figure 1.2.8). Natural rubber prices were propelled by rising demand as oil prices drove up the price of synthetic rubber. Cotton prices also picked up over the course of the year, though they still posted a lower average than in 2004. Prices of raw materials (especially minerals and wood) rose on the strength of demand in Asia and the US, production bottlenecks, and increases in energy costs. They are expected to plateau in 2006 as the bottlenecks ease.

Capital flows and markets

Net private foreign equity flows to emerging Asia continue to grow steadily (Figure 1.2.9). While foreign direct investment in Asia has remained fairly constant in dollar terms since the Asian financial crisis, portfolio investments have increased significantly, rising from 8% of net equity flows at the end of the crisis in 1998, to 39% in 2005. Meanwhile, flows of credit to the region, particularly those routed through banks, are recovering from negative levels in 1998, but have been fitful of late. Consequently, when compared to precrisis financing, a shift from credit to equity financing can be seen. Figure 1.2.10 shows that the risk spreads on both Asian and all emerging market debt fell in 2005. Each of these trends is consistent with a resurgence of foreign confidence in Asian markets, and in emerging markets generally.

Credit flows in recent years have moved in sync with world interest rate differentials. In 2004, net foreign credit flows to Asia surged in response to low interest rates in the US, and perhaps as a result of speculation that some Asian currencies would appreciate. In 2005, as US interest rates rose and relevant Asian central banks' currency positions were clarified, these credit flows reversed somewhat. However, the

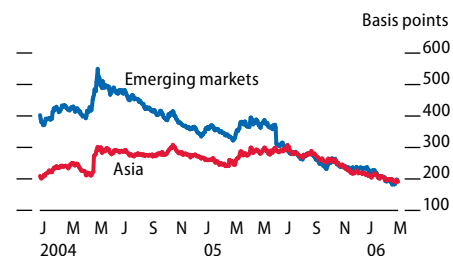
1.2.9 Capital flows to emerging Asia



Note: Emerging Asia follows the definition used in the source.

Source: Institute of International Finance, Inc., available: <http://www.iif.com/emr/data.quagga>, downloaded 30 March 2006.

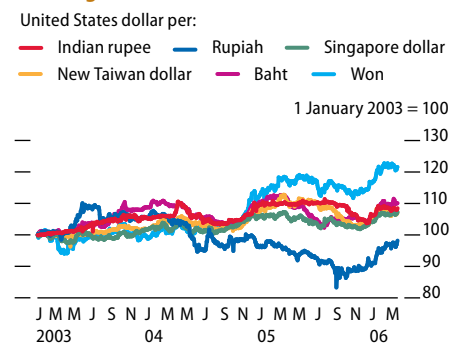
1.2.10 Sovereign risk spreads, emerging markets



Notes: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds. Emerging markets and Asia follow the definition of JP Morgan, available: http://www.utdt.edu/~ely/intro_embig.pdf.

Source: Datastream, downloaded 15 March 2006.

1.2.11 Nominal United States dollar exchange rate index



Source: Datastream, downloaded 15 March 2006.

reduction in net foreign credit to Asia was outweighed by strong foreign investment in Asian equities, and aggregate capital flows to Asia were positive in 2005.

Figure 1.2.11 shows that most Asian currencies have appreciated relative to the dollar. The demand for Asian currency is being supported by capital and current account trends, with both contributing to increases in foreign exchange holdings. If the payments imbalances that underpin these movements unravel rapidly, the real adjustment costs could be high. The likely outcome would be a depreciation of the US dollar relative to Asian currencies, a movement out of dollar-denominated assets, and an increase in long-term US interest rates. Such a rate rise would crimp US demand growth, and could also have secondary impacts by bringing down housing prices sharply, reducing household wealth and spending. Currency appreciation would have adverse effects on Asia's exports, with potentially serious consequences for growth and employment. Policy coordination to ensure an orderly transition to a steadier international regime would be desirable. This baseline assumes that resolution of the imbalances will not be quick, and sudden changes are not anticipated.

Subregional summaries

Central Asia

Economic performance

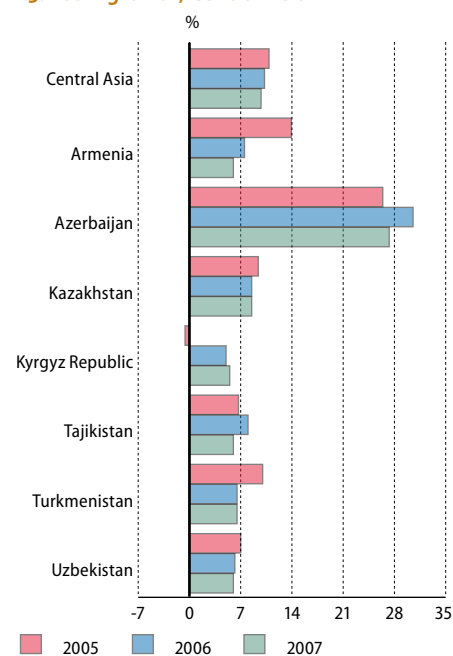
Growth in the Central Asian republics (CARs) for 2005 is estimated at 10.9% (Figure 1.3.1), higher than the 8.7% projection made in *ADO 2005*, with net exports acting as the main driver of growth. Within the subregion, however, growth performance varied markedly. The oil-exporting countries, led by Azerbaijan, saw greater production and continued high prices for oil and gas, and consequently expanded rapidly. Armenia, a non-oil exporting country, also saw robust growth in 2005, owing to rapid expansion of the construction sector for both housing and manufacturing facilities. At the other end of the spectrum, the Kyrgyz Republic, which underwent a political upheaval in 2005 and suffered a drop in gold production (a major export), saw a contraction. High growth in some of the countries translated into rapidly rising private consumption, for example Kazakhstan, while in other countries that also experienced accelerated growth private consumption remained flat, for example Uzbekistan.

Both fiscal and external balances strengthened in 2005. Fiscal balances improved mainly because the oil price windfall boosted revenues, though streamlining of tax administration also helped in some countries. At a structural level, Armenia, Kyrgyz Republic, and Tajikistan carried out economic programs supported by IMF arrangements under the Poverty Reduction and Growth Facility, and all met their fiscal targets and other program objectives for the year.

The external current account position for the subregion swung into positive territory, with Kazakhstan and Uzbekistan posting significant surpluses. Hydrocarbon exports continued to dominate in Kazakhstan, and cotton, gas, gold, and heavy machinery in Uzbekistan, though the latter economy is making progress toward export diversification in light industry. In Azerbaijan, the heavy current account deficit in 2004, which had been caused by large oil and gas sector investment, improved sharply to rough balance in 2005, reflecting the startup of production and exports from some new fields.

Stronger workers' remittances made substantial contributions to strengthening external positions of Armenia, Tajikistan, and Uzbekistan. Interestingly, recent studies have noted a rising trend in trade flows among some of the CARs, which together have been referred to as a "Russia-centric trading bloc." FDI inflows moderated during the year, reflecting completion of some hydrocarbon projects in Azerbaijan and Kazakhstan. At the same time, the People's Republic of China and the Russian Federation have been pursuing investment deals in several countries in the subregion. Notably, foreign direct investment in Uzbekistan's hydrocarbon sector could pick up as a result of these two countries' quest to secure sources of energy supply.

1.3.1 GDP growth, Central Asia



Sources: Asian Development Outlook database; staff estimates.

Inflation in the CARs rose from 5.8% in 2004 to 7.4% in 2005, but Armenia bucked the trend by bringing inflation down sharply. Azerbaijan, Kazakhstan, and Uzbekistan experienced a buildup in inflationary pressures with rapid monetary and credit growth and substantial wage increases in the public sector.

Some countries continued to make structural progress. The Transition Indicator scores of the European Bank for Reconstruction and Development for 2005 show upgrades for Armenia (in large-scale privatization, competition policy, and banking reform), Azerbaijan (in trade and the foreign exchange system), and Tajikistan (in small-scale privatization). Yet most of the countries in the subregion need to strengthen their “at-the-border” trade liberalization measures (Armenia and the Kyrgyz Republic are already WTO members) at the same time as reducing “behind-the-border” barriers to trade. These barriers present a diverse array among the CARs, ranging from import monopolies to large differences between the excise taxes levied on certain imports and the same domestically sourced products. Recent progress made in policy and institutional reform to reduce behind-the-border barriers includes simplification of the tax system (Armenia), acceptance of IMF Article VIII convertibility obligations (Azerbaijan), draft legislation to boost competition and investment and to lower costs in infrastructure (Kazakhstan), labor market reform (Kyrgyz Republic), allowing more competition in the banking sector including entry of foreign banks (Tajikistan), and commitment to remove cash restrictions (Uzbekistan). Still, the remaining agenda in domestic policy reform, particularly in the area of market competition, remains long.

While strong growth has generally translated into lower poverty incidence in Armenia, Kazakhstan, Kyrgyz Republic, and Tajikistan, this pattern is less evident in Uzbekistan. A possible explanation may be found in trends in inequality: in countries that have achieved a reduction in poverty incidence, income inequality as measured by their gini coefficients have also experienced a decline.

Prospects for 2006 and 2007

The near-term outlook remains favorable, albeit with some downside risks. Growth in the subregion is expected to slow marginally to about 10% in 2006 and 2007, reflecting easing in growth in a few countries. The exceptions are Azerbaijan, which is expected to see another growth spurt in 2006 with a ramping up of its oil and gas production, and the Kyrgyz Republic, where the economy should recover from the 2005 downturn. Inflation is likely to continue at over 7% in the subregion in 2006 with relatively minor variations in country performance from 2005. However, inflation in Azerbaijan is expected to jump due to a very large increase in government expenditure. The subregional current account surplus is forecast to increase moderately.

Medium-term outlook

Over the medium to long term, the outlook for the oil- and gas-producing countries will depend on how well they manage their windfall and diversify their economies to a broader base. For the other countries, prospects will rely heavily on how much headway the subregion makes

in reducing barriers to trade, transport, transit, and investment. A recent study has attempted to quantify the costs of noncooperation and the benefits from cooperation, and suggests that potential benefits could raise per capita incomes by 50–100%, but over the next few years, at least, subregional cooperation is likely to remain limited with greater cooperation achieved in certain country groupings (among, for example, Kazakhstan, Kyrgyz Republic, and Tajikistan). Over the longer term, the demonstration effects of such cooperation may foment closer collaboration among the less cooperative countries.

East Asia

Economic performance

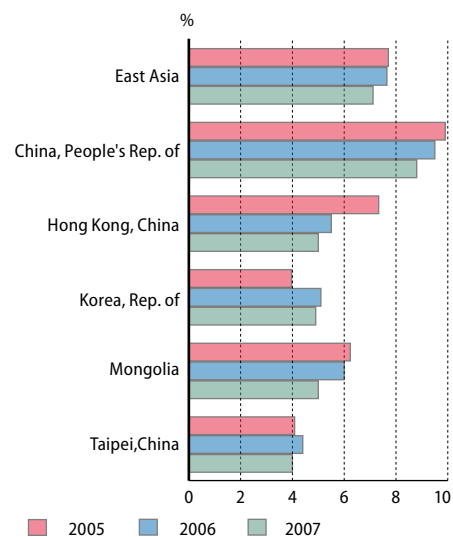
Economic growth for East Asia as a group was 7.7% in 2005, 0.6 percentage points below that of 2004. All five economies in the subregion posted lower expansion rates than in 2004. The deceleration was slight in the PRC, the biggest economy, and sharp in Mongolia, the smallest (Figure 1.3.2).

Growth in the PRC, at 9.9%, was slightly below that in 2004 and, once again, was driven by investment and export-oriented industrial production. Gross fixed capital formation increased by 16%, supported by expanding liquidity and credit. Merchandise exports grew by about 30% thanks to robust global demand and increasing market penetration of PRC-manufactured goods in foreign markets, while import growth decelerated to 17.6%, as a result of the use of inventories accumulated in earlier years and increasing domestic substitution for imports.

Mongolia grew by 6.2%, still a robust rate but slowing sharply from an exceptionally strong 10.7% in 2004, when GDP surged on the rebuilding of livestock herds and the expansion of mining. The services sector made the biggest contribution. Agriculture also contributed, but industrial production was hit by cutbacks in the clothing industry after the end of global quotas in major export markets. In Korea, growth of 4.0% was led by a recovery in private consumption, following a 2-year slump, and a strong performance by exports (though they grew far more slowly than in 2004). Growth of fixed capital formation remained weak. Taipei, China's expansion decelerated to 4.1% as export growth slowed. Merchandise import growth also fell (more than exports), reflecting weak domestic investment demand. Although public investment strengthened significantly, private investment fell, so the overall contribution of capital formation to GDP growth was negligible. Hong Kong, China registered growth of 7.3% in 2005. This rapid pace was mainly the result of an acceleration in net exports, reflecting the linkages between the economy and that of the PRC. Private consumption contributed the rest; government consumption detracted from growth as a result of a conservative fiscal stance, and investment made a minor contribution.

The impact of soaring global oil prices on inflation was muted, in part because fuel subsidies in the PRC shielded its consumers from the full effect. Inflation in the PRC eased from 3.9% in 2004 to 1.8%, and in the subregion as a whole from 3.3% to 2.0%. In Mongolia, consumer price inflation accelerated to 12.7% as the money supply grew at a significantly

1.3.2 GDP growth, East Asia



Sources: Asian Development Outlook database; staff estimates.

faster pace than nominal GDP. Korea's inflation eased to 2.7%, damped a little by interest-rate rises. In Taipei, China, inflation was held to 2.3% by currency appreciation and imports of low-priced manufactured goods from the PRC. After years of deflation, prices rose by 1.1% in Hong Kong, China, largely in response to the broad-based economic pickup.

Prospects for 2006 and 2007

East Asia's growth in 2006 in aggregate is expected to remain at 7.7%, and in 2007 it is seen decelerating by about a half percentage point to 7.1%. Growth in the PRC will abate slowly, to 9.5% in 2006 and to 8.8% in 2007. Under the recently approved 11th Five-Year Program for 2006–2010, the authorities there have provided an indicative average target of 7.5% for 2006–2010. It seems unlikely, however, that growth will slow to that rate in the near term, since for this to occur, investment would have to decelerate significantly, which is difficult as the country is facing rising unemployment, and local governments and state enterprises face incentives that are biased toward investment.

Mongolia's economy is expected to expand by about 6% in 2006 and by about 5% in 2007, after the livestock sector returns to its trend growth rate. In the case of Korea, growth is expected to increase significantly in 2006 to 5.1%, supported by the upswing in global electronics demand, and remain close to 5% in 2007. Expansion in Taipei, China is expected to pick up to 4.4% in 2006, also as a result of a stronger global electronics industry, before decelerating in 2007. Hong Kong, China's growth is expected to slow in 2006 and 2007 to about 5.5% and 5%, respectively, mainly as a result of the increase in domestic interest rates, but also due to the slight deceleration in growth in the PRC.

The subregional current account surplus is expected to decline to 5.5% of GDP this year, from 5.8% in 2005. The PRC's current account surplus will fall a little as export growth moderates and the trade surplus is partly offset by a services deficit. Korea's trade and current account surpluses will decline as stronger domestic demand and recent appreciation of the won push up imports.

Inflation is seen edging up in the PRC in the next 2 years to about 2–3%, as administered prices of electricity, gas, water, and petroleum products increase. In contrast, the prices of some manufactured products may decline. Price rises in Mongolia are expected to ease to about 5–5.5%, reflecting likely lower upward pressure from oil prices and steps taken by the Mongolian central bank. Inflation in Korea is expected to remain at about 2.8–3%, and in Taipei, China to moderate to 1.6% and to 1.3% over the next 2 years. Finally, prices are expected to continue creeping up in Hong Kong, China on the back of tightening labor and land markets and of rising energy prices.

Medium-term outlook

The major challenge for the PRC in the medium term is how to guide its economy to a more sustainable growth path where private consumption plays a more prominent role. After many years of phenomenal expansion, several structural weaknesses have surfaced, including—especially—overcapacity (in various industries) and income inequalities (primarily between rural and urban areas). Unemployment and underemployment

are also on the rise. Finally, the environment has suffered from heavy industrialization. To address these problems, the Five-Year Program aims to achieve more balanced, equitable, and sustainable growth through strategies designed to boost private consumption and rebalance the composition of aggregate demand, and to promote rural development, protect the environment, and reduce income inequality.

Over 2006–2010, the average growth rate for the PRC is likely to be about 9%. Growth in Mongolia over this period is forecast to average about 5%, with the primary sector a more significant contributor to growth. For Korea, the estimated growth rate in the medium term is 4.5–5.0%, substantially higher than most other economies in the Organisation for Economic Co-operation and Development, but lower than rates achieved by Korea in its earlier stages of development. Taipei, China is expected to grow in the range 4.0–4.5%, on the assumption of stable cross-strait relations and continued efforts to address structural reforms, while Hong Kong, China is seen expanding by an average of 5% in the medium term.

South Asia

Economic performance

South Asia's GDP growth is estimated to have reached 7.8% in 2005, which is higher than the projected growth of 6.7% in *ADO 2005* and the subregion's actual growth rate of 7.2% in 2004. The higher growth was driven by the strong performance of the Indian and Pakistan economies. In fact, the majority of countries performed better than in 2004 (the exceptions were Bangladesh, Maldives, and Nepal) (Figure 1.3.3).

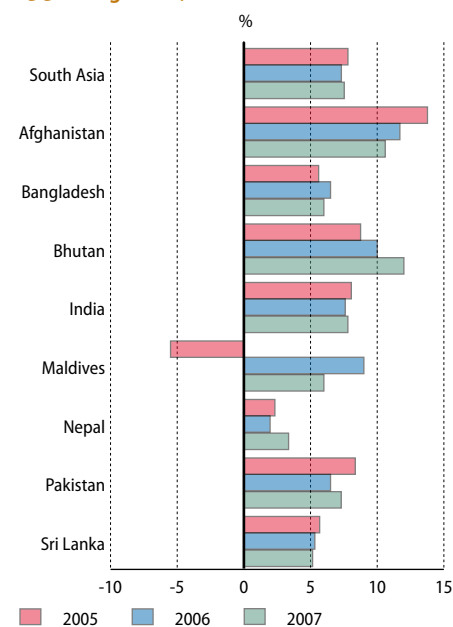
India has been able to maintain its high growth momentum with an 8.1% expansion of GDP in 2005, significantly above trend and 0.6 percentage points higher than in 2004. The broadly favorable monsoon and robust growth in the industry and services sectors consolidated high growth. Aggregate demand was strong, private sector investment picked up, and consumer spending remained buoyant.

The Pakistan economy registered impressive economic growth of 8.4% in 2005, the highest in the last two decades and 2 percentage points above the previous year. Private consumption increased by 16.8% in real terms, and led GDP growth for the second consecutive year. However, for the first time in 4 years, the balance of payments was in deficit.

Bangladesh experienced a decelerating GDP growth rate of 5.6% in 2005. Still, it was above trend, despite devastating floods, escalating international oil prices, and the end of textile and clothing quotas. Steady expansion in industry and services continued to support growth. The strong increase in workers' remittances virtually matched the increase in the cost of petroleum imports, but a larger trade deficit moved the current account balance to a deficit.

Growth of the formal economy in Afghanistan again reached double-digit levels (estimated at 13.8% in 2005) as higher rainfall pushed agricultural output higher. The reconstruction effort kept rapid growth rolling in the construction, trade, transport, and telecommunications sectors. It was also the first time since 2001 that opium production

1.3.3 GDP growth, South Asia



Sources: Asian Development Outlook database; staff estimates.

declined, though only slightly. The country is undertaking slow, but measured, sound macroeconomic policy and structural reforms.

Sri Lanka's GDP growth at 5.7% in 2005 was higher than trend and better than the previous year, despite the devastating Asian tsunami of December 2004. The engine of growth was nontourist-related services industry (import-related trade, telecoms, and financial services). The end of the quota system did not generate a large number of bankruptcies and closures in the textile industry (as earlier feared), but export growth still slowed sharply, to 3.1%. The trade gap widened with oil payments accounting for 50% of the overall growth in imports in 2005.

Nepal's economic performance declined largely as the result of domestic insurgency and strikes. Light monsoon rains brought down paddy production, adding to price pressures that brought up annual average inflation to 4.5%. The tourism industry also saw a downturn because of the conflict. GDP grew by only 2.3%. The economy of the Maldives contracted by an estimated 5.5% in 2005, primarily due to a reduction in tourism as a result of tsunami-related damage. Increased expenditure associated with the restructuring of the Government raised the budget deficit. The external current account deficit is projected to have increased to about 40% of GDP. Bhutan's economic growth remained strong and was estimated at 8.8% for 2005, with construction of a major hydropower project the major economic driver.

Prospects for 2006 and 2007

South Asia's growth is projected to moderate to 7.3% in 2006 as a result of some slowing in India and Pakistan. Bangladesh, Bhutan, and Maldives are projected to achieve higher economic growth than the previous year. In 2007, the subregion's growth rate is forecast to rise to 7.5%, when India and Pakistan are seen resuming their recent growth trajectory.

India's economy is likely to continue its high-growth trend, though expansion is expected to slow to 7.6% in 2006 before picking up to 7.8% the following year. Both the industry and services sectors should maintain strong growth. Import growth is likely to slow but still outpace export expansion, thereby increasing the current account deficit to about 3% of GDP in 2006. Inflation is set to pick up to 5.5% in 2006, reflecting the need to raise domestic prices of petroleum products to eliminate large subsidy costs.

In Pakistan, economic growth of 6.5% is in prospect for 2006, about 2 percentage points weaker than 2005, but still robust. After an unusually strong gain in 2005, agriculture is expected to grow by only 3.0% in 2006, reflecting smaller cotton and sugarcane crops. High domestic oil prices will also limit economic growth, as will (to some extent) the effects of the 8 October earthquake.

Economic prospects in Afghanistan are favorable, with GDP growth estimated at 11.7% and 10.6% in 2006 and 2007, respectively. This good performance is projected on the basis that another drought does not hit agricultural production. The current account deficit (excluding grants) is projected to improve as grant aid tapers down while the deficit (including grants) increases slightly, reflecting somewhat greater foreign direct investment and public loan inflows. In Bangladesh, GDP growth is projected to increase to 6.5% in 2006 as a result of strong domestic and

external demand. Healthy private consumption and buoyant workers' remittances will continue to underpin growth. However, growth is seen moderating to 6.0% in 2007 amid the political uncertainty of the January 2007 election.

Economic growth in Sri Lanka will likely decline somewhat to 5.3% in 2006 and 5.2% in 2007, which is in line with the country's long-term economic growth trend. The private sector will continue to buttress growth, especially in textile and clothing manufacturing and in services. Nepal's economic outlook includes a modest pickup in economic performance. GDP growth is projected to be 2.0% in 2006 and 3.4% in 2007. The low growth rates reflect the continuing domestic conflict; political instability; a slowdown in reform momentum; and growing polarization between the Government on the one hand, and the political parties and the insurgents on the other. In the Maldives, prospects are for an economic recovery to 9.0% growth in 2006 (but deceleration to 6.0% the following year). Persistence of the fiscal crisis that began in 2005 and a drop in foreign exchange reserves constitute significant risks over the next few years.

Bhutan's GDP growth is expected to accelerate to 10.0% and 12.0% in 2006 and 2007, respectively. The completion of the Tala hydroelectric project, which is being brought online in March through June this year, will substantially boost exports and the country's budget revenues.

South Asia's export growth decelerated in 2005 to 14.9% from 21.4% in 2004. With the exception of Afghanistan and Pakistan, all countries in the subregion registered lower export growth. Subregional import growth also decelerated, to 28.2% from 40.5% in 2004. The current account deficit on the balance of payments widened sharply to 2.3% of GDP. India's current account deficit increased to 2.5% of GDP. It is expected that in 2006, the subregion's balance-of-payments deficit will increase to 3.0% of GDP.

Average inflation for South Asia in 2005 moderated to 5.3%, from the high of 6.2% in 2004. However, Pakistan and Sri Lanka experienced substantial increases in inflation in 2005. Adjustments in domestic prices of petroleum products (to dilute or remove subsidies) will likely be the main factor lifting the subregion's inflation rate to 6.1% in 2006, even in a context of tightening monetary policy. Countries with high inflation in 2005 (Afghanistan, Pakistan, and Sri Lanka) should be able to reduce inflation somewhat, but inflation in Bangladesh, India, and Nepal will likely rise.

Medium-term outlook

The medium-term outlook for growth in India is for GDP to expand by 8–8.5% over 2006–2010. This will require a sizable pickup in gross fixed capital formation from about 26% to 30% of GDP and making substantial improvements in the physical infrastructure. In addition, various structural changes are required to improve the investment environment. The main imperatives are to direct greater investment into agriculture to raise productivity and living conditions for the rural poor, and to rapidly expand manufacturing industry to generate much-needed employment opportunities and underpin strengthening in the balance of payments.

Pakistan faces similar challenges. However, planned substantial public sector investment in agriculture and private investment in mechanization should continue to boost incomes, productivity and growth in the sector. Capacity expansion, balancing, and modernization in key industries (such as textiles and clothing) will also need to be sustained. Greater investment, particularly in the infrastructure sector, is a key challenge.

Substantial progress has been made in recent years in structural reform that have been supported by international financial institutions. Despite this, medium-term economic prospects in Afghanistan, Nepal, and Sri Lanka rest heavily on achieving solutions to political conflicts that threaten to retard development. Bhutan's economy will remain dependent on the performance of hydropower.

Southeast Asia

Economic performance

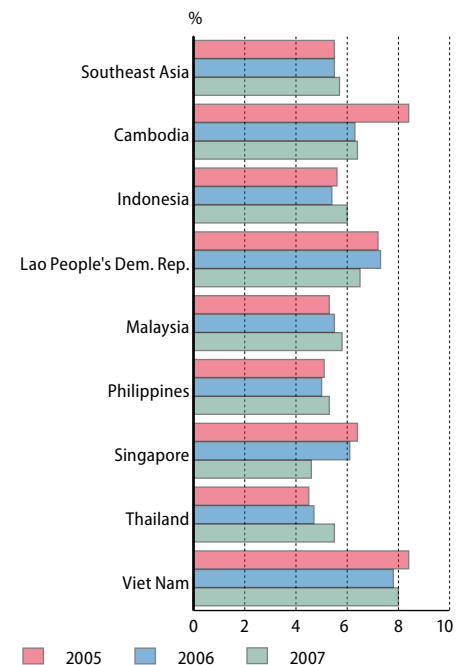
The economies of Southeast Asia expanded by 5.5% in aggregate last year, above the average of the previous 5 years, but easing from a rapid 6.3% in 2004. In a notable performance, Indonesia ramped up its growth rate, despite some major hurdles. Growth in the smaller economies—Cambodia, Lao People's Democratic Republic (Lao PDR), and Viet Nam—accelerated and topped the subregional list (Figure 1.3.4). However, the pace slowed in four of the five biggest economies, namely Malaysia, Philippines, Singapore, and Thailand.

Indonesia had to deal with the impact of the December 2004 tsunami, and later in 2005, a slump in the rupiah, a sharp rise in fuel prices, and a resulting surge in inflation and interest rates. Even then, growth in Southeast Asia's biggest economy picked up by 0.7 percentage points to 5.6% in 2005, having accelerated over 4 years from 3.8%. Private consumption and fixed investment contributed most to last year's expansion.

Viet Nam's economic performance continued to be robust, with growth accelerating above 8%, fueled by surging private investment and strong domestic demand. (As a net oil exporter, the economy has benefited from higher world oil prices.) However, inflation has also accelerated. Cambodia's economy, too, expanded by more than 8%, bolstered by stronger agricultural production that partly reflected a recovery from drought and an increase in clothing exports. The Lao PDR grew by an estimated 7.2%, with its industry sector the main source of expansion, driven by gold and copper mining.

Thailand's growth slowed to 4.5% in 2005. This economy was hurt by a drought in the first half that reduced agricultural production, the effects of the tsunami on tourism, and high global oil prices. Consumption remained the major contributor to GDP growth. Higher oil prices and buoyant demand for capital goods pushed up imports, and the surplus on the trade and current accounts swung into deficit. In Malaysia, growth decelerated to 5.3%, mainly because of weaker external demand for the country's electronics products. Private consumption was the main driver of growth, supported by low interest rates, easy access to credit, and firm commodity prices that lifted rural incomes. The Philippines was also

1.3.4 GDP growth, Southeast Asia



Note: Myanmar's performance cannot be assessed because of inadequate data.

Sources: Asian Development Outlook database; staff estimates.

affected by drought in the first half of the year, and, to a lesser extent, by slower growth in services. GDP grew by 5.1%. Buoyed by a strong flow of remittances from overseas workers, personal consumption spending was the largest contributor to growth. Government consumption was weak as the Government reined in its fiscal deficit.

Singapore benefited late in the year from the upswing in global demand for electronics products and from a recovery in domestic demand, which was buttressed by strengthening employment and a pickup in the property market. GDP grew by 6.4%, although this was well below the high rate recorded in 2004.

Prospects for 2006 and 2007

Growth in 2006 is forecast to remain at around 5.5% for Southeast Asia as a group, with a slight increase to 5.7% penciled in for 2007. Cambodia and Viet Nam, the economies that grew the fastest last year, are likely to moderate their expansion rates. Growth is expected to be slightly stronger in Lao PDR, Malaysia, and Thailand, and a little lower in the other subregional economies. Consumption in several of the bigger economies will be damped by continuing high oil costs and firming interest rates. Investment, though, is forecast to pick up.

Indonesia will be constrained for much of 2006 by high inflation and interest rates. Increased fiscal spending allowed by a reduction in fuel subsidies last year will start to counteract this weakness, leaving full-year growth at about 5.4%. The authorities are pushing to improve the investment climate, which will help pave the way for a pickup to 6.0% in 2007, when inflation and interest rates should be lower than now.

Thailand is projected to grow by 4.7% in 2006, with a moderate increase in public investment, better performance in agriculture, and robust exports. The trade and current account deficits are expected to widen. Growth is seen accelerating to 5.5% in 2007 when the Government is scheduled to increase spending on a megaprojects program. In Malaysia, growth is forecast to rise to 5.5% this year and 5.8% in 2007, driven by robust consumer spending, a lift in private investment, and higher public spending related to the start of the Ninth Malaysia Plan. Growth in the Philippines could soften to 5.0% this year, partly because crop production may be reduced by forecast heavy rains. Also, investment and exports are expected to weaken. In 2007, growth is seen recovering to 5.3%, when agriculture should have a better year (because of more normal weather) and investment is likely to rise.

Singapore, the most export-dependent economy in Asia, is benefiting from stronger exports of electronics and from a continued recovery of domestic demand. The full-year 2006 expansion rate is forecast at 6.1%. Growth is expected to soften later in 2006, and further into 2007, when it is seen at 4.6%.

Viet Nam's growth is projected to consolidate at around 8% in the next 2 years. Exports will probably grow at slightly below recent rates as world prices retreat for some of its commodities. The momentum for domestic demand is likely to be maintained through sustained expansion of FDI, private remittances, and tourism receipts. The country is expected to join WTO in the forecast period, which should assist its export efforts and maintain its momentum toward domestic market-oriented reforms.

Cambodia is expected to post an average growth of around 6.3% in 2006–2007. Agriculture will return to slightly lower growth rates after the rebound from drought, while clothing exports will face intensified competition. In the Lao PDR, growth is underpinned by investment in a major hydroelectric project and in mining. This economy is seen expanding by 7.3% this year, and by 6.5% in 2007.

Medium-term outlook

In the 2006–2010 period, Indonesia is expected to grow by about 6% on average, so long as the investment environment continues to improve. For Thailand, the outlook is for growth in the 5–6% range, with assistance from major public investment projects. Malaysia is seen growing at around 5.5%. In the Philippines, average growth is projected at 5%, but this could be boosted if momentum builds behind reforms and the capital stock expands much faster than in recent years. Viet Nam will continue to grow at the fastest rate in Southeast Asia, averaging 7.5–8.0%, provided that it pushes ahead with market-oriented reforms. The Lao PDR is expected to grow by 6–7.0% and Cambodia by perhaps 6.0% over the medium term. Singapore, at a much higher level of development, is seen growing at 4.5–5.0%.

The Pacific

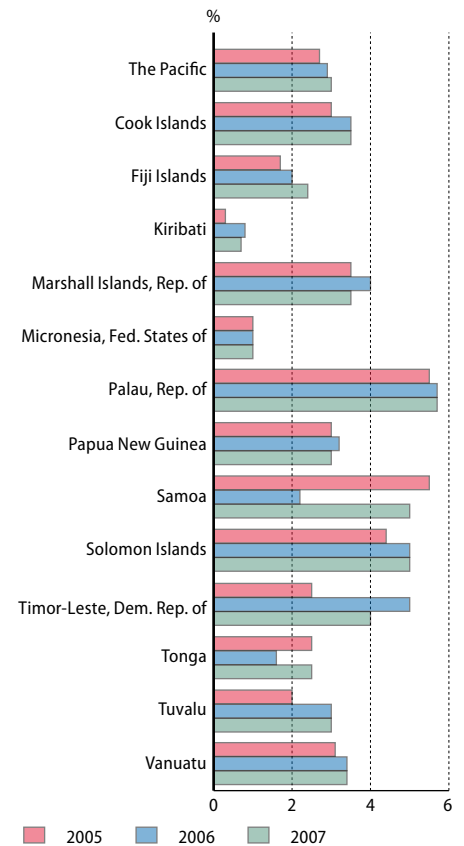
Economic performance

Economic growth picked up in about half the Pacific developing member countries in 2005, though the aggregate growth rate slipped to an estimated 2.7% from 3.1% in 2004. This was the result of a slowdown in the Fiji Islands (the second-biggest subregional economy accounting for a quarter of output). Hurt by the end of clothing quotas in the US and slower growth in some other industries, growth in the Fiji Islands decelerated to 1.7% in 2005 from 4.1%.

Papua New Guinea, the biggest subregional economy, recorded marginally improved growth of 3.0%, consolidating its better performance of the previous 2 years. Agriculture performed particularly well, assisted by stronger global prices for commodities such as coffee and rubber. Growth would have been stronger still but for a landslide at the large Porgera gold mine, which reduced mineral production. Political stability and supportive fiscal, monetary, and trade policies have helped to revive this economy, reflected in a buildup of foreign reserves, fiscal consolidation, a stable exchange rate, and lower interest rates and inflation. The surge in global oil prices is a factor, too, given that Papua New Guinea is an oil exporter. So is Timor-Leste, the number three economy in the Pacific. Its growth rate stepped up to 2.5% from 1.8% a year earlier as the country recovered from an earlier steep contraction in the economy. Growth is supported by rising government income from the country's share of oil and gas production in the Timor Sea.

Many of the smaller Pacific economies rely on fishing (including license fees from fishing fleets) and on income from remittances, tourism, aid flows, and trust funds. The continuing strength of international capital markets boosted the market value of trust funds in Kiribati,

1.3.5 GDP growth, The Pacific



Sources: Asian Development Outlook database; staff estimates.

Marshall Islands, Federated States of Micronesia, and Tuvalu. Income from remittances remained at high levels in Samoa, Tonga, and Tuvalu. For the Fiji Islands, remittances have become the second biggest source of foreign exchange. International aid continued to be a key factor in underpinning economic activity. The Marshall Islands and the Federated States of Micronesia benefited from funds provided by a renewed Compact Agreement with the US. Compact funds also underwrote development in Palau, while aid projects provided important support for infrastructure in Papua New Guinea, Solomon Islands, Timor-Leste, and Tuvalu.

Fish products and fishing license fees are sources of income for many Pacific countries. However, fish harvests were generally low in 2005, raising concerns about falling stocks, particularly of some species of tuna. Prices for some subregional export commodities, such as coconut oil and copra, weakened later in the year, but are still considerably higher than the low points of several years ago. One industry doing well across much of the Pacific is tourism, helped in part by the entry of budget airlines into the subregion. Tourism stimulates the construction industry and a range of services including hotels, restaurants, and transport. In the Fiji Islands, tourist arrivals have increased for 4 years and this industry is a pillar of the economy. Tourism also is important to the Cook Islands, Palau, Samoa, Tonga, and Vanuatu, but provides limited income for Kiribati and Solomon Islands. Australia and New Zealand are the two major source countries, but Japan, United Kingdom, and US are also important, while organized tours from the PRC are beginning to generate revenues for some island economies. Tourism has strong potential for further growth, provided that it does not ruin the natural environment, which is a major pull for many tourists.

High world oil prices continue to have an adverse impact (other than on the two oil exporters). Most of the subregion relies on imported petroleum products for air and sea connections and for generating electricity. The increased oil prices led to a pickup in inflation in some countries, though for the subregion as a whole inflation moderated to 2.6% in 2005, down nearly 1 percentage point from 2004. (Inflation was much higher in Samoa, Solomon Islands, and Tonga than elsewhere.)

Budgetary positions were relatively stable in 2005, though several countries need considerable fiscal consolidation. Tonga faces the largest adjustment, following a decision to increase civil servants' salaries by some 60–80%. The fiscal position of Timor-Leste has been bolstered by income from petroleum production; it has more of a problem with disbursing funds. Several countries made strides in implementing structural reforms last year: Papua New Guinea continues to implement a tax and tariff reduction policy; Solomon Islands established an economic reform unit in the Ministry of Finance; and Vanuatu is developing an economic regulatory framework to improve efficiency and lower costs of utilities.

Prospects for 2006 and 2007

In 2006–2007, subregional growth is forecast to pick up to 2.9–3.0% (Figure 1.3.5). Growth is expected to edge higher in most countries, for varying reasons. The Fiji Islands will benefit from growth in tourism, but

it faces major adjustments in its clothing and sugar industries because of declining preferential trade concessions in major markets. Papua New Guinea has a building growth momentum, and government spending could rise ahead of 2007 elections. Timor-Leste's government spending, financed by oil revenues, will support growth. Cook Islands and Vanuatu are forecast to lift earnings from tourism. Palau, Marshall Islands, and Tuvalu will see more public investment, and Solomon Islands is still pulling out of its deep decline. Weaker growth is seen in Tonga, because of fiscal adjustments, and in Samoa, partly because of weakness in manufacturing. Kiribati is likely to record marginal GDP growth, but GNP should continue to receive support from buoyant capital markets in Australia where trust fund assets are invested. The Federated States of Micronesia is forecast to grow at a similar rate to 2005. Nauru is expected to remain in a vulnerable condition because of its very limited sources of income and lack of arable land for food production.

Inflation over the next couple of years should remain in the 2–3% range for most countries, if oil prices are fairly steady. However, Solomon Islands and Tonga are expected to record inflation of about 7–8%, mirroring recent trends and ongoing fiscal and current account pressures. Inflation should abate in Samoa to about 4% in the next 2 years.

Medium-term outlook

External conditions are projected to remain favorable, and transport and telecoms costs have fallen over a long period. This setting should offer the subregion an opportunity to accelerate economic development and improve social indicators. Despite this, the environment for rapid private sector development is unfavorable in most of the Pacific, and governments dominate many of the economies. Key constraints to the private sector include traditional communal land-ownership arrangements; governance problems, including in some cases those of law and order; government aversion to privatization; and policy uncertainty and investment restrictions, especially for foreign investors. The recently formulated Pacific Plan for strengthening cooperation and integration may facilitate better policies. However, it will take some time to raise economic growth so that per capita incomes improve significantly, particularly as population growth of around 2.4% is likely to continue in the medium term.

Textiles and clothing in the post-quota era: The outlook for Asian suppliers

The end to quota restrictions at the end of 2004 on textile and clothing exports of developing countries was expected to provide substantial market access benefits to competitive Asian suppliers led by the People's Republic of China (PRC) and India. Indeed, over the course of 2005 shipments from the PRC to the United States and the European Union surged in volume and value terms. This led authorities in these two large markets to invoke the special safeguards clause in the PRC's World Trade Organization accession agreement and to restore quantitative limits on fast-growing categories of PRC shipments in the latter part of 2005 through 2008.

While marginal Asian and Pacific developing country suppliers, along with former large quota holders, have seen market shares in these two markets evaporate in 2005, a number of competitive Asian suppliers have done relatively well. In fact, they have outperformed non-Asian preferential suppliers in both markets with Bangladesh, Cambodia, India, Indonesia, Pakistan, Sri Lanka, and Viet Nam all competing effectively. Going forward, it is likely that the PRC will lose some of the rapid gains it made in market share in 2005 and preferential non-Asian suppliers will continue to see contraction while other Asian suppliers increase their market shares. This suggests that the fears of the collapse of the industry with the end of quotas were exaggerated.

Introduction: An end to quotas?

The liberalization of the global system of trade restraints on exports of textiles and clothing from developing countries, which had operated for more than four decades, was accomplished on 31 December 2004 with the full implementation of the Agreement on Textiles and Clothing (ATC). The freeing-up of trade in textiles and clothing from nontariff barriers was heralded as one of the most significant outcomes of the Uruguay Round negotiations that led to the founding of the World Trade Organization (WTO). This crucial agreement affects nearly 4% of world trade in manufactures, worth \$453 billion in 2004 (WTO 2005). Benefits from the ATC were expected to be divided between competitive Asian suppliers and consumers in the markets of Europe and North America. Expected losers were the protected suppliers in the domestic markets of those two regions, and marginal exporters that had emerged in many locales in the developing world purely as a result of "quota-hopping" investments in footloose clothing factories.

"Temporary" quantitative limits on exports of textile and clothing products from developing countries were first imposed in the late-1950s on Asian economies.¹ Quantitative restrictions on textile and clothing exports from developing countries generally were formalized in 1962 under the Long-Term Agreement on Cotton Textiles. These restrictions on cotton textiles were extended to products from man-made fiber, wool, silk, and vegetable fiber under the Multifibre Arrangement (MFA), which

became effective in 1974, through 1994. The quotas negotiated between industrial and developing countries were administered by exporting countries, and the rents generated led rapidly to the emergence of interest groups, in both sets of countries, which had a strong motive in seeing the system remain intact. Hence the breakthrough in the Uruguay Round, which led to the ATC as of 1 January 1995, can be viewed as one of the triumphs of free trade advocates across the globe.

The ATC was gradually implemented in four phases over a 10-year period beginning on 1 January 1995 and ending on 31 December 2004. The liberalization had two dimensions: first, the phased integration of harmonized system tariff codes or lines into the General Agreement on Tariffs and Trade (GATT) (16% in 1995, 17% in 1998, 18% in 2002, and 49% in 2005); and second, higher growth rates in remaining quota-constrained categories (6.96% in 1995–1997, 8.7% in 1998–2001, and 11.05% in 2002–2004) (James et al. 2003).² In this way, the ATC gradually but progressively liberalized world trade in textiles and clothing in these two dimensions of integration and growth in the remaining quotas.

During those 10 years, however, several unforeseen developments occurred that have important consequences for the outcome of the liberalization. The first of these is the post-Uruguay Round proliferation of preferential trade agreements around the major trading hub countries of the European Union (EU)—Belgium, France, Germany, Italy, and United Kingdom—and North America. These agreements include programs aimed at providing new life to the textile complexes in the older industrial economies through “outsourcing” and “production sharing” arrangements with neighboring developing countries and countries in transition from central planning to market economies. The preferential agreements include so-called “free trade agreements” as well as unilateral preference treaties such as the General Preferential Tariff program of Canada, the Everything But Arms initiative of the EU, and the African Growth and Opportunities Act of the United States (US). All of these discriminatory agreements are enforced by rules of origin that usually encourage exclusive use of textile intermediate products (yarn and fabric) from the hub countries. That these agreements have had a substantial impact on the direction and composition of trade is not in doubt. What is in doubt is whether they will continue to allow high-cost textile producers in the hub countries to survive.

The second unforeseen development during the negotiation of the ATC was the dramatic emergence of the PRC as an industrial power and its accession to WTO in late 2001, near the end of the second phase of the implementation of the ATC. The fact that the PRC would benefit from the relaxation of quotas meant that the benefits expected from the agreement by other large Asian suppliers of textiles and clothing would, at a minimum, have to be shared with it. The extent to which the PRC would gain, however, remains uncertain. This is because the accession agreement includes a special textile safeguard arrangement that is valid through 2008.³

The imposition of safeguard quotas on the PRC in mid-2005 by the EU and US (followed by other WTO members including Argentina, Brazil, Peru, and Turkey) is significant in that the PRC is the world’s leading producer and exporter of clothing and is a major producer and

exporter of intermediate and made-up textile products. As the PRC's shares of the EU (30%) and US (25%) imports of all textile and clothing products in 2005 were large, imposition of quota restraints may erode gains to consumers through prices higher than would otherwise have been charged. This also means that the world is not completely quota free (except for a brief interlude in early 2005). Hence, one may refer to the "almost" post-quota era between the present and the end of 2008. Even then the outcome is not determinate because the PRC's accession agreement allows WTO members to treat the PRC as a nonmarket economy for another extended period (up to 2016). This allows any WTO member to enact antidumping measures by comparing import prices of PRC goods with prices of similar goods in a representative market economy rather than domestic prices of these goods in the PRC.⁴ In any case, normal WTO safeguards and other contingent forms of protection remain available.⁵

In this section of the *Asian Development Outlook*, the historical significance of production and trade in textiles and clothing in the economic development of the Asian Development Bank (ADB) developing member countries is discussed and past performance is briefly reviewed. Then new statistical data that are collected on a "real time" basis in the EU and US for the entire year of 2005 are examined in order to understand the trends under the (almost) quota-free trading environment and, in particular, to compare the situations of preferential and nonpreferential suppliers. Finally, an agenda for future reform of trade policy in this important area of world trade is considered, an agenda that may be influential both in the current Doha negotiations and in crafting other trade agreements.

Historical perspective on textiles and clothing in Asian development

The reintegration of textile and clothing trade into the system of world trade at the completion of the ATC on 31 December 2004 was of particular significance to Asian developing economies and had prompted much speculation of what the possible effects could be. These economies had seen large increases in exports of textiles and clothing—especially clothing—as they moved up the ladder of industrialization from largely agricultural economies to modern manufacturing and services-based economies over a 30–40-year period. In the last two decades, textiles and clothing have been the second-fastest growing segment of world trade (after electronics), despite the presence of the quota system (Hayashi 2005). Of course, in the decade after the ATC was agreed upon, market access improved, foreign investment flows rose, and buyers and suppliers began to reposition themselves in light of the PRC's WTO accession, the end of quotas, and the proliferation of preferential trade agreements.

The success that economies like Japan; Hong Kong, China; Republic of Korea; Taipei, China; and Singapore had with textiles and clothing in the early stages of their industrialization, particularly before the quota system became embedded in the GATT in 1974, was outstanding, with export-led growth leading to rapid gains in production, employment (especially

of younger female workers), and technological and management skills. These economies tended to develop large textile complexes and labor-intensive clothing industries, the latter dominated by small and medium enterprises.

Following Japan's earlier experience, the East Asian newly industrialized economies that held large quotas in recognition of their large capacity and competitiveness in textiles and clothing in the 1960s and early 1970s, gradually became uncompetitive in the most labor-intensive segments of the industry. The rising labor and energy costs of the 1970s and early 1980s helped prompt the migration of these industries to Southeast Asia, a process that was accelerated by currency appreciation after the Plaza Accord of 1985 (Thee 1991 and 2003).

Once reforms took hold in the PRC, textile and clothing factories from higher-cost locations in East Asia and Southeast Asia began to relocate production either there or to other locations where preferences were large enough and costs competitive enough to justify the investments. Hong Kong, China; Korea; and Taipei, China still retain niches in high-end fashion wear requiring very skilled sewing and design operations and in high-quality and capital-intensive segments of the textile industry, such as expensive man-made fabrics and industrial textiles. Korea and Taipei, China retain some of the largest textile capacity in Asia, with only the PRC, India, Pakistan, and Indonesia (ranked by size) having larger mill capacities (USITC 2004, Table 3.1). Thailand also has large textile capacity, exceeding that of Mexico in 2003 (USITC 2004). Pakistan has the third-largest cotton textile industry, after the PRC and India. Viet Nam is now developing a modern textile industry but it is in the early stages of development. USITC (2004) shows that large Asian countries have the lion's share of textile mill capacity in knitting, spinning, and weaving among all regions of the developing world. Outside Asia, Turkey, Mexico, and Egypt (ranked by size) have the most significant capacities among developing countries.

The data for 2003 indicate that Asian-based textile mills accounted for 60% of world fiber consumption. Estimates of spinning and weaving capacities indicate that Asian mills accounted for 66% and 68%, respectively, of all machinery in these textile segments globally (USITC 2004).⁶ Member countries of the Organisation for Economic Co-operation and Development (OECD) imported about 31% of textile imports from non-OECD sources in 2001, of which 79% came from Asia. For the larger category in imports, namely clothing, two thirds of OECD imports were from non-OECD countries. Asian suppliers accounted for 44% of total OECD clothing imports or two thirds of all imports of clothing from non-OECD countries in 2001 (OECD 2004).

The migration of textile production has been to large developing Asian countries; smaller countries almost exclusively assemble clothing but rely on imported intermediate textile fabrics. This process is still taking place as the largest textile company in Taipei, China—Formosa Plastics—has recently chosen to invest in a large-scale textile complex in Viet Nam.⁷ Later, it will be seen that the presence or absence of large-scale production capacity in intermediate textile products is a critical factor in the emerging trading environment. One consequence is that the textile industry is likely to be increasingly dominated by a few large

Asian players. However, because of fragmentation, small countries that are competitive with low labor costs or highly skilled workers, and have low trade costs because of smooth customs operations and good infrastructure, are likely to survive and may even thrive in the (almost) quota-free trading environment.

For some Asian countries, the textile and clothing industry has become the leading source of manufactured exports and, indeed, total merchandise exports. Over 80% of the merchandise exports of Cambodia (85%) and Bangladesh (83%) are clothing. For Sri Lanka (55%), Nepal (51%), and Lao People's Democratic Republic (42%), clothing exports are also by far the largest item in merchandise exports. For Pakistan, 70% of merchandise exports are in textiles or clothing.⁸

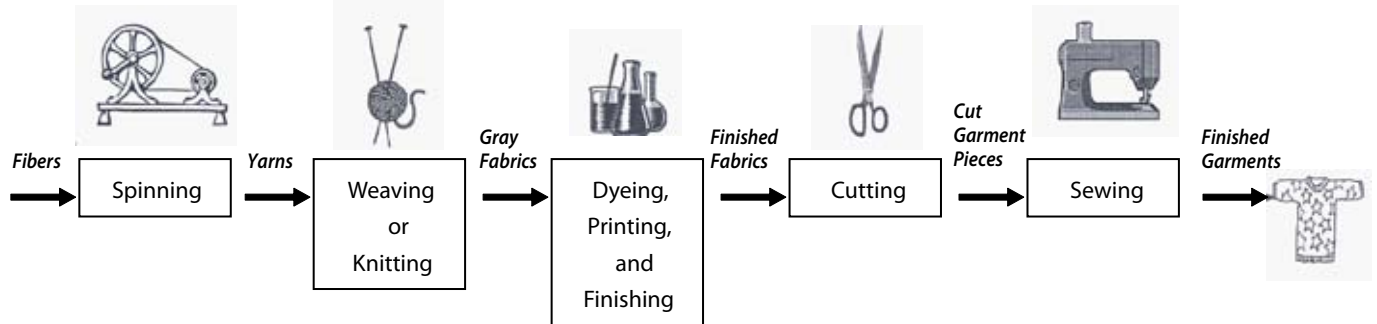
It is hard to overstate the significance of the employment and incomes that accrue to female workers, often new entrants to the labor force. Without these jobs, there would be little alternative formal employment of young female workers in manufacturing. The opening of the formerly closed economies of South Asia and the transitional economies of Southeast Asia would not have been as rapid, had it not been for the growth of a strong export-oriented industrial lobby based in the clothing sector.

As pointed out in Part 3 of the *Asian Development Outlook 2006*, the development of export-oriented manufacturing industries under open trade regimes has had important social benefits for Asian countries related to employment, participation rates, household formation, and female status in society. It has also had some beneficial impacts on labor standards and human rights, as experience in Cambodia demonstrates. Cambodia, for example, has adopted International Labour Organization codes and conventions and has taken their enforcement quite seriously as a result of the critical position of the export-oriented clothing industry and its reliance on markets in the EU and North America.⁹ Some fear that these benefits may be lost if the industry collapsed. This anxiety has been repeatedly expressed for the small clothing exporters in the region, but is the concern—expressed in such articles as the *Far Eastern Economic Review* (2003)—valid? An attempt is made to address this issue in the following section.

Before turning to recent trade performance, it is important to note briefly the industrial structure of textiles and clothing and to understand the various factors thought to be important in determining where production takes place. Viewed as an integrated whole, the value chain in textiles and clothing consists of the following five production stages (Figure 1.4.1): (i) spinning of fibers into yarn; (ii) knitting or weaving of yarn into gray fabric; (iii) dyeing, printing, and finishing of fabrics for clothing production; (iv) cutting of fabric into clothing parts; and (v) assembly or sewing operations (combined with accessories like buttons and zippers) to create finished clothing.

The presence of large domestic supplies of cotton or wool as in PRC, India, Pakistan, and Egypt provides a basis for cotton and wool textile production, but cotton or wool may also be imported from other suppliers of raw material (e.g., Australia and New Zealand). Man-made fabric (MMF) is produced from polyester filaments. Finishing operations are capital intensive (particularly dyeing and fabric finishing) and require

1.4.1 Major production stages for textiles and clothing



Source: USITC. 2004. *Textiles and Apparel: Assessment of the Competitiveness of Certain Foreign Suppliers to the U.S. Market* (2 volumes). Publication 3671. Washington, DC. January. Available: <http://www.usitc.gov>.

large supplies of freshwater and power in addition to chemicals, dyes, and paints. Cutting and assembly operations for clothing are often subdivided as well, with simple sewing being the most labor intensive of all the production stages.

A developing country typically begins with importing cut clothing pieces for sewing into clothing items. As the industry develops, cutting of fabrics and sewing the pieces into clothing represents a second phase of development. As the producers become more sophisticated, standard trim and accessories are added to production (e.g., white buttons on men's dress shirts). Finally, a full-package clothing producer does the sourcing of the fabric and contracts for the cutting, sewing, and trim operations along a global supply chain or production network.

The ability to fragment production allows the full-package producer to place each operation in the most cost-effective location. The big differences in factor prices are what enable low-income developing countries to enter these global production networks. For example, clothing workers in Indonesia (earning \$0.27/hour), India (\$0.38/hour), Bangladesh (\$0.39/hour), Pakistan (\$0.41/hour), and Sri Lanka (\$0.48/hour) can compete with those in the PRC (\$0.78/hour) in labor-intensive sewing operations, provided that productivity is adequate, while workers in Mexico (\$2.45/hour) may have difficulty doing so for markets as distant as Japan or Europe (USITC 2004). However, it takes only 2 days to ship clothing from Mexico to US retail outlets, but 21 days for clothing from the PRC to reach retail markets in Los Angeles, and time is literally money (Hummels 2001).¹⁰ Hence, in certain clothing categories, the labor cost advantage of the PRC may be offset by geographic proximity, if trade costs are low in the competitor country.

The following factors must also be taken into account in addition to time, distance, and labor cost adjusted for productivity (unit labor costs): business climate in the supplying country (including policies and conditions for trade, investment, and the financial and labor markets); infrastructure (including use of electricity, informatics, ports, roads, telecommunications, water, and human resource-related infrastructure in, for example, health and education); and, most important, market access (whether a supplier is entitled to preferential tariff treatment or is subject to discriminatory tariff and nontariff barriers). All of these factors must be taken into consideration to understand the outcome of the liberalization that was completed under the ATC.¹¹ While space prevents

this brief review from conducting an evaluation of these factors in the developing Asian countries, it can be assumed that those that perform well in the post-quota trading environment are likely to have satisfied the requirements in most dimensions of these factors.

Recent performance under the ATC and in the (almost) post-quota era

In 2003 and again in 2004, growth in world textile and clothing trade was in double digits (WTO 2005), averaging 12–13% in value. Asian exports of textile and clothing products to Europe and North America increased at an annual rate of 18% during these 2 years in dollars and euros (Anson and Brocklehurst 2005).

In 2005, growth was anticipated to expand in volume terms (as all quotas are on the volume of exports and not on the value, which is determined by prices and quantities) but the outcome in value terms was indeterminate because it was not known if increases in volumes would outpace decreases in prices. Then again, it was only at the midnight hour of the fourth and final phase of the ATC that binding quotas on nearly half of all textile and clothing tariff lines in the harmonized system were finally ended for all WTO contracting member states by Canada, EU, and US.

The elimination of quotas is a double-edged sword for developing countries because of the existence of discriminatory preferential trade agreements with industrial countries. These agreements provided a large “margin of preference” to beneficiaries prior to 2005 because the tariff equivalent of the quotas imposed on large Asian nonpreferential suppliers was substantial. The elimination of quotas therefore implied a significant erosion of the margin of preference enjoyed by preferential suppliers as the tariff equivalents fell to zero as of 31 December 2004. This meant that shifts in market shares away from preferential suppliers and downward pressure on prices were likely to be seen as 2005 progressed.

The United States Office of Textiles and Apparel was empowered to rapidly collect import data on textile and clothing imports by quota categories, even after quotas were eliminated, through electronic data processing. It increased its efforts beginning in 2005 to monitor imports from the PRC in view of the special safeguard agreement that was part of the WTO accession agreement with that country. Data therefore became available by product and source country of imports with only a 2-month lag. Similarly, Eurostat put in place a system to monitor textile and clothing imports on a “real time” basis for the same purpose.¹² In the US case, detailed data on imports under special import programs are available so that preferential imports may be distinguished from imports facing most-favored nation tariffs. These data allow for the separation of what is happening in terms of volume and value (and, consequently, unit prices) in various categories of textile and clothing imports from preferential and nonpreferential suppliers, as well as for more aggregate measures of imports such as market share.

The following sections offer an overview of Asian exporters’ recent performance to the US and EU markets.

United States market

Clothing

The annual volume changes of US imports from all major suppliers for clothing in million square meter equivalents for 2002–2005 are shown in Table 1.4.1, which indicates a 10.3% increase in 2005 over 2004 and represents a sharp acceleration of growth compared with the previous year. The value of US imports of clothing in millions of current US dollars rose by about 6%—indicative of falling unit prices in 2005 compared with 2004 (Table 1.4.2). Clothing imports from the PRC increased by nearly 100% in volume and by about 70% in value—revealing a steep cut in unit values of the PRC's products. The full-year increase in the PRC's share of the US import market of about 12% in volume and 8% in value cements the PRC's position as the lead supplier of US imports of clothing, despite the imposition of safeguard quotas in the second half of the year.

In contrast, former major quota holders like Hong Kong, China; Taipei, China; and Korea (ranked by size of quota holdings) saw a cumulative drop in market share from 9.7% in 2004 to 6.1% in 2005 in volume and a drop from 11.1% to 8.4% in value over the same period. Preferential suppliers overall saw a decline in market shares in clothing shipments in volume of about 5% and in value by a little more than 4% in 2005 compared with 2004 (Tables 1.4.1 and 1.4.2). A group of competitive Asian suppliers more than held their own in the US market in 2005 led by Bangladesh, India, Indonesia, Cambodia, Pakistan, Sri Lanka, and Viet Nam, cumulatively increasing volume share by about 1 percentage point to about 24% in 2005 versus 23% in 2004, and increasing value share to 22.7% from 20.5% over the same time frame. This group managed this performance mainly because their unit values kept pace or grew faster than volumes. In fact, in Viet Nam and Sri Lanka, volumes rose more slowly than the world average but values increased more rapidly than the world average.

Moreover, in the case of Indonesia growth of value (nearly 20%) clearly outpaced volume growth (17%), indicating that rather than competing directly with the PRC, producers moved into higher-quality clothing lines. In particular, high growth in shipments of cotton clothing figured prominently in the success of these Asian suppliers, offsetting a generally weaker performance in shipments of MMF clothing. The latter category has much higher tariffs than cotton clothing (typically over 20% as against 10% for cottons) that may have priced some of them out of the market for certain products, compared with the PRC. The PRC lifted the volume of MMF clothing shipments by 140% in 2005 but increased value by half that, indicating a sharp reduction in its prices of MMF clothing. Even though the PRC also faces high tariffs on these items, its price competitiveness was strong enough to overcome them. Preferential suppliers were also able to preserve their market share in MMF clothing (a decline of 3.5% in volume but only 1.7% in value) better than in cotton clothing (a decline of 7.8% in volume and 7.2% in value).

In some contrast to competitive Asian suppliers, Malaysia, Philippines, and Thailand continued to have fading performances in clothing shipments in both volume and value terms relative to the world average. This suggests that producers in these cases failed to adjust in the manner of the more competitive suppliers.

1.4.1 United States imports of clothing, by volume

	Volume change over previous year (%)				Market share (%)				
	2002	2003	2004	2005	2001	2002	2003	2004	2005
Nonpreferential suppliers	12.64	14.40	10.40	21.87	52.19	54.87	57.41	59.93	66.20
Asia-Pacific DMC suppliers	12.88	14.73	11.43	26.46	47.23	49.75	52.21	55.01	63.05
People's Republic of China	60.35	46.32	29.81	97.93	6.06	9.07	12.14	14.90	26.73
Bangladesh	-3.96	-1.58	3.14	19.45	6.00	5.38	4.84	4.72	5.11
Indonesia	0.15	3.92	13.83	17.07	3.69	3.45	3.28	3.53	3.74
India	26.29	4.59	14.52	29.68	2.50	2.95	2.82	3.05	3.59
Viet Nam	1,022.36	134.38	5.12	3.13	0.17	1.83	3.92	3.89	3.64
Cambodia	22.67	19.97	20.28	11.87	2.23	2.55	2.80	3.18	3.23
Thailand	8.32	1.20	7.45	0.69	2.81	2.84	2.63	2.67	2.44
Hong Kong, China	-10.43	-4.36	-5.92	-19.27	5.69	4.76	4.16	3.70	2.71
Pakistan	10.10	16.12	17.06	11.28	2.15	2.21	2.35	2.60	2.63
Philippines	-0.49	-0.90	-5.87	1.00	3.44	3.19	2.89	2.57	2.36
Sri Lanka	-2.31	0.28	5.08	9.32	2.50	2.28	2.09	2.08	2.06
Republic of Korea	2.86	-11.43	8.48	-42.44	3.92	3.77	3.05	3.13	1.63
Taipei, China	-6.25	2.61	-3.18	-31.56	3.81	3.34	3.13	2.87	1.78
Malaysia	-0.14	-0.67	10.09	0.36	1.20	1.12	1.01	1.06	0.96
Mongolia	23.12	3.34	12.35	-35.53	0.27	0.31	0.29	0.31	0.18
Turkmenistan	2.39	43.95	-2.46	-6.51	0.09	0.09	0.12	0.11	0.09
Nepal	-28.93	3.51	-11.26	-44.85	0.33	0.22	0.21	0.17	0.09
Uzbekistan	90.23	39.59	-36.72	26.29	0.02	0.04	0.05	0.03	0.04
Kyrgyz Republic	485.97	176.51	-11.26	-33.92	0.00	0.01	0.03	0.02	0.01
Armenia	-18.46	-25.48	23.69	-68.54	0.03	0.02	0.01	0.02	0.00
Kazakhstan	67.39	166.48	36.32	-91.59	0.01	0.02	0.06	0.07	0.01
Fiji Islands	-14.21	-7.97	21.38	-80.46	0.14	0.11	0.09	0.11	0.02
Maldives	49.28	11.92	-3.83	-93.74	0.15	0.20	0.21	0.19	0.01
Tajikistan	-	10,544.65	-33.44	-99.75	-	0.00	0.02	0.01	0.00
<i>Excluding People's Rep. of China</i>	5.89	7.69	5.86	-0.09	41.17	40.68	40.07	40.11	36.32
Other nonpreferential suppliers	10.36	11.15	0.05	-29.39	4.97	5.12	5.20	4.92	3.15
Preferential suppliers	2.12	2.98	2.30	-4.50	43.12	41.09	38.71	37.44	32.41
Central American Free Trade Agreement	4.90	5.46	2.87	-0.09	20.69	20.25	19.54	19.00	17.21
Mexico	-5.81	-8.34	-4.10	-10.17	14.22	12.50	10.48	9.50	7.74
Others	8.86	13.95	8.72	-7.82	8.21	8.34	8.69	8.94	7.47
World	7.15	9.32	5.76	10.32	100.00	100.00	100.00	100.00	100.00

DMC = developing member country of the Asian Development Bank.

Notes: Sum of nonpreferential and preferential suppliers does not add up to world total because some minor suppliers are not included; numbers may not sum precisely due to rounding.

Source: United States Department of Commerce, Office of Textiles and Apparel, available: <http://www.otexa.ita.doc.gov/>, downloaded 10 March 2006.

Small and marginal suppliers in the US market, such as the Fiji Islands and Nepal, which had already been losing ground before the ending of quotas, were hard hit in 2005. Most of the countries in Central Asia as well as Maldives and Mongolia saw their market shares evaporate in 2005. These were cases where distance and geography now count for more than other factors and, with the end of quotas, footloose producers have packed up and moved on.

In the main, however, many countries' fears of being squeezed out of the US market—by a combination of the rising strength of the PRC on the one hand and the proliferation of US preferences with non-Asian suppliers on the other—were not realized.

Textiles

Intermediate textile products include yarns and fabrics used in the manufacture of clothing. The trade in intermediate textile products is concentrated in fewer countries than trade in clothing, reflecting the large scale-economies in production of textiles compared with clothing.

1.4.2 United States imports of clothing, by value									
	Value change over previous year (%)				Market share (%)				
	2002	2003	2004	2005	2001	2002	2003	2004	2005
Nonpreferential suppliers	2.48	11.32	8.69	15.12	56.37	57.26	59.36	60.93	66.11
Asia-Pacific DMC suppliers	2.48	12.06	9.60	19.90	48.25	49.00	51.15	52.93	59.83
People's Republic of China	21.54	29.75	23.01	69.61	8.15	9.82	11.87	13.78	22.04
India	10.74	5.26	10.77	34.24	3.04	3.34	3.27	3.42	4.33
Hong Kong, China	-7.93	-4.53	3.98	-8.79	7.46	6.81	6.05	5.94	5.11
Indonesia	-7.81	5.69	11.36	19.67	3.92	3.58	3.53	3.71	4.18
Viet Nam	1,768.80	165.29	7.91	6.33	0.08	1.57	3.88	3.96	3.97
Bangladesh	-10.38	-1.86	7.01	19.93	3.72	3.31	3.02	3.05	3.45
Cambodia	11.58	18.92	15.27	19.86	1.65	1.83	2.03	2.21	2.49
Thailand	-5.44	-0.40	5.13	0.47	3.22	3.02	2.80	2.78	2.63
Philippines	-4.02	2.11	-3.66	2.51	3.35	3.19	3.03	2.76	2.66
Sri Lanka	-6.04	1.60	7.92	6.51	2.66	2.48	2.35	2.39	2.40
Pakistan	-5.71	15.61	12.04	10.65	1.65	1.54	1.66	1.76	1.83
Republic of Korea	-5.49	-12.39	0.15	-36.17	3.86	3.62	2.95	2.79	1.68
Taipei,China	-12.98	2.21	-3.86	-26.76	3.21	2.77	2.63	2.39	1.65
Malaysia	-5.42	-4.77	3.84	-4.79	1.35	1.26	1.12	1.10	0.99
Mongolia	11.97	13.40	28.56	-40.78	0.25	0.27	0.29	0.35	0.20
Nepal	-27.56	20.00	-24.31	-37.59	0.26	0.19	0.21	0.15	0.09
Turkmenistan	10.46	42.28	-4.09	-20.38	0.05	0.06	0.08	0.07	0.05
Uzbekistan	63.05	80.00	-53.16	62.54	0.01	0.02	0.03	0.02	0.02
Fiji Islands	-18.54	9.48	7.90	-77.74	0.16	0.13	0.13	0.13	0.03
Kyrgyz Republic	162.02	227.62	-28.79	-43.67	0.00	0.00	0.02	0.01	0.01
Kazakhstan	-5.36	357.72	-15.66	-75.07	0.01	0.01	0.03	0.02	0.00
Armenia	-13.95	-23.04	-1.38	-80.91	0.02	0.02	0.01	0.01	0.00
Maldives	20.30	-9.52	-10.73	-94.18	0.15	0.18	0.15	0.13	0.01
Tajikistan	-	10,247.18	-46.20	-99.45	-	0.00	0.01	0.00	0.00
<i>Excluding People's Rep. of China</i>	-1.40	7.63	5.54	2.40	40.09	39.18	39.28	39.15	37.79
Other nonpreferential suppliers	2.47	6.92	3.03	-16.54	8.12	8.25	8.22	7.99	6.29
Preferential suppliers	-0.06	1.96	4.01	-6.46	39.52	39.15	37.18	36.52	32.20
Central American Free Trade Agreement	1.77	0.98	3.57	-4.26	15.82	15.96	15.01	14.68	13.25
Mexico	-4.95	-7.01	-3.17	-9.07	13.83	13.03	11.29	10.32	8.85
Others	3.87	15.03	12.08	-6.91	9.87	10.16	10.88	11.52	10.11
World	0.89	7.37	5.90	6.09	100.00	100.00	100.00	100.00	100.00

DMC = developing member country of the Asian Development Bank.

Notes: Sum of nonpreferential and preferential suppliers does not add up to world total because some minor suppliers are not included; numbers may not sum precisely due to rounding.

Source: United States Department of Commerce, Office of Textiles and Apparel, available: <http://www.otexa.ita.doc.gov/>, downloaded 10 March 2006.

Only seven Asian suppliers have a market share in US imports of textile intermediates of more than 1%, compared with double that number for clothing (Tables 1.4.3 and 1.4.4). Similarly, only three preferential suppliers (Canada, Mexico, and Israel—ranked by size) have a share exceeding 1% of US imports of intermediate textile products compared with seven preferential suppliers of clothing. Imports of intermediate products are aggregated in Tables 1.4.3 (volume) and 1.4.4 (value).

The volume of trade measured by US imports increased by only 3% in 2005 from the previous year and the increase in value was even smaller, at only 2%. Only three big Asian suppliers had growth in shipments of intermediate textile products to the US after 2004 large enough to increase market share: the PRC (up 83% in volume and 56% in value); India (up 79% in volume and 22% in value); and Indonesia (up 7% in volume and 4% in value). Other significant Asian suppliers such as Korea and Taipei,China increased the volume of shipments but saw values fall,

1.4.3 United States imports of textile intermediate products, by volume

	Volume change over previous year (%)				Market share (%)				
	2002	2003	2004	2005	2001	2002	2003	2004	2005
Nonpreferential suppliers	29.98	-2.45	12.24	9.08	53.31	58.09	56.95	58.94	62.39
Asia-Pacific DMC suppliers	38.40	-2.48	14.80	15.55	34.38	39.89	39.09	41.38	46.41
People's Republic of China	82.66	16.06	29.52	82.70	3.56	5.45	6.35	7.59	13.45
Republic of Korea	58.26	15.42	20.88	5.85	6.41	8.51	9.87	11.00	11.30
Pakistan	32.01	-12.59	17.99	-10.48	7.59	8.40	7.38	8.03	6.97
Taipei, China	59.45	-14.71	4.27	1.20	4.04	5.39	4.62	4.45	4.37
Indonesia	19.46	-17.46	16.38	6.74	2.94	2.95	2.44	2.62	2.72
India	18.10	-3.35	14.35	79.30	1.65	1.63	1.59	1.67	2.91
Thailand	8.38	-19.31	-3.21	-7.23	3.87	3.52	2.85	2.55	2.29
Malaysia	41.04	11.30	2.16	-25.55	0.91	1.07	1.20	1.13	0.82
Viet Nam	11,536.75	184.12	23.74	16.85	0.00	0.12	0.33	0.38	0.43
Philippines	46.86	17.64	-18.49	-60.59	0.78	0.95	1.13	0.85	0.32
Hong Kong, China	-30.04	-48.21	24.13	10.87	1.40	0.82	0.43	0.49	0.53
Sri Lanka	-1.40	-10.00	-27.16	-39.93	0.43	0.36	0.32	0.22	0.13
Bangladesh	-28.02	20.67	-1.89	-63.85	0.11	0.06	0.08	0.07	0.02
Cambodia	309.43	-39.72	37.96	-53.23	0.02	0.06	0.04	0.05	0.02
Uzbekistan	13.53	-26.98	-33.43	-57.87	0.56	0.54	0.39	0.24	0.10
Nepal	233.99	67.40	100.90	626.41	0.00	0.00	0.00	0.00	0.00
Mongolia	-34.03	-99.67	-41.85	6,343.94	0.00	0.00	0.00	0.00	0.00
Turkmenistan	-41.56	23.99	-41.37	-45.77	0.10	0.05	0.06	0.03	0.02
Kyrgyz Republic	-	-	-	-	-	-	-	-	0.00
Armenia	-	-	-	-	-	-	-	-	0.00
Kazakhstan	-	-100.00	-	-100.00	-	0.00	-	0.00	-
Fiji Islands	808.88	-89.08	616.36	-88.08	0.00	0.00	0.00	0.00	0.00
Maldives	-	-	-	-	-	-	-	-	-
Tajikistan	-92.63	64.55	2,825.57	-77.67	0.01	0.00	0.00	0.02	0.00
<i>Excluding People's Rep. of China</i>	33.29	-5.41	11.94	0.48	30.82	34.44	32.74	33.79	32.95
Other nonpreferential suppliers	14.70	-2.38	6.64	-6.19	18.93	18.20	17.86	17.56	15.99
Preferential suppliers	4.36	0.83	3.18	-5.87	43.75	38.27	38.78	36.90	33.71
Mexico	8.58	-4.27	12.87	-5.93	10.55	9.61	9.24	9.62	8.78
Central American Free Trade Agreement	-18.33	14.45	24.76	-32.95	0.58	0.40	0.46	0.53	0.34
Others	577.29	2.38	-0.24	-5.32	32.61	28.27	29.08	26.75	24.59
World	19.28	-0.49	8.45	3.03	100.00	100.00	100.00	100.00	100.00

DMC = developing member country of the Asian Development Bank.

Notes: Sum of nonpreferential and preferential suppliers does not add up to world total because some minor suppliers are not included; numbers may not sum precisely due to rounding.

Source: United States Department of Commerce, Office of Textiles and Apparel, available: <http://www.otexa.ita.doc.gov/>, downloaded 10 March 2006.

losing market share in value terms. Only Canada, Mexico, and Israel, among all preferential suppliers, ship large amounts of intermediate textile products to the US and all of them saw decreases in the volume of shipments in 2005 of 5–6%. However, Mexico increased the value of its shipments enough to increase market share marginally. Indeed the market share of preferential suppliers as a group fell hardly at all in value (by only about two tenths of a percentage point), indicating that preferential rules of origin are likely at work, diverting trade in these products. This is in fact unsurprising, given the stringent “triple-transformation” (covering the second through fifth major steps in production shown in Figure 1.4.1 above) rules of origin in the North American Free Trade Agreement (NAFTA) as regards textiles and clothing.

Asia might benefit by looking at EU and US experience with rules of origin in negotiating and designing rules for its own bilateral and regional trade agreements that will influence the future textile and

1.4.4 United States imports of textile intermediate products, by value									
	Value change over previous year (%)				Market share (%)				
	2002	2003	2004	2005	2001	2002	2003	2004	2005
Nonpreferential suppliers	9.32	-1.50	11.25	2.27	63.98	65.66	65.45	67.14	67.30
Asia-Pacific DMC suppliers	14.02	-4.68	10.23	5.32	36.69	39.27	37.88	38.50	39.75
People's Republic of China	47.74	13.72	23.19	55.80	4.36	6.04	6.96	7.90	12.07
Republic of Korea	8.31	-6.51	6.13	-0.13	9.71	9.88	9.35	9.15	8.95
Pakistan	30.39	-2.69	22.29	-19.21	5.14	6.29	6.20	6.99	5.53
Taipei, China	16.08	-10.41	1.65	-4.00	6.41	6.98	6.33	5.93	5.58
Indonesia	-1.25	-8.52	17.90	3.61	1.97	1.83	1.69	1.84	1.87
India	10.33	6.94	6.90	21.96	1.87	1.94	2.10	2.07	2.47
Thailand	-0.87	-20.38	0.77	-4.64	2.54	2.37	1.91	1.77	1.66
Malaysia	10.34	-1.85	-2.64	-22.61	0.67	0.70	0.69	0.62	0.47
Viet Nam	32,745.72	202.55	23.59	-4.02	0.00	0.07	0.20	0.23	0.22
Hong Kong, China	-31.09	-47.57	-12.66	-32.09	2.52	1.63	0.86	0.70	0.46
Philippines	28.18	34.19	-11.96	-69.59	0.60	0.72	0.98	0.79	0.24
Sri Lanka	-8.96	-24.36	-25.31	-40.99	0.40	0.34	0.26	0.18	0.10
Cambodia	162.33	-50.54	29.04	-25.26	0.02	0.06	0.03	0.03	0.03
Bangladesh	-24.81	13.70	20.48	-65.45	0.05	0.04	0.04	0.04	0.02
Uzbekistan	4.52	-29.68	-21.46	-69.04	0.37	0.37	0.26	0.19	0.06
Nepal	2.60	277.32	-9.14	114.31	0.00	0.00	0.00	0.00	0.00
Maldives	-	-	-	-	-	-	-	-	-
Mongolia	-33.84	-96.99	158.90	134.41	0.00	0.00	0.00	0.00	0.00
Turkmenistan	-13.86	-11.04	-6.31	-44.47	0.04	0.03	0.03	0.02	0.01
Fiji Islands	249.26	-75.25	192.53	-83.09	0.00	0.00	0.00	0.00	0.00
Kyrgyz Republic	-	-	-	-	-	-	-	-	0.00
Kazakhstan	-	-100.00	-	-100.00	-	0.00	-	0.00	-
Armenia	-	-	-	-	-	-	-	-	0.00
Tajikistan	-92.15	76.28	2,346.08	-76.50	0.01	0.00	0.00	0.04	0.01
<i>Excluding People's Rep. of China</i>	9.47	-8.03	7.31	-7.71	32.33	33.23	30.93	30.60	27.68
Other nonpreferential suppliers	2.99	3.25	12.65	-1.83	27.29	26.39	27.57	28.64	27.56
Preferential suppliers	0.38	-0.91	3.35	1.34	32.76	30.88	30.96	29.51	29.31
Mexico	6.82	-6.04	8.23	3.08	9.44	9.47	9.00	8.98	9.08
Central American Free Trade Agreement	-18.24	-0.22	36.43	-19.31	0.27	0.21	0.21	0.26	0.21
Others	-2.04	1.37	1.01	0.84	23.05	21.20	21.75	20.26	20.02
World	6.52	-1.19	8.45	2.02	100.00	100.00	100.00	100.00	100.00

DMC = developing member country of the Asian Development Bank.

Notes: Sum of nonpreferential and preferential suppliers does not add up to world total because some minor suppliers are not included; numbers may not sum precisely due to rounding.

Source: United States Department of Commerce, Office of Textiles and Apparel, available: <http://www.otexa.ita.doc.gov/>, downloaded 10 March 2006.

clothing trade of its developing countries. The US has demonstrated some flexibility in designing rules of origin in preferential agreements as far as intermediate textile products are concerned. For example, the US-Central American Free Trade Agreement (CAFTA) allows cumulation¹³ in textiles and clothing between CAFTA and NAFTA so that textile yarns and fabrics from Mexico are counted as originating within the CAFTA countries. In its free trade agreement with Jordan, either US or Israeli fabrics or clothing parts may be used in Jordan's clothing shipments to the US with duty-free treatment.¹⁴

European Union Market

Following the PRC's entry into WTO in late 2001, the country's access to the EU market improved: its shipments of textile and clothing products to the EU rose, and its share of the market in volume terms increased from 17% in 2001 to 26% in 2004 and in value terms from 18% in 2001 to 23% in

1.4.5 European Union imports of textiles and clothing, by volume

	Volume change over previous year (%)						Market share (%)					
	1996–2000 ^a	2001	2002	2003	2004	2005	1995–2000 ^b	2001	2002	2003	2004	2005
Asia	9.14	57.11	-23.88	14.32	5.76	13.94	56.19	65.27	59.92	62.34	62.59	66.78
People's Republic of China	14.04	44.39	3.88	28.37	10.86	36.39	13.73	16.89	21.16	24.71	26.01	33.37
India	5.92	5.94	-6.25	6.41	2.92	4.73	11.64	8.44	9.54	9.24	9.02	8.81
Bangladesh	9.02	401.16	-77.99	26.97	17.68	-1.18	5.26	19.38	5.14	5.94	6.64	6.13
Pakistan	6.38	8.24	11.72	12.98	6.82	-3.03	5.80	4.23	5.70	5.86	5.95	5.31
Hong Kong, China	-2.03	40.65	-12.81	-8.92	-16.95	-20.06	2.95	2.37	2.49	2.06	1.63	1.19
Indonesia	7.51	18.65	-6.05	-7.80	-7.95	-7.26	5.04	4.12	4.67	3.92	3.43	3.00
Republic of Korea	25.69	-3.14	-1.81	2.00	-2.89	-19.17	2.83	2.56	3.03	2.81	2.59	1.97
Thailand	3.85	9.01	7.02	3.74	-4.67	4.92	2.85	2.03	2.62	2.48	2.24	2.20
Sri Lanka	7.06	-4.22	5.08	6.64	12.11	-9.00	1.12	0.71	0.90	0.87	0.93	0.79
Taipei,China	17.57	26.77	-19.83	-0.22	-12.05	8.47	2.61	2.48	2.39	2.17	1.81	1.86
Viet Nam	30.42	20.09	-1.71	7.19	6.95	-1.16	0.71	0.92	1.09	1.06	1.08	1.01
Cambodia	33.79	71.12	-9.09	19.70	24.70	-7.97	0.23	0.33	0.36	0.39	0.47	0.40
Philippines	0.31	2.02	-3.60	0.72	14.74	-33.49	0.63	0.36	0.42	0.38	0.42	0.26
Nepal	-5.10	-21.68	-20.60	-0.29	9.45	-11.09	0.27	0.10	0.10	0.09	0.09	0.08
Non-Asia	13.79	16.52	-3.10	5.57	5.23	-1.39	18.95	18.04	21.08	20.25	20.23	18.50
Turkey	15.81	17.90	-3.31	7.21	8.14	2.12	10.77	10.67	12.45	12.14	12.47	11.78
Romania	19.31	21.91	9.88	7.80	2.19	-8.96	2.17	2.48	3.29	3.22	3.13	2.66
Tunisia	7.51	8.77	-4.52	-5.11	-3.68	-8.06	2.49	1.96	2.26	1.95	1.78	1.52
Morocco	7.50	6.63	-8.70	3.20	-1.43	-8.27	2.58	1.90	2.09	1.96	1.84	1.56
Bulgaria	17.42	26.54	-19.30	6.86	10.27	3.16	0.94	1.03	1.00	0.97	1.02	0.97
World	8.78	35.55	-17.08	9.89	5.33	7.16	100.00	100.00	100.00	100.00	100.00	100.00

^a Average growth rate from 1996 to 2000 relative to previous year. ^b Average market share in 1995–2000.

Note: Sum of Asia and non-Asia suppliers does not add up to world total because some minor suppliers are not included.

Source: Eurostat, available: http://epp.eurostat.ec.eu.int/portal/page?_pageid=1996,45323734&_dad=portal&_schema=PORTAL&screen=welcomeref&open=/&product=EU_external_trade&depth=4, downloaded 1 March 2006.

2004 (Tables 1.4.5 and 1.4.6). Most Asian suppliers lost market share but the biggest losers were the large quota holders (Hong Kong, China; Korea; and Taipei,China). India, Philippines, Sri Lanka, and Thailand had small initial losses in 2002 but market shares were quite stable in 2003 and 2004. Several Asian suppliers with preferential access to the EU under the Generalised System of Preferences and the Everything But Arms initiative actually improved market shares, including Bangladesh, Cambodia, and Pakistan during 2002–2004. Nepal and Viet Nam did not perform well despite available preferences. Non-Asian preferential suppliers had a similarly mixed performance. Turkey did well between 2002 and 2004 and firmed up its place as the second-largest developing country supplier, after the PRC. However, preferential suppliers in the Mediterranean rim and North Africa, such as Tunisia and Morocco, lost market share in that period. Romania and Bulgaria, on the other hand, performed reasonably well.

Unit values of EU imports have fallen since the end of 2002, as total import volume has increased more than import value. In 2005, growth in import volume exceeded that in import value by just 1.6 percentage points, so downward pressure on prices in the EU was muted.

The impact of the final phase of quota integration by the EU was expected to be less than in the US case, as the liberalization had gone further in Europe than in North America under the ATC, largely because the EU eliminated quotas for many small supplier countries earlier under various arrangements or because the lines it chose to liberalize were

1.4.6 European Union imports of textiles and clothing, by value

	Value change over previous year (%)						Market share (%)					
	1996–2000 ^a	2001	2002	2003	2004	2005	1995–2000 ^b	2001	2002	2003	2004	2005
Asia	12.42	0.96	-0.35	0.53	8.05	13.37	51.41	51.67	51.64	52.16	53.77	57.91
People's Republic of China	16.58	6.95	10.48	7.24	12.35	40.07	15.66	17.96	19.90	21.45	22.99	30.66
India	6.70	5.53	-4.74	-1.05	5.14	16.10	7.63	7.14	6.82	6.78	6.80	7.50
Bangladesh	21.48	8.95	-2.76	12.24	20.19	-6.43	3.36	4.41	4.30	4.86	5.57	4.95
Pakistan	7.53	6.80	4.49	3.65	9.64	-11.25	3.38	3.16	3.31	3.44	3.60	3.00
Hong Kong, China	4.70	-16.90	-9.89	-9.81	-6.37	-22.35	5.79	4.09	3.69	3.35	2.99	2.17
Indonesia	11.02	-1.99	-14.48	-11.82	-3.81	-12.66	3.93	3.68	3.16	2.80	2.57	2.16
Republic of Korea	19.08	-8.75	-9.83	-11.59	-7.69	-26.71	2.65	2.75	2.49	2.21	1.95	1.36
Thailand	9.41	-5.84	-1.23	-5.59	4.24	-8.63	2.27	2.02	2.01	1.90	1.89	1.64
Sri Lanka	13.87	-7.74	-3.69	-5.59	13.34	-3.12	1.34	1.27	1.22	1.16	1.26	1.14
Taipei,China	16.55	-10.63	-10.71	-11.77	-16.37	-19.80	1.96	1.70	1.52	1.35	1.08	0.82
Viet Nam	24.44	0.61	-8.62	-20.97	19.38	1.88	1.10	1.30	1.19	0.94	1.08	1.05
Cambodia	48.76	39.69	7.44	-0.72	22.49	-10.02	0.30	0.59	0.64	0.64	0.74	0.64
Philippines	6.04	-10.88	-0.12	-5.60	13.76	-35.85	0.69	0.52	0.52	0.49	0.53	0.33
Nepal	4.66	-27.43	-29.90	-12.28	10.80	-6.56	0.28	0.17	0.12	0.11	0.11	0.10
Non-Asia	12.39	15.32	6.66	2.13	2.07	-1.17	25.47	28.83	30.84	31.65	30.82	28.71
Turkey	12.06	10.50	10.95	5.81	4.48	3.18	11.97	12.86	14.31	15.21	15.17	14.73
Romania	22.17	29.04	11.42	2.97	1.39	-5.72	3.60	5.47	6.11	6.32	6.11	5.46
Tunisia	8.51	13.41	0.69	-5.83	-4.49	-5.56	4.64	4.68	4.72	4.47	4.07	3.61
Morocco	7.51	11.87	-0.56	-5.70	-1.93	-7.74	4.20	4.16	4.15	3.93	3.68	3.20
Bulgaria	22.91	29.90	-7.20	10.11	9.53	1.19	1.06	1.66	1.55	1.71	1.79	1.71
World	10.93	4.32	-0.29	-0.48	4.81	5.52	100.00	100.00	100.00	100.00	100.00	100.00

^a Average growth rate from 1996 to 2000 relative to previous year. ^b Average market share in 1995–2000.

Note: Sum of Asia and non-Asia suppliers does not add up to world total because some minor suppliers are not included.

Source: Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1996,45323734&_dad=portal&_schema=PORTAL&screen=welcomeref&open=/&product=EU_external_trade&depth=4, downloaded 1 March 2006.

of real commercial interest to developing country exporters. However, as the PRC was quota constrained in some important categories, some significant shifts in 2005 were seen, and its overall market share rose sharply from 23% to 31%, or by over one third. India is the only other Asian supplier that gained market share following the liberalization in the fourth and final phase of the ATC. Every preferential supplier lost market share, as did former large quota holders.

In 2005, the EU introduced a system to monitor imports from the PRC and eight other Asian economies (Bangladesh; Cambodia; Hong Kong, China; India; Pakistan; Sri Lanka; Taipei, China; and Thailand) in 15 categories of clothing (similar to the merged categories in the US case) and six categories of intermediate textile products deemed to be “sensitive.” Indeed, prior to the final implementation of the ATC, the European Commission had prepared and published “alert levels” of imports in textile and clothing categories that had been used to allocate quotas under the ATC, and so forewarned the PRC that it would take action if the alert levels (expressed in volume terms) were breached. In the first quarter of 2005, shipments from the PRC rose at rates of over 100% relative to the same period in 2004 in volume terms in eight categories of clothing and textiles: knit shirts and t-shirts, sweaters, men’s trousers, blouses, hosiery, women’s overcoats, and dresses; and woven flax fabric.¹⁵ In two other categories, volumes were up by over 60%: brassieres and cotton fabrics.

Thus, in the second quarter of the year, the European Commission started the process of introducing special safeguards on these 10

categories and in June 2005 negotiated a comprehensive agreement to restrict these products. However, before the ink was dry on the agreement, import shipments that had already been in transit began arriving at European ports in amounts that breached the agreed limits. Ironically, a trade dispute resulted immediately with angry retailers demanding customs release shipments that were technically in violation of the negotiated agreement. This incident became known as the “bra war” as thousands of brassieres piled up in docks and customs warehouses. The comprehensive agreement appeared to be unraveling even before the EU negotiators could unpack their suitcases after returning from negotiations in Beijing.

Fortunately, a full trade war was averted when the EU compromised and agreed to allow the items to be released but to be counted against the quota for 2006. It is too early to tell if the EU safeguard quotas will have the same effect of slowing the buildup in the PRC’s market share or even reversing it, allowing the other Asian suppliers or preferential suppliers to fill the gap.

Impact of new US restrictions on the PRC’s shipments of textiles and clothing

Looking forward, the situation in the US market appears to be favorable for continued penetration by Asian competitive suppliers, provided that they do not run up against more systematic protection through US antidumping measures or other forms of contingent protection.¹⁶ Some of the new US bilateral free trade agreements may move some trade from Asia in the coming years, yet this shift may be offset as several Asian suppliers seek bilateral trade agreements with the US to attain preferential access of their own (not least of which are Malaysia and Thailand—see Table 3.3 in section 3 of Part 3 of *Asian Development Outlook 2006*). Viet Nam may also see its terms of market access improve when it becomes a WTO member (possibly this year).

The most significant event influencing market access in the US for Asian suppliers in the next 2–3 years, however, is likely to be the negotiated new quantitative limits on 21 categories of imports of clothing and textile yarns, fabrics, and made-up products from the PRC as set out in the 5 November 2005 memorandum of understanding between the US and the PRC concerning trade in textile and apparel products. This sets out agreed levels of imports by volume for the next 3 years (2006–2008) and provides for progressive increases in quota growth but well below growth attained in 2005 before the safeguards were invoked (James 2005). Most of the restrictions apply to clothing categories that are quite broad in the sense that two or even three types of fiber (cotton, wool, MMF) are subject to restriction in the merged categories (Table 1.4.7). For example, in the categories of sweaters and hosiery, all such items made from cotton, wool, and MMF are restricted. For knit shirts, woven shirts, brassieres, underwear, and swimwear, restrictions are applied to cotton and MMF items. In the case of trousers, coverage includes all possible fabrics: cotton, wool, MMF, and silk and vegetable fibers. The coverage of total shipments of textiles and clothing to the US in terms of the value and volume of shipments in 2005 from the PRC (Table 1.4.7) is significant, but even

1.4.7 Restricted imports under the memorandum of understanding between the United States and the People's Republic of China

Category	Value (\$ million)					Change (%)		
	2004	2005	Jan 2004	Jan 2005	Jan 2006	2005 from 2004	Jan 2005 from Jan 2004	Jan 2006 from Jan 2005
200/301 sewing thread/combed cotton yarn	16.40	28.31	0.98	0.94	2.78	72.67	-3.61	194.84
222 knit fabric	46.34	73.55	5.40	2.98	9.50	58.72	-44.81	218.49
229 special purpose fabric	122.26	174.22	6.79	13.25	12.98	42.50	95.17	-1.99
332/432/632 socks	237.51	223.57	11.29	24.25	12.46	-5.87	114.87	-48.62
338/339 cotton knit shirts	216.47	635.65	17.37	48.61	18.22	193.64	179.91	-62.53
340/640 men and boys woven shirts	160.63	295.45	15.11	23.54	8.45	83.93	55.80	-64.10
345/645/646 sweaters	101.28	448.67	8.54	9.71	15.30	343.01	13.68	57.68
347/348 cotton trousers	271.88	1,066.86	16.86	93.01	25.70	292.40	451.75	-72.36
349/649 brassieres	446.76	516.47	41.17	53.28	45.28	15.60	29.43	-15.01
352/652 underwear	137.13	218.83	11.28	18.07	3.45	59.58	60.16	-80.91
359S/659S ^a swimwear	186.03	306.87	12.52	17.22	28.45	64.96	37.52	65.24
363 pile towels	70.81	176.07	8.29	10.45	26.48	148.64	25.99	153.44
666pt ^b window blinds and shades	241.86	293.92	16.93	19.20	24.24	21.52	13.41	26.25
443 men and boys wool suits	5.20	52.53	0.53	1.70	11.85	909.66	223.18	595.28
447 men and boys wool trousers	10.77	27.88	1.18	1.72	1.92	158.98	45.29	11.95
619 polyester filament	3.09	29.70	0.33	0.98	2.63	860.57	195.09	169.77
620 other synthetic filament	11.64	42.20	0.95	1.83	0.91	262.48	92.88	-50.06
622 glass fabric	12.61	13.93	0.95	0.85	1.05	10.46	-11.10	24.05
638/639pt man-made fiber knit shirts	235.14	433.35	23.43	48.13	17.68	84.29	105.40	-63.28
647/648pt man-made fiber trousers	287.71	424.49	22.20	38.68	17.80	47.54	74.23	-53.99
847 silk and vegetable fiber trousers	1,034.86	919.48	104.17	100.17	125.70	-11.15	-3.84	25.48
Subtotal—restricted categories	3,856.41	6,402.00	326.26	528.56	412.82	66.01	62.01	-21.90
Total textile and clothing imports	14,558.08	22,405.22	1,198.21	1,550.25	1,813.97	53.90	29.38	17.01
Share of restricted categories	26.49	28.57	27.23	34.10	22.76			

^a Assumed to be 25% of imports in category.

^b Assumed to be 20% of imports in category.

Notes: Items in categories 200 are of cotton or man-made fiber; items in categories 300 are cotton; items in categories 400 are wool; items in categories 600 are man-made fiber (synthetic fiber); items in categories 800 are silk or vegetable fiber.

Source: United States Department of Commerce, Office of Textiles and Apparel, available: <http://www.otexa.ita.doc.gov/>, downloaded 14 March 2006.

more important is that these are high-growth sectors in US imports and therefore of strong commercial interest to competitive Asian suppliers. This point is confirmed by an examination of data for the first semester of 2005 (i.e., post-quota) versus the same period in 2004 (ATC quotas in effect). The growth rate of the items that the US restricted was, in value terms, 143% from the PRC (Table 1.4.8) and would certainly be nearly 200% in volume terms. Overall growth of imports in value terms from the world to the US reached 12% and would certainly have reached 20% in volume terms. Thus, there is confirmation that the US targeted high growth and growth potential categories for application of the safeguards.

Evidence suggests that the quota restrictions may well halt the advance of the PRC's market share in US imports or even reverse some of the gains made in 2005. This is because the categories restricted are among those with the highest actual growth and potential for future growth for the PRC and other competitive Asian suppliers in the US market (Tables 1.4.9 and 1.4.10).

The restriction of imports from the PRC appears to be benefiting a number of Asian suppliers based upon data for the first month of 2006, with high volume rates of growth in restricted categories for India, Cambodia, Indonesia, Bangladesh, and a few others, in contrast to contraction for the PRC and for preferential suppliers to the US market including CAFTA, Mexico, Sub-Saharan Africa, Jordan, and Andean

1.4.8 United States imports of restricted items under the memorandum of understanding between the United States and the People's Republic of China, by value

	Value (\$ million)		
	Jan–Jun 2004	Jan–Jun 2005	Change (%)
Nonpreferential suppliers	11,458.84	14,150.20	23.49
Asia-Pacific DMC suppliers	9,661.80	12,539.44	29.78
People's Republic of China	1,769.30	4,303.97	143.26
India	683.76	931.90	36.29
Hong Kong, China	1,086.29	903.74	-16.80
Bangladesh	548.00	711.01	29.75
Indonesia	735.02	874.19	18.93
Viet Nam	834.10	766.74	-8.08
Cambodia	366.20	458.61	25.23
Philippines	477.52	527.79	10.53
Sri Lanka	388.23	521.47	34.32
Pakistan	499.70	567.09	13.49
Thailand	487.25	585.37	20.14
Republic of Korea	788.62	617.11	-21.75
Malaysia	230.94	208.00	-9.93
Taipei, China	540.63	442.89	-18.08
Mongolia	57.52	46.63	-18.93
Turkmenistan	20.43	16.70	-18.23
Nepal	48.38	27.33	-43.51
Uzbekistan	7.16	8.61	20.26
Fiji Islands	38.15	13.42	-64.82
Kazakhstan	6.07	0.41	-93.23
Kyrgyz Republic	3.11	1.64	-47.08
Armenia	1.37	0.09	-93.46
Maldives	41.72	4.72	-88.69
Tajikistan	2.33	-	-100.00
<i>Excluding People's Rep. of China</i>	7,892.50	8,235.47	4.35
Other nonpreferential suppliers	1,797.04	1,610.77	-10.37
Preferential suppliers	10,133.24	10,227.18	0.93
Central American Free Trade Agreement	3,982.55	4,203.18	5.54
Mexico	2,902.85	2,758.97	-4.96
Others	3,247.84	3,265.03	0.53
World	22,241.93	24,877.61	11.85

Notes: Sum of nonpreferential and preferential suppliers does not add up to world total because some minor suppliers are not included; numbers may not sum precisely due to rounding.

Source: United States Department of Commerce, Office of Textiles and Apparel, downloaded 14 March 2006.

countries (Bolivia, Colombia, Ecuador, and Peru) (Table 1.4.9). India (2.15 points), Bangladesh (1.28 points), Indonesia (1.08 points), Cambodia (1.01 points), Pakistan (0.91 points), Viet Nam (0.54 points), Thailand (0.49 points), Philippines (0.42 points), and Sri Lanka (0.11 points) add a cumulative 7.99 percentage points to market share in the US import volume in 2006 compared with 2005. These gains come mostly at the expense of preferential suppliers that all together suffered a 6.15 percentage point drop in the first month of 2006 compared with the same month in 2005. There were similar changes in value market share (Table 1.4.10) and once more the gains by the competitive Asian suppliers of 9.87 percentage points cumulatively are mainly at the expense of preferential suppliers (down 6.49 percentage points). The PRC's loss of market share by volume was less than by value, reflecting the impact of restrictions on unit prices. Hong Kong, China also shows modest gains in market share in volume (0.41 percentage points) and value (1.59 percentage points) in 2006, reversing losses in 2005 somewhat.

1.4.9 United States imports of restricted items under the memorandum of understanding between the United States and the People's Republic of China, by volume

	Volume change over previous year (%)					Market share (%)						
	2002	2003	2004	2005	Jan 2006	2001	2002	2003	2004	2005	Jan 2005	Jan 2006
Nonpreferential suppliers	26.0	13.3	13.0	19.6	17.7	42.96	47.45	49.61	52.20	57.60	56.62	63.08
Asia-Pacific DMC suppliers	28.9	14.8	14.9	24.1	19.8	35.92	40.60	42.97	45.94	52.59	50.78	57.62
People's Republic of China	95.1	75.8	49.2	79.2	-2.5	2.87	4.91	7.97	11.06	18.29	16.49	15.23
India	33.4	12.9	19.9	75.2	130.6	1.45	1.70	1.77	1.98	3.20	1.82	3.97
Hong Kong, China	-5.7	-6.7	1.6	0.3	22.2	4.00	3.31	2.85	2.69	2.49	2.58	2.99
Bangladesh	4.2	1.8	6.9	18.9	45.6	3.60	3.29	3.08	3.07	3.37	3.38	4.66
Indonesia	1.1	6.8	23.6	12.0	49.3	2.59	2.30	2.26	2.60	2.69	2.60	3.68
Viet Nam	976.6	151.0	-19.6	4.1	29.1	0.13	1.21	2.80	2.09	2.01	2.42	2.96
Cambodia	23.2	8.9	12.5	52.7	117.0	0.79	0.85	0.86	0.90	1.26	0.95	1.96
Philippines	19.6	-1.0	-13.5	3.1	38.2	1.95	2.05	1.87	1.51	1.43	1.37	1.79
Sri Lanka	-6.2	-6.6	9.7	28.7	13.7	1.43	1.18	1.01	1.04	1.23	1.41	1.52
Pakistan	26.9	11.4	33.9	15.9	38.8	2.05	2.28	2.34	2.92	3.12	2.89	3.80
Thailand	10.8	0.3	13.2	10.4	25.9	2.38	2.32	2.14	2.26	2.30	2.53	3.02
Republic of Korea	45.8	5.5	9.6	-9.9	-2.7	6.51	8.32	8.10	8.26	6.87	7.85	7.23
Malaysia	15.8	-0.0	12.1	13.4	69.4	0.82	0.83	0.77	0.80	0.84	0.73	1.17
Taipei, China	34.7	-12.7	0.9	-13.3	10.3	4.28	5.05	4.07	3.82	3.06	3.13	3.27
Mongolia	4.3	15.3	6.3	-24.0	-11.3	0.23	0.21	0.22	0.22	0.15	0.20	0.17
Turkmenistan	0.9	36.2	-1.2	-7.6	9.2	0.10	0.09	0.12	0.11	0.09	0.09	0.10
Nepal	-19.5	9.6	-17.7	-42.4	-48.7	0.23	0.17	0.17	0.13	0.07	0.11	0.05
Uzbekistan	33.8	-1.8	-22.3	-41.1	-16.4	0.17	0.20	0.18	0.13	0.07	0.03	0.02
Fiji Islands	-20.6	4.8	4.3	-78.8	-88.0	0.13	0.09	0.09	0.09	0.02	0.05	0.01
Kazakhstan	83.7	74.1	-10.2	-83.1	259.1	0.01	0.02	0.04	0.03	0.00	0.00	0.01
Kyrgyz Republic	251.9	245.5	-2.6	-50.2	-23.5	0.00	0.01	0.02	0.02	0.01	0.02	0.01
Armenia	-42.1	-38.8	65.4	-83.0	3,082.7	0.01	0.01	0.00	0.00	0.00	0.00	0.01
Maldives	47.7	13.1	-3.8	-93.7	-100.0	0.17	0.22	0.23	0.21	0.01	0.12	0.00
Tajikistan	-	6,102.9	-33.5	-100.0	-	0.00	0.00	0.01	0.01	0.00	0.00	0.00
<i>Excluding People's Rep. of China</i>	23.2	6.3	7.1	6.6	30.6	33.05	35.68	35.00	34.88	34.29	34.29	42.39
Other nonpreferential suppliers	11.1	5.0	1.2	-13.0	-1.2	7.04	6.85	6.64	6.26	5.02	5.84	5.46
Preferential suppliers	4.6	3.8	3.6	-2.4	-10.2	53.44	48.99	46.88	45.22	40.72	41.12	34.97
Central American Free Trade Agreement	7.4	5.6	5.8	3.3	-11.1	19.58	18.44	17.96	17.69	16.85	14.69	12.37
Mexico	0.1	-5.3	0.4	-9.1	-8.9	15.21	13.35	11.67	10.90	9.14	8.95	7.72
Others	5.2	8.8	3.5	-4.0	-10.1	18.64	17.20	17.26	16.62	14.73	17.48	14.88
World	14.1	8.4	7.4	8.4	5.6	100.00	100.00	100.00	100.00	100.00	100.00	100.00

DMC = developing member country of the Asian Development Bank.

Notes: Sum of nonpreferential and preferential suppliers does not add up to world total because some minor suppliers are not included; numbers may not sum precisely due to rounding.

Source: United States Department of Commerce, Office of Textiles and Apparel, downloaded 14 March 2006.

Agenda for future trade reform

Competitive Asian suppliers of intermediate textile products and clothing have to continue unilateral reform efforts in reducing “behind the border” trade barriers and trade frictions in order to compete successfully in large markets that are offering competitors from outside Asia preferential tariff access. They also have scope to better integrate the value chain in the region through efforts to reduce border barriers to trade in intermediate textile products and clothing accessories. High most-favored nation tariffs on imports remain in many of the larger countries in textiles and clothing tariff lines, particularly those in South Asia and Southeast Asia, as well as the PRC. Asian policy makers could help this process by making these tariffs lower and more uniform (and setting bound tariff rates closer to applied rates).

This rationalization of the tariff structure for textiles and clothing

1.4.10 United States imports of restricted items under the memorandum of understanding between the United States and the People's Republic of China, by value

	Value change over previous year (%)					Market share (%)						
	2002	2003	2004	2005	Jan 2006	2001	2002	2003	2004	2005	Jan 2005	Jan 2006
Nonpreferential suppliers	7.6	11.0	8.1	16.2	15.8	47.51	49.00	50.84	52.02	57.25	57.42	64.50
Asia-Pacific DMC suppliers	7.7	11.4	9.2	21.3	18.6	39.45	40.73	42.44	43.89	50.41	49.37	56.80
People's Republic of China	21.5	31.6	32.3	66.0	-21.9	4.54	5.29	6.51	8.15	12.82	13.60	10.31
India	11.1	6.9	20.5	34.5	78.5	2.42	2.58	2.58	2.95	3.75	2.89	5.01
Hong Kong, China	3.1	-5.0	7.0	16.4	33.4	5.86	5.79	5.15	5.21	5.75	5.41	7.00
Bangladesh	-4.1	-2.7	13.1	27.4	60.0	2.91	2.68	2.44	2.61	3.15	2.84	4.41
Indonesia	-5.8	9.1	13.1	23.6	44.7	3.29	2.97	3.03	3.24	3.79	3.42	4.80
Viet Nam	1,554.5	175.7	-11.0	7.5	43.2	0.09	1.48	3.82	3.22	3.27	3.24	4.50
Cambodia	19.9	16.0	7.9	36.8	88.5	1.33	1.53	1.66	1.70	2.20	1.63	2.97
Philippines	9.7	3.4	-7.3	16.6	36.1	2.40	2.52	2.44	2.14	2.36	2.15	2.84
Sri Lanka	-8.1	-3.3	14.8	24.1	12.9	2.10	1.85	1.67	1.82	2.13	2.43	2.67
Pakistan	-4.0	16.5	16.7	13.2	59.6	2.08	1.92	2.09	2.31	2.48	1.75	2.71
Thailand	9.8	-1.6	8.6	12.0	14.8	2.34	2.46	2.26	2.33	2.47	2.76	3.07
Republic of Korea	4.5	-9.6	2.0	-20.9	-12.4	4.35	4.36	3.68	3.56	2.66	3.32	2.82
Malaysia	-5.3	-2.3	4.6	3.4	42.5	1.26	1.14	1.04	1.03	1.01	0.77	1.07
Taipei, China	-3.5	-0.8	-4.0	-17.4	-10.2	3.43	3.17	2.94	2.67	2.09	2.48	2.16
Mongolia	15.9	19.9	5.7	-22.1	-9.9	0.25	0.28	0.32	0.32	0.23	0.28	0.25
Turkmenistan	11.5	36.7	-3.7	-21.2	50.8	0.07	0.08	0.10	0.09	0.07	0.06	0.09
Nepal	-23.9	29.6	-29.0	-42.3	-50.0	0.26	0.19	0.23	0.16	0.08	0.13	0.06
Uzbekistan	37.2	55.6	-44.3	22.6	63.1	0.03	0.04	0.05	0.03	0.03	0.02	0.02
Fiji Islands	-19.6	15.2	3.6	-79.5	-85.5	0.20	0.15	0.17	0.16	0.03	0.10	0.01
Kazakhstan	2.4	449.8	-30.7	-71.8	841.9	0.01	0.00	0.03	0.02	0.00	0.00	0.01
Kyrgyz Republic	107.9	241.6	-33.2	-45.3	25.0	0.00	0.01	0.02	0.01	0.01	0.01	0.01
Armenia	-32.8	-41.0	55.1	-94.1	1,029.6	0.01	0.01	0.00	0.01	0.00	0.00	0.00
Maldives	19.7	-9.1	-10.7	-94.2	-100.0	0.21	0.24	0.20	0.17	0.01	0.09	0.00
Tajikistan	-	7,898.0	-48.1	-100.0	-	0.00	0.00	0.01	0.00	0.00	0.00	0.00
Excluding People's Rep. of China	5.9	8.4	5.1	11.1	33.9	34.91	35.44	35.93	35.74	37.59	35.77	46.50
Other nonpreferential suppliers	6.8	8.8	2.2	-11.1	-1.3	8.07	8.26	8.40	8.13	6.84	8.04	7.70
Preferential suppliers	1.8	2.7	5.1	-4.9	-13.6	48.73	47.55	45.68	45.45	40.93	40.09	33.60
Central American Free Trade Agreement	5.4	1.5	5.5	-2.7	-11.6	18.78	18.97	18.01	17.98	16.57	14.18	12.16
Mexico	-3.6	-6.5	-2.4	-8.4	-12.7	17.06	15.76	13.79	12.74	11.06	10.20	8.64
Others	3.8	15.9	12.0	-4.6	-16.0	12.88	12.81	13.89	14.72	13.30	15.72	12.81
World	4.3	6.9	5.6	5.6	3.1	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Notes: Sum of nonpreferential and preferential suppliers does not add up to world total because some minor suppliers are not included; numbers may not sum precisely due to rounding.

Source: United States Department of Commerce, Office of Textiles and Apparel, downloaded 14 March 2006.

would stimulate intraregional trade and efficient vertical specialization, as has already happened in electronics and office machinery, and it could be safely done on a nondiscriminatory basis. Protection could be retained on less important textile made-up products. The tariff reforms could be carried out on a concerted unilateral basis (e.g., voluntarily) and this would assist development of the intermediate textiles and clothing value chain. Asian suppliers should also seek to improve the terms of their market access to EU, Japan, and US by supporting the Doha Round, which offers the potential to lower peak tariffs in the industrial countries on a most-favored nation basis. The "Swiss formula" adopted at the Ministerial Meeting of WTO in Hong Kong, China in December 2005 under the nonagricultural market access negotiation is designed to accomplish this outcome (see *The Doha Development Agenda* in Part 1). In addition, acting to negotiate improved discipline over antidumping and other contingent forms of protection, such as safeguard measures under

the Trade Rules component of the Doha Round, would help preempt the use of these instruments to take away hard-won gains in Asian suppliers' market shares in world markets for textiles and clothing.

Rules of origin are used to determine which products will or will not receive preferential treatment under the many new bilateral trade agreements that Asian countries are negotiating. Negotiators should strive to adopt simple and consistent rules of origin in order to avoid undermining the development of efficient production-sharing networks. This will be crucial to maintaining the long-run competitiveness of Asian suppliers in the world market for textiles and clothing. As incomes rise and consumption-driven growth prospects increase within developing Asia, simple and consistent rules of origin will facilitate growth in this lucrative segment of intraregional trade.

Endnotes

- ¹ Quantitative limits on Asian exports were first imposed on Japan by the United States in 1957. The United Kingdom followed with restrictions on Hong Kong (1958), and India and Pakistan shortly thereafter (1959). A number of Western European countries insisted upon safeguard clauses prior to accepting Japan's application for membership in the General Agreement on Tariffs and Trade in 1960. See Hayashi (2005). Hayashi presents a detailed timeline, adapted from Spinanger (2000), of the regimes governing world trade in textiles and clothing since these restrictions were first imposed.
- ² Table 1 in this source gives the precise formula used to calculate the growth of quotas and for the four phases of integration of tariff lines.
- ³ In the second quarter of 2005, the EU and US began to implement special safeguards on merged categories of clothing imports (that is, categories such as cotton and wool sweaters that include more than one type of fiber) from the PRC. These resulted in comprehensive trade agreements with the PRC that set out quantitative limits on imports in 10 broad categories in the EU and 21 categories in the US over the period 2006–2008 (see below for discussion and more details on the restrictions). Texts of the agreements are available online at <http://www.otexa.ita.doc.gov> and can also be found at http://europa.eu.int/comm/index_en.htm or www.emergingtextiles.com.
- ⁴ The “nonmarket” designation means that “dumping margins” used to calculate penalty tariffs can be extremely large, easily pricing PRC products out of the market of the countries that impose such measures.
- ⁵ Antidumping measures are imposed with more frequency on the PRC than on any other WTO member state (see WTO homepage, at www.wto.org). Most recently, the EU has imposed antidumping duties on leather shoes exported by the PRC and Viet Nam, and is also conducting an investigation into polyester fibers from the PRC (see www.emergingtextiles.com for more details).
- ⁶ These estimates are for 2000, but USITC also shows that investment (cumulative purchases of machinery for spinning and weaving) has also been larger in Asia over 1999–2001 than in any other region (USITC 2004).
- ⁷ The Formosa Chemical & Fiber Corporation is an affiliate of Formosa Plastics (the parent) and initially invested in a textile factory with 200,000 spindles in 2001 in an industrial park outside of Ho Chi Minh City and, in anticipation of Viet Nam's WTO accession, it and other textile producers are raising production capacity there in polyester spinning, yarn, and fiber. See www.fibre2fashion.com (25 February 2005).

- ⁸ Data are for 2003 and are as reported in USITC (2004) and Hayashi (2005). The data are compiled from the United Nations Conference on Trade and Development. Pakistan differs from the small clothing exporters as it has substantial capacity in textiles, both cotton and man-made fiber.
- ⁹ See www.emergingtextiles.com, “Cambodia apparel exports rise helped by improved working conditions,” 31 October 2005.
- ¹⁰ Hummels estimates that each day added to shipping time is equivalent to a tariff of 0.8%, hence, a 20-day difference is equivalent to the more distant producer paying an additional 16% tariff.
- ¹¹ A very comprehensive review of these factors in all of the main foreign suppliers (except the PRC) to the US market is USITC (2004). By definition, if a country prospers in the post-quota environment, it has likely to have in place the policies and institutions necessary to compete in the new trading environment for clothing and textiles.
- ¹² However, given the recent enlargement of the EU to 25 member states, some hiccups in implementing the monitoring program in some of the new members might be anticipated. As a result, there is a 3-month lag in reporting EU imports of textiles and clothing by product and source country.
- ¹³ Or the adding up of regional content in more than one partner country of different free trade agreements—what is sometimes referred to as “diagonal cumulation” in EU agreements such as Mediterranean rim free trade agreements.
- ¹⁴ Jordan managed to negotiate a simple “single-transformation” rule of origin for its clothing shipments to the US. As a result, Jordan was the only major preferential supplier with a market share of at least 1% of US clothing imports that actually improved its market share in 2005 relative to 2004. The liberal rule of origin is allowed because Jordan will never threaten to take a big share of US imports given its tiny size and remoteness.
- ¹⁵ Volume measures differ between the US and EU as the former uses million square meter equivalents and the latter uses weight in hundreds of kilograms. Hence, while both measures allow aggregation, they are not strictly comparable.
- ¹⁶ These are types of protection that remove concessions on a discriminatory basis but that are allowed under WTO law, such as antidumping measures.

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The Doha Development Agenda: Asian challenges and prospects after the Ministerial Meeting in Hong Kong, China

The Doha Development Agenda is the first “round” of multilateral trade negotiations under the World Trade Organization and is also the first time that multilateral trade talks have explicitly sought to focus on the interests of developing countries. Developing Asia therefore has much at stake in the talks and has a strong interest in a positive and ambitious outcome. The key areas of market access negotiations are in industrial products, agriculture, and services. Each area raises distinct issues and nuances for various groups of developed and developing countries. In addition, the Doha Agenda includes the rules governing contingent forms of protection and regional trade agreements. Finally, “aid for trade” and trade facilitation are part of the agenda. Asia has a vital interest in multilateral liberalization prospering in the Doha talks.

Introduction

The Doha Development Agenda constitutes the ninth trade “round” since the founding of the General Agreement on Tariffs and Trade (GATT) in 1947, and the first under the aegis of the GATT successor, the World Trade Organization (WTO) (Box 1.5.1). It is also the first set of multilateral negotiations that are intended to focus on issues of interest to developing countries.

There is a great deal at stake for Asia at Doha. First, given the outward-oriented policy strategy that essentially all Asian countries now embrace, the region relies increasingly on a vibrant, open international marketplace. All sectors currently being negotiated under the Doha Development Agenda are relevant to the economic prosperity of the region, including manufactures, agriculture, services, and trade facilitation measures. Many of these areas have hitherto been neglected or ignored completely in earlier rounds of negotiation, suggesting a unique opportunity for the region. Bringing down peak tariffs (known as “mega-tariffs” at Doha) in manufactures and pervasive obstacles to trade in agriculture are particularly important to Asia. Better rules governing the comportment of WTO member states in regulating trade will also be extremely useful. Developing member states have often been the target of contingent protection (i.e., antidumping duties, countervailing duties, and the like). The People’s Republic of China (PRC) has recently been the most obvious target of such actions, but it certainly is not alone: practically all developing member states have been subject to antidumping duties. Better rules are even more important now that Asia has become extremely active in creating its own web of free trade areas, for improved rules could lead to better agreements and less policy distortions.

Second, the potential negative effects of the recent surge in free trade

1.5.1 A brief history of the World Trade Organization: From GATT rounds to Doha

The General Agreement on Tariffs and Trade (GATT) was signed in 1944, with the immediate objective of preventing future trade wars and inconsistent commercial policies that had plagued international trade in the 1930s. It was originally intended to be a temporary body: the International Trade Organization (ITO) was supposed to replace it as a permanent body with international legal status, on par with other Bretton Woods institutions, such as the International Monetary Fund and the World Bank. ITO was never ratified; however, GATT came into effect on 1 January 1948 as an ad hoc organization that would only have its existence enshrined in a permanent, legal form in 1994, with the creation of the World Trade Organization (WTO).

The *raison d'être* of GATT was to reduce international barriers

areas, discussed at length in Part 3 of *Asian Development Outlook 2006*, will be amplified in the case of a Doha failure. This is likely for two reasons: (i) the more liberalized the global economy, the less the potential impact of discrimination inherent in free trade areas; and (ii) a failure at Doha could (and, most likely, will) lead to considerable disillusionment with the multilateral system, and starting a new set of negotiations would probably only be possible in the medium or long term. Regionalism and bilateralism will continue to be important with or without a successful conclusion to Doha. However, if there is no progress at the multilateral level, these preferential trade agreements will no doubt fill the void. This scenario could create spheres of influence and trade blocs that could easily work to the region's detriment.

Third, since a country will generally gain more from its own liberalization, a positive outcome at Doha would facilitate domestic reform and restructuring, as well as open foreign markets and create a more level trade "playing field." Negotiators consider offering tariff reductions as a bargaining chip that is only to be given in exchange for something in return. It is, therefore, ironic that almost all simulations of trade liberalization in a global context show the more protected economies gaining much more than the more open ones. Hence, a successful Doha Round would show greatest gains in agriculture for the European Union (EU) and the United States (US), whereas developing countries would generally gain more through their own liberalization of manufactures (Anderson and Martin 2006). One can expect that ultimately Asian countries with the highest trade barriers will tend to gain the most through liberalization.

A fourth and related point regards support for the national economic reform programs of Asian countries. The linking of a broad array of sectors in a concerted, international framework of liberalization negotiations under WTO tends to give greater political clout to those favoring more open trade. Hence, WTO sets in motion a political-economy dynamic that makes liberalization easier than, say, on a unilateral basis.

Finally, like GATT/WTO negotiations before it, the Doha Development Agenda will be critical in setting the stage for deeper liberalization in future rounds.

However, Doha negotiations have not been smooth sailing. Indeed, the waters have been more frequently choppy than smooth. In large part, this is a reflection of the complicated nature of the WTO talks, at which a wide variety of sensitive issues have been put on the table, including such areas as agricultural export subsidies; domestic support for agriculture; tariff reductions; and harmonization in labor-intensive manufactured goods, trade in services, antidumping duties, and rules governing regional trading agreements.

Indeed, the oft-cited difficulties of Doha are in part a reflection of previous successes in multilateral negotiations: earlier GATT rounds were able to reduce considerably tariffs on nonsensitive manufactured goods, leaving the most difficult items to be tackled. Moreover, the nonuniformity of cuts in tariffs and nontariff barriers resulting from compromises in earlier GATT rounds has been problematic because they can create their own distortions.¹ Further, the exigencies of globalization

to trade on a nondiscriminatory (or "most-favored nation") basis. The modality to do this would be through concerted, multilateral negotiations called "rounds." Since the creation of GATT, there have been eight rounds, i.e., Geneva, Switzerland, 1947–48; Annecy, France, 1949; Torquay, United Kingdom, 1950–51; Geneva, 1956; the Dillon Round, 1960–62; the Kennedy Round, 1963–67; the Tokyo Round, 1973–79; and the Uruguay Round, 1986–93. The ongoing WTO negotiations have been dubbed the Doha Development Agenda, with the intention of underscoring the importance of developing countries in this series of talks.

Earlier GATT rounds were successful in reducing tariffs on manufactured goods. The Uruguay Round began to address more complicated issues, from quantitative restrictions in sensitive areas like agriculture and textiles and clothing to trade-related areas such as investment measures and intellectual property protection. The Doha Development Agenda was initiated to go further down the road of "deep" integration. The process has been difficult, given the political sensitivity of many of the key areas being addressed. In fact, the 2003 Ministerial Meeting in Cancun ended without any agreement.

The Ministerial Meeting in December 2005 held in Hong Kong, China was successful in keeping the Doha negotiations alive. WTO members agreed to undertake liberalization negotiations generally under four pillars: Non-Agricultural Market Access; Agriculture; Services; and Rules (such as those pertaining to administrative actions, e.g., anti-dumping and countervailing duties, and regional trade agreements). This meeting reemphasized the primacy of the "development dimension" to the talks. The leaders have set April 2006 as the deadline for the Doha package.

require far more extensive liberalization packages than in the past.

No doubt another complicating factor concerns the necessary emphasis on developing countries, which are extremely diverse and often have different priorities and interests. The least-developed countries (LDCs), in particular, face a complicated situation. The LDCs require open international markets in order to boost growth and reduce poverty—and, so, a successful Doha Development Round would help achieve this. However, as they benefit from preferential access to developed-country markets for the lion's share of their exports, a good Doha deal will inevitably have the effect of reducing this advantage (“preference erosion”), a process that is being exacerbated by the trend toward regionalism. Doha is seeking a way to compensate them for this (under the “aid for trade” rubric).

In any event, the going has been tough, and at some points, it seemed as if the talks would fail. The successor to the Uruguay Round was originally intended to be launched in Seattle in December 1999, rather than in Doha in November 2001. The Seattle debacle is well known. The Cancun Ministerial Meeting in September 2003 ended in failure as well, and the negotiations were saved only in July 2004 when a framework agreement for negotiations (the “July Package”) was finalized. Hence, while many believe that the Ministerial Meeting in Hong Kong, China in December 2005 could have gone much further in terms of ambition and progress in defining modalities of liberalization, others were relieved that the talks are at last moving forward.

Asia can serve as a key protagonist at Doha. Given the less than stellar progress in negotiations, leadership in fostering a proactive approach in all areas under discussion is essential. As one of the most open regions in the world whose outward-oriented development strategy has been highly successful, Asia can contribute significantly in this regard. Moreover, active participation of Asian countries will ensure that the sectors and rules deemed most important to the region will be included in the final package. In addition, Asia is able to overcome the (usually counterproductive) division between “north” and “south.” Most countries in Asia subscribe to the same types of outward-oriented policies, and while the region does have divergent interests, differences are not generally drawn along north-south lines.

In short, Asia has a strong interest in a positive outcome at Doha. The goal of this section of *Asian Development Outlook 2006* is both to summarize the ongoing Doha negotiations, which should be completed in 2007 at the latest, and to consider the negotiations' implications for the developing member countries of the Asian Development Bank (ADB). First, the evolution of the Doha negotiations is considered, followed by a review of the liberalization

1.5.1 ADB developing member countries and WTO

	Joined WTO	2005 population (million)	2005 GDPpc1 (US\$)	2005 GDPpc2 (US\$)
WTO members, as of December 2005				
Myanmar	1995	54.80	1,417.0	106.8
Nepal	2004	25.30	1,471.2	247.5
Cambodia	2004	13.80	2,116.0	371.2
Bangladesh	1995	137.00	1,997.9	401.2
Kyrgyz Republic	1998	5.14	2,061.0	455.5
Solomon Islands	1996	0.48	1,922.5	583.6
Papua New Guinea	1996	5.66	2,414.2	585.5
Mongolia	1997	2.55	2,045.5	671.3
India	1995	1,107.00	3,315.7	686.6
Pakistan	1995	153.96	2,549.3	777.3
Armenia	2003	3.22	4,048.1	1,077.6
Sri Lanka	1995	19.68	4,144.7	1,110.8
Philippines	1995	85.24	4,770.2	1,111.2
Indonesia	1995	221.26	3,939.5	1,232.5
PRC	2001	1,310.00	6,193.4	1,461.6
Maldives	1995	0.30	7,639.5	2,465.9
Thailand	1995	65.30	8,542.4	2,562.8
Fiji Islands	1996	0.83	6,282.1	3,206.5
Malaysia	1995	26.70	11,159.6	5,110.4
Taipei, China	2002	22.65	27,512.8	14,447.0
Korea	1995	48.29	22,665.7	16,492.9
Hong Kong, China	1995	6.94	32,292.2	24,714.9
Singapore	1995	4.35	28,228.0	26,252.7
Observers				
Tajikistan		6.77	1,373.3	368.6
Lao People's Dem. Rep.		5.61	2,049.0	456.5
Uzbekistan		26.00	1,834.4	419.3
Viet Nam		83.10	2,782.2	567.5
Bhutan		0.77	3,329.8	801.9
Azerbaijan		8.44	4,500.3	1,434.9
Vanuatu		0.21	3,415.4	1,487.1
Samoa		0.19	6,389.9	1,820.9
Tonga		0.10	7,689.9	2,141.7
Kazakhstan		15.17	8,252.4	3,592.3
Afghanistan		24.70	-	-
Non-WTO Members				
Timor-Leste, Dem. Rep. of		0.83	-	371.6
Kiribati		0.10	2,590.9	686.7
Turkmenistan		6.59	7,854.0	3,516.3
Marshall Islands, Rep. of		0.06	-	-
Micronesia, Fed. States of		0.11	-	-
Palau		0.02	-	-
Tuvalu		0.01	-	-
Cook Islands		0.02	-	-
Nauru		-	-	-

Notes:

GDPpc1 = GDP per capita at purchasing power parity; GDPpc2 = GDP per capita at current exchange rates.

Sources: World Trade Organization, available: http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm; International Monetary Fund, available: <http://www.imf.org/external/pubs/ft/weo/2005/02/data/dbgnim.cfm>; *Asian Development Outlook* database.

strategies currently being discussed. The subsequent section offers some estimates of the economic effect of Doha on the region's economies. Finally, prospects for the global system after Doha are considered.

Key issues in the Doha Development Agenda

The majority of ADB developing member countries are WTO members. Of the rest, a little over half have applied to join and are at various phases in the accession process; Viet Nam should join in 2006. Table 1.5.1 presents ADB developing member countries by increasing order of per capita gross domestic product (GDP)² and offers details regarding when (or if) they joined WTO. These countries are quite dispersed among the many existing coalitions, a reflection of the diversity in trade regimes in the region (Table 1.5.2). Columns 1 to 5 of Table 1.5.2 present the coalitions that are centered on developing countries' role in WTO. These countries tend to seek exemptions from various WTO disciplines and commitments for their members, e.g., the "Least-Developed Countries" (LDC) group, the "Small and Vulnerable Economies" (SVEs) coalition, and the "Like-Minded Group" (LMG). Columns 6 to 9 focus on coalitions ranked by their position on agricultural liberalization, from a group that opposes liberalization (G10) to one that promotes open global markets (the Cairns Group).³

There follows a brief survey of the key issues articulated at the Ministerial Meeting in Hong Kong, China, namely Non-Agricultural Market Access (NAMA), Agriculture, Services, and Rules. Select aspects of the Doha Development Agenda of particular interest to developing Asia, i.e., aid for trade and trade facilitation, are stressed.

Non-Agricultural Market Access

As noted above, trade in manufactures has been the traditional area of focus at previous multilateral rounds, with considerable success: developed-country tariffs tend to be quite low on average in this area. However, tariff levels in developing countries continue to be quite high (though they also have come down considerably over the past 10 years); hence, there is considerable asymmetry in tariff levels between countries, as well as across sectors within countries.

An important facilitating format established at the Ministerial Meeting in Hong Kong, China was the agreement to use the "Swiss formula" (Box 1.5.2) as the main vehicle of liberalization and harmonization under NAMA. The beauty of the Swiss formula lies in its simplicity: negotiators need only to agree on one element of the formula (the reduction factor); the rest of the process is automatic and completely transparent. And there is no need to have a common reduction factor for all economies; several reduction factors could be used, with such indicators as per capita GDP determining which reduction factor could be applied to which country group. It allows the process to eschew the definition of what is a "developing economy" and to apply "special and differential treatment" (SDT), a concept that was not only accepted but emphasized at the Hong Kong, China meeting. The Swiss formula's transparency and simplicity also empower even the least-developed member states to participate actively in the negotiations.

From an economic point of view, the Swiss formula cuts higher tariffs

1.5.2 The "Swiss formula" and Doha

The process of reducing tariff discrepancies between countries, as well as within countries, is known as tariff harmonization. As the main goal of Non-Agricultural Market Access is to reduce and harmonize tariffs between countries, the Ministerial Meeting in Hong Kong, China approved the adoption of the "Swiss formula," which was first introduced by Switzerland and subsequently adopted during the Tokyo Round (1973–79). Such harmonization is effective not only in reducing global tariffs and making them more even across the board but also in avoiding unintended distortions stemming from divergent tariff levels within countries (the "effective rate of protection" problem).

The simple Swiss formula is expressed as $T = [rt/(r+t)]$ where t refers to initial tariff rates, T the post-negotiation tariff rates, and r the reduction factor (there is also a "weighted" version of the Swiss formula that combines each country's tariff average with the reduction factor, but the Ministerial Meeting in Hong Kong, China did not specify which type should be used).

An example might illustrate how the Swiss formula would both harmonize and reduce tariffs. Suppose there are two countries, A and B, who apply tariffs on automobiles of 150% and 10%, respectively. Further, suppose that the reduction factor (r) is 25 ("Swiss 25") and the period of adjustment would be over 6 years. At the end of the tariff reduction period, country A would have a 21.4% ($= 150 \times 25 / (150 + 25)$) tariff on automobiles, whereas country B would have a 7.1% ($= 10 \times 25 / (10 + 25)$) tariff. Hence, while there would continue to be a discrepancy, the country A tariff would fall to only three times that of country B, whereas before liberalization the corresponding difference was 15 times. Moreover, tariffs have fallen across the board.

The key question, of course, relates to what the reduction factor should be. Doha Development Agenda negotiators are currently working out possible options.

1.5.2 Membership of ADB member countries in WTO coalitions and other country groupings

	G77	LDC	G90	SVEs	LMG	G10	G33	G20	Cairns	ACP	CIS
WTO Members, as of December 2005											
Nepal	1	1	1								
Cambodia	1	1	1								
Bangladesh	1	1	1								
Kyrgyz Republic											1
Solomon Islands	1	1	1	1						1	
Mongolia	1			1			1				
Pakistan	1				1		1	1			
India	1				1		1	1			
Papua New Guinea	1		1	1							
Sri Lanka	1				1		1				
Philippines	1						1	1	1		
Armenia											1
Indonesia	1				1		1	1	1		
PRC	1						1	1			
Maldives	1	1	1								
Thailand	1							1	1		
Fiji Islands	1		1	1					1	1	
Malaysia	1				1				1		
Taipei,China						1					
Korea						1	1				
Hong Kong, China											
Singapore					1						
Myanmar	1	1	1								
Observers											
Tajikistan											1
Lao PDR	1	1									
Uzbekistan											1
Viet Nam	1										
Bhutan	1	1									
Azerbaijan											1
Vanuatu	1	1								1	
Samoa	1	1								1	
Tonga	1									1	
Kazakhstan											1
Afghanistan	1	1									
Non-WTO members											
Timor-Leste, Dem. Rep. of	1	1									
Turkmenistan	1										
Kiribati		1								1	
Marshall Islands, Rep. of	1									1	
Micronesia, Fed. States of	1									1	
Palau	1									1	
Tuvalu		1								1	
Cook Islands										1	
Nauru										1	

ACP = African, Caribbean and Pacific countries; Cairns = a group of agricultural exporting nations lobbying for agricultural trade liberalization; CIS = Commonwealth of Independent States; LDC = least-developed countries (as defined by the United Nations); G10 = a coalition of countries lobbying for agriculture to be treated as diverse and special because of nontrade concerns; G20 = a coalition of countries pressing for ambitious reforms of agriculture in developed countries with some flexibility for developing countries; G33 = a group of countries advocating that developing countries be granted flexibility to self-designate a number of "special products" on which they would not have to make any tariff reduction or tariff-rate quota commitments; G77 = a coalition of developing countries; G90 = coalition of African, ACP, and least-developed countries; LMG = Like-Minded Group (a loose coalition of WTO members with similar concerns about the WTO agenda); SVEs = small vulnerable economies.

Source: World Trade Organization, available: http://www.wto.org/english/thewto_e/minist_e/minos_e/brief_e/brief25_e.htm.

by more than the smaller tariffs. By doing so, it enhances economic benefits from trade liberalization in two ways: it delivers higher welfare gains than in the case of, say, a straight-line approach,⁴ and it may improve tariff revenues.⁵ Moreover, from a political point of view, the Swiss formula tends to reduce domestic bickering regarding post-liberalization tariffs between domestic vested interests because it does not change the *ranking* of the domestic protection by industry, though it does reduce differentials.

The tariff structures of 18 countries actively involved in the Doha negotiations are summarized in Table 1.5.3. As these countries together account for over three fourths of world GDP, a deal between them has the potential to trigger a successful outcome of the Doha Development Agenda. Table 1.5.3 is based on the detailed tariff rates available at the Harmonized System six-digit level (HS6) of disaggregation, usually including some 4,000 products. It differentiates “bound” tariff rates,⁶ above which a country cannot raise its tariffs, from “applied” tariff rates, i.e., those that were in effect as of 2001. Negotiators focus on bound tariffs; to the extent that the bound tariffs exceed the applied tariffs, there is said to be “water” in the tariffs. Water in the tariffs is spread widely across WTO member states. This is problematic; if a country reduce its (bound) tariff to a level that is above the actual applied tariff, it will have no effect on trade.

Table 1.5.3 shows that the developed countries have little to offer in the NAMA negotiations, as their tariff structures are characterized by low bound and applied tariffs, with the exception of “mega-tariffs,” i.e., products with tariffs of 20% or higher. The developed countries also tend to have far less water in their tariffs. Hence, it is clear that the developed-country *negotiators* are keen to promote liberalization in NAMA (as “*demandeurs*,” in WTO-speak) and certain developing countries’ *negotiators* are less anxious to do so (as “*demandées*”). The compromise would have to be in the developed countries offering up more in agriculture, services, and certain aspects of “rules” (discussed below).

As previously noted, the compromise is an ironic one. Developing Asian countries resisting NAMA cuts have the most to gain from an ambitious Swiss formula, as liberalization would lead to greater welfare gains due to their higher levels of protection. Such a “sacrifice” is the economic equivalent of “crocodile tears.” Still, negotiators view “concessions” as negotiating chips, which they hope will be successful in eliciting “sacrifices” from developed countries under agriculture. Successful negotiations lead to a “prisoner’s delight” scenario in which all countries gain, though not due to the intentions of the negotiators (who tend to focus on the interests of producers alone).

In the 2004 July Package, negotiators agreed on “flexibility” provisions, with the intent to take into account the “special needs and interests of developing countries.” A first provision refers to longer implementation periods; this approach is traditional in GATT/WTO negotiations and so is not particularly controversial. The two other provisions are much more complicated, that is: (i) the possibility of excluding a certain percentage of total import value from the formula cuts; and (ii) the possibility of excluding a certain percentage of tariff lines from the formula cuts. Critics stress that these two flexibility

1.5.3 Uruguay Round tariffs, selected countries

	Total number of tariff lines (HS6)	All tariffs			Mega tariffs (higher than 20%)				Maximum tariffs			
		Average applied tariff	Average bound tariff	Average tariff water	Number of tariff lines	Average applied tariffs	Average bound tariffs	Average tariff water	Maximum applied tariff	Maximum bound tariff	Maximum tariff water	Number of prohibitive tariffs ^a
Industrial economies												
Japan	4,327	1.6	2.3	0.8	16	17.1	23.8	6.7	25.0	28.5	13.3	0
US	4,428	2.6	3.4	0.8	47	20.7	26.0	5.3	33.1	38.6	21.3	0
EU	4,441	3.9	4.0	0.0	17	23.1	24.1	1.0	42.8	57.5	14.7	1
Canada	4,427	3.3	5.3	2.0	25	14.9	21.3	6.5	20.1	25.0	25.0	0
Australia	3,911	3.5	11.0	7.4	506	13.7	34.7	21.0	25.0	55.0	45.0	101
New Zealand	4,095	3.1	11.1	8.0	1,208	8.2	26.5	18.3	40.0	45.0	40.0	0
Developing economies												
PRC	4,330	9.1	9.2	0.1	286	24.4	24.6	0.2	50	50	5.9	3
Korea	4,347	6.7	10.2	3.5	336	13.2	30.4	17.3	30.0	36.8	28.8	0
Singapore	4,306	0.0	4.1	4.1	0	n.a.	n.a.	n.a.	0.0	10.0	10.0	2
Taipei,China	4,266	4.5	4.7	0.2	50	25.4	27.4	1.9	40.0	60.0	22.5	0
South Africa	4,247	8.3	11.0	2.8	1,082	24.7	29.1	4.4	60.0	60.0	32.1	72
Malaysia	4,247	8.6	11.2	2.6	1,467	21.4	25.9	4.5	215.6	300.0	100.2	18
Philippines	4,053	9.2	16.7	7.4	1,877	13.9	26.5	12.6	40.0	50.0	47.0	127
Thailand	3,522	13.4	20.2	6.8	2,247	17.1	27.0	9.9	80.0	80.0	50.0	24
Brazil	4,233	15.1	29.4	14.3	3,768	16.1	31.4	15.3	35.0	85.0	72.5	1
Mexico	4,374	17.2	34.8	17.6	4,316	17.4	35.1	17.8	50.0	50.0	47.0	76
Indonesia	4,229	8.3	35.0	26.6	3,861	8.7	37.6	28.9	80.0	125.0	125.0	21
India	3,736	33.9	37.0	3.1	3,504	35.9	39.2	3.2	52.0	150.0	108.0	715
Least-developed countries												
Bangladesh	4,437	21.7	22.7	1.0	2,391	31.6	33.4	1.9	37.5	200.0	200.0	62

^a Defined as tariff rates higher than 50%; n.a. = not applicable. HS6 = Harmonized System six-digit level.

Note: Country classification is based on the Integrated Tariff Analysis System.

Source: Australian Government Productivity Commission, 2004, An Integrated Tariff Analysis System: Software and Database, Productivity Commission Staff Working Paper, available: <http://www.pc.gov.au/research/swp/itas/itas.pdf>.

provisions could undermine the negotiating, economic, and political advantages of the Swiss formula.⁷ It certainly would not be to the advantage of developing Asian countries.

Without a successful conclusion to NAMA talks, the Doha negotiations will not progress. Also, the ultimate substance of NAMA will be critical to the effectiveness of Doha and in setting the stage for future WTO negotiations. While NAMA needs to be ambitious in cutting tariffs, it is essential that it be symmetric in its applications. It could absolve the system of many of its past sins by creating a far more uniform tariff structure within and between countries. The structural adjustment that will result from such a process will make future WTO rounds that much easier. The Swiss formula approach offers an excellent opportunity to do this. However, a “flexible” compromise in which sectors are excluded could significantly reduce the potential gains from Doha, postpone once again liberalization in key sectors, and set another bad precedent for future rounds.

Agriculture

Agriculture has traditionally been one of the most difficult sectors to liberalize, for reasons familiar to both developed and developing countries. In the main, this is due to various political and political-economy-related issues. Politicians will often resist liberalization on

the basis, among other things, of “food security,” “national security,” cultural preservation, the need to maintain a beautiful countryside (the “multifunctionality” of agriculture), and health-related issues. While some of these arguments may be legitimate in theory, in practice they tend not to be. Instead, they are often merely finely wrapped excuses hiding old-fashioned protectionism.

Farm lobbies are extremely strong in most developed countries, especially the EU, US, and Japan. It is an easy application of the political economy of protectionism (see, for example, Baldwin 1982); farmers tend to be geographically concentrated, have a well-defined producer interest, and can use politically popular slogans to mask the higher prices, fiscal cost, and other distortions created by agricultural protectionism. Less than 5% of the labor force is employed in agriculture in developed countries. Yet protection of this sector in the Organisation for Economic Co-operation and Development (OECD) costs over \$300 billion a year (a multiple of the value of development assistance, for example) and has often caused modest results in trade negotiations of all kinds. Disputes pertaining to trade in agriculture almost scuttled the Uruguay Round; it was in part responsible for the failure at Cancun in 2003, and experts who are skeptical about the future of Doha generally point to the powerful protectionist forces in this area.

The Uruguay Round was not particularly successful in liberalizing farm trade. Today, the level of agricultural protection in the OECD countries is still close to its level in 1986–1988, the reference years used by the Uruguay Round negotiators. Nevertheless, the Uruguay Round was instrumental in introducing the minimal level of transparency necessary to prepare for profound future changes in OECD agricultural markets.⁸ In particular, it helped to place farm liberalization at the forefront of the Doha negotiations and reinforced the steady decline of OECD public support for a highly subsidized farm sector.

Moreover, the emergence of developing countries as key negotiators at Doha has also helped place agriculture at the top of the agenda. Net exporters of farm products with a long-term comparative advantage in agriculture, such as Brazil or Thailand, have been effective in applying and organizing pressure at Doha for agricultural liberalization. And many other developing countries have realized that they are at the stage where farm exports are essential to their development because their farm sector is large and labor intensive. Agriculture accounts for 40% of GDP, 35% of exports, and 50–70% of total employment in LDCs (12%, 15%, and 15–40%, respectively, in the other developing countries). Three quarters of the world’s poorest people live in rural areas, with the proportion in LDCs as high as 90%. This being the Doha *Development Agenda*, agriculture must be part of a final package.

Farm negotiations in the Doha Round are taking place under three pillars: (i) rules on export subsidies; (ii) rules on domestic support; and (iii) tariff cuts. This structure is a source of difficulty in negotiation because the use of these instruments is asymmetrical. Most OECD countries use all three instruments, while developing countries protect their farm sector only behind tariffs. Negotiating on the combined effects of these instruments would be ideal, but is not technically possible.

Export subsidy elimination

The Ministerial Meeting in Hong Kong, China confirmed the need to eliminate farm export subsidies by 2013 (2006 for cotton export subsidies). This decision has received considerable publicity, despite the fact that export subsidies only represent roughly 5–6% of total farm subsidies, and that it simply binds the reduction of export subsidies unilaterally undertaken by the EU since the late 1990s.⁹ Nevertheless, economic calculations, e.g., Anderson and Martin (2006), have shown that eliminating export subsidies without cutting tariffs and domestic support will generate noticeable welfare losses in many of the developing countries that are net importers of subsidized farm products. These calculations have also consistently shown that the only way to (more than) counterbalance this negative impact is to reduce domestic support and tariff rates in order to boost world production.

In the export subsidies domain, the Hong Kong Ministerial Declaration may prepare for future WTO negotiations by expanding the definition of export subsidies to include the export subsidy elements of export credits, food aid, and state trading enterprises. These instruments are currently of marginal importance (Hoekman and Messerlin 2006); nevertheless, such disciplines are significant in inhibiting their intensive use in the future, perhaps to fill the void left by the elimination of existing export subsidies.

Domestic support

Domestic support is an area where the OECD countries have de facto benefited from a “reverse” special and differential treatment (SDT) under the Uruguay Round. Whereas there is an outright legal prohibition against trade-distorting subsidies in manufacturing (and countries importing subsidized goods are allowed to impose countervailing duties), in agriculture domestic support is only disciplined by rules against highly distorting subsidies and practices. These tend to be extremely expensive, which explains to some extent why only developed countries tend to use them. The US and EU together represented over three fourths of global farm domestic support in the early 2000s (Anderson et al. 2006a).

Table 1.5.4 presents the reform proposals put forward by the EU, G20, and US at the Ministerial Meeting in Hong Kong, China, focusing on the two largest subsidizers, the EU and US. It shows that the proposed subsidy cuts (applied to Uruguay Round commitments) may look huge in percentage terms, but in effect they reflect a good deal of “water” in the subsidies. For instance, the EU has made a proposal, which is a mere binding at WTO of its already-completed reforms of the Common Agricultural Policy (CAP) undertaken since 2000 (Kutas 2006).

The EU approach in particular has been very much criticized for several reasons. First, there is a long WTO tradition (that the EU has always supported) that unilateral liberalization should not be credited as WTO concessions. Second, the EU proposal in farm tariff cuts is viewed as weak (see below) whereas its requests for tariff cuts in NAMA are substantial (see above). Last, but not least, the 2003 CAP reform did not really liberalize the EU farm sector. All other things being constant, the overall level of EU protection has decreased marginally from 57% to 56% after the 2003 reform (OECD 2004).

1.5.4 Farm domestic support in the United States and European Union

	Unit	US	EU
The Amber Box (the most trade-distorting subsidies)			
Uruguay Round commitments	\$ billion	19	89
Effective amounts in 2004	\$ billion	13	42
Estimated amounts in 2006–2010 (EU CAP)	\$ billion	—	26
Doha proposals			
EU proposal	% cut	60	70
US proposal	% cut	60	83
G20 proposal	% cut	70	80
EU proposal	\$ billion	8	27
US proposal	\$ billion	8	15
G20 proposal	\$ billion	6	18
Overall trade-distorting support (sum of AMS, de minimis and Blue Box)			
Uruguay Round commitments	\$ billion	55	149
Effective amounts in 2004	\$ billion	23	74
Estimated amounts in 2006–2010 (EU CAP)	\$ billion	—	40
Doha proposals in terms of subsidy cuts			
EU proposal	% cut	60	70
US proposal	% cut	53	75
G20 proposal	% cut	75	80
EU proposal	\$ billion	22	45
US proposal	\$ billion	26	37
G20 proposal	\$ billion	14	30

— = not available; CAP = Common Agricultural Policy.

Notes:

Amber box—contains a list of subsidies that WTO members have agreed to reduce under the WTO agriculture negotiations.

Blue box—a category of domestic subsidies specific to the Agreement on Agriculture permitted only because they are believed to distort trade less than amber box subsidies.

AMS—Aggregate Measure of Support. An index that measures the monetary value of the extent of government support to a sector.

De minimis—minimum threshold below which spending on domestic support does not need to be included in AMS classification.

Sources: EU, US, and G20 proposals at the Ministerial Meeting in Hong Kong, China; Penn 2005; Jales and Nassar 2006; Kutas 2006.

Tariff cuts and the “Big Bargain”

Tariff cuts are crucial to agricultural liberalization because they are the best way to reduce and control subsidies, as lower tariffs make existing subsidies more visibly expensive.¹⁰ Unfortunately, the ongoing Doha negotiations on farm tariff cuts face a much more complicated format than did the NAMA negotiations, with the risk they will reduce the level of ambition in farm liberalization, already fragile because of the political importance of the farm sector to almost every WTO member.

First, complicated modalities in farm negotiations flow from the fact that the proposals on tariff cuts for the Ministerial Meeting in Hong Kong, China have adopted a tiered format, with four ranges of tariffs, each range being subjected to a different percentage cut, as shown in Table 1.5.5. These proposals differ with respect to the figures defining the various ranges and percentage cuts. As a result, negotiators need to strike deals on the three thresholds defining the four tariff ranges, on the four percentage cuts for each range, and on the use and definition of a tariff cap. If there are different cuts for developed and developing countries (an almost certain situation), negotiators have to agree on 16 figures at least, which is no mean feat. The fact that “specific tariffs” (i.e., a tariff based on a fixed value and/or quantity, rather than a

Table 1.5.5 Tabled proposals on farm tariff cuts, 2005

	EU proposal		G20 proposal		US proposal	
	Definition of the tiers (%)	Tariff cut (%)	Definition (%)	Tariff cut (%)	Definition (%)	Tariff cut (%)
Tariff cuts to be imposed on developed countries						
Highest tier	>90	60	>75	75	>60	85–90
Medium high	60–90	50	50–75	65	40–60	75–85
Medium low	30–60	45	20–50	55	20–40	65–75
Lowest tier	0–30	35	0–20	45	0–20	55–65
Tariff cuts to be imposed on developing countries						
Highest band	>130	40	>130	40	>60	^a
Medium high	80–130	35	80–130	35	40–60	^a
Medium low	30–80	30	30–80	30	20–40	^a
Lowest band	0–30	25	<30	25	0–20	^a
Other elements of tariff rates						
Cap tariff (developed countries)	n.a.	100	n.a.	100	n.a.	75
Cap tariff (developing countries)	n.a.	150	n.a.	150	n.a.	100

n.a. = not applicable.

^a Reference to “slightly lesser reductions” without more precision.

Source: The EU, G20, and US proposals at the Ministerial Meeting in Hong Kong, China.

percentage-based “ad valorem” tariff, which are almost always applied in manufactures) exist on agricultural products complicates matters, as they would likely need to be converted to an ad valorem equivalent in order to be liberalized. This presents a problem in that the conversion can lead to greater protection.¹¹

Such a difficult format for negotiators could prove counterproductive. Thus, there is a strong incentive to look for more simplified parameters for negotiations, keeping in mind that the Hong Kong Ministerial Declaration (paragraph 24) says: “[...] we instruct our negotiators to ensure that there is a comparably high level of ambition in market access for Agriculture and NAMA.” Importing the Swiss formula from NAMA to the farm negotiations seems a first condition to ensure a comparably high level of ambition by using the same instrument for tariff cuts in farm and NAMA negotiations. There is no extra cost for such a move; the Swiss formula requires that specific tariffs be transformed into ad valorem tariffs, but this exercise will be necessary anyway for the tiered proposals articulated at the Ministerial Meeting in Hong Kong, China. A Swiss formula approach would have the same advantages of transparency and symmetry as in the case of NAMA, to much greater effect given the greater divergence in tariff rates within and between countries in agriculture. It would also be instrumental in setting the stage for effective future WTO rounds and would reduce the “exceptionalist” mentality regarding agriculture that has always accompanied WTO negotiations. Finally, the Swiss formula opens the possibility of a clearer linkage between the NAMA and farm negotiations; that is, it opens the door to a transparent “Big Bargain” with trade in goods.

In sum, Doha negotiations particularly in the areas of domestic support and tariff cuts continue to be controversial, and the outcome is unclear. However, past experience has shown that developing countries in particular are placing a high priority on this area. An underestimation of the seriousness of developing countries in this regard was in evidence at the Cancun Ministerial Meeting, at which a compromise agreement

between the EU and US in agriculture was rejected by developing countries (under the leadership of the G20). This should not happen again. These three areas of agriculture will also have to be an important part of a final Doha package.

Still, agriculture is complicated and faces strong resistance at the local level in developed and developing countries. As farm interests in the EU, for example, attempted to keep any commitments at the Ministerial Meeting in Hong Kong, China as modest as possible, Korean farmers also actively sought to influence their country's position. However, WTO has matured such that it needs to tackle trade in agriculture seriously, unlike in the past. Doha presents an opportunity to do this, that is, to treat agricultural trade more like trade in manufactures, in which trade-distorting subsidies are eliminated and tariffs are lowered and made more uniform. The adoption of the Swiss formula to agricultural tariffs would help to achieve this.

Trade in services

Globally, services represent more than 50% of the GDP of any country, and more than 70% of many developed economies. International trade in services is becoming commensurately important; in 2003, it came to \$1.8 trillion, about one quarter the value of merchandise trade (WTO, *International Trade Statistics*, 2004, Table 1). Although data on barriers to trade in services are notoriously rare and often incomplete, in-depth studies on specific services sectors suggest that protection in this sector is much higher than is the case for trade in goods, suggesting that trade liberalization in services has significant potential for all WTO member states.

While services are not included in the Doha liberalization scenario reviewed below using ADB's General Equilibrium Model of Asian Trade (GEMAT), Francois et al. (2003) do estimate the potential gains from various scenarios of liberalization in services trade. Assuming a 50% reduction in their estimated barriers to trade in services and increasing returns to scale, they calculate a \$68 billion global gain, double that of a similar reduction in protection in manufactures and about one fourth more than in agricultural liberalization. Developing countries almost gain as much as the OECD countries, with the PRC and India accounting for over three fourths of this share. Clearly, the potential economic gains from services liberalization are high.

Nevertheless, negotiations under services have hitherto produced very little at Doha. As of July 2005, less than half of WTO's member countries had tabled proposals of any kind. Moreover, the content of these offers seems thin, especially in Mode 3 (commercial presence, see Box 1.5.3), which is of special interest to the industrial economies, and in Mode 4 (that is, trade in labor services), which is of special interest to some developing countries (for example, in Asia, Bangladesh, India, Pakistan, Philippines, and Sri Lanka).

A first reason for this deadlock is the negotiating process per se, which is complicated in part due to measurement problems. In trade in goods, negotiators balance the concessions granted to trading partners via tariff cuts at home with those they receive in return, a straightforward calculation. In services, it would make little sense to balance, say, the

1.5.3 The Four Modes of Services Liberalization

The complicated and diverse nature of trade in services explains why liberalization in this sector can be far more difficult than trade in goods. Services can be high tech or low tech; inputs and/or final products; publicly provided or privately provided; and closely related to other areas, such as foreign direct investment (FDI) and immigration. Trade in goods internationally tends to be almost always privately provided, with strong GATT/WTO controls on state intervention, including the technical prohibition against state subsidies and constraints in the form of state-owned enterprises having to abide by market principles (GATT Article XVII). Many services areas, however, still include government involvement, and state prerogatives in certain areas are recognized by the General Agreement on Trade in Services (GATS). Moreover, trade in goods tends to be separate from FDI, though clearly there exist indirect links between trade and FDI. In the area of services, however, trade can be intricately linked to FDI; in some subsectors, trade in services is impossible without FDI.

The Organisation for Economic Co-operation and Development defines four “modes” of trade in services:

(1) cross-border supply, in which a company exports the service from its home country, e.g., by fax or email; (2) consumption abroad, in which the user of the service consumes it outside his/her home country, e.g., tourism; (3) commercial presence, in which a company directly supplies the service to foreign customers (this involves establishment of an affiliate abroad and constitutes over three fourths of all trade in services); and (4) presence of natural persons, in which the service-exporting country sends personnel abroad to supply services.

In the Doha Development Agenda, key areas of contention in trade in services relate to Mode 3 and Mode 4, which is no doubt why little has been offered. Mode 3 is a high priority for developed countries; in fact, after the “Singapore issues” were taken off the agenda after the 2003 Cancun Ministerial Meeting, Mode 3 is the main area in which facilitating FDI policies are being discussed. Liberalization in Mode 4 is an important priority for labor-exporting developing Asian countries, which are especially concerned about working visa policies and other immigration-related procedures in developed countries.

number of licenses granted to foreign insurance companies with the number of visas obtained for domestic nurses willing to work outside the country. Moreover, until the Ministerial Meeting in Hong Kong, China, negotiations were exclusively based on bilateral offers and requests, a cumbersome procedure that complicates the negotiations. So does the fact that substantial services liberalization can require behind-the-border changes (e.g., changing a law or bureaucratic regulations).

To simplify things, services negotiations under WTO in the past have focused on national treatment, that is, on the elimination of measures that discriminate against foreign service providers. Such an approach allows regulatory flexibility, but this comes at a price: there is no “forced” regulatory efficiency. The failure of countries to adopt “best practices” in this regard has been estimated to be high (OECD 2005, Estevão 2005). In order to allow for deeper integration in the services context, the Ministerial Meeting in Hong Kong, China decided that countries could pursue services negotiations on a “plurilateral,” rather than the usual bilateral, basis. That is, more than two countries can negotiate a liberalization package in a certain sector, a result which would be extended on a most-favored-nation basis.¹²

Although there could be some breakthroughs in the less controversial areas, the paucity of proposals on services thus far does not bode well for a breakthrough in this area. Nevertheless, it is an increasingly important sector with great potential. A successful conclusion to the Doha negotiations would also likely produce a strong commitment to focus on services in future rounds of multilateral negotiations.

Rules

The Doha discussions on “rules” focus on several issues; for developing

Asia (and other developing regions) it is argued that the most important areas relate to contingent protection (antidumping and countervailing duties) and regional trading agreements. (Aid for trade, including trade facilitation, is handled in the next subsection.)

During the last decade, WTO has been unable to monitor effectively the use of nontariff barriers (NTBs). The success of the Uruguay Round to eradicate “gray measures” (such as quotas and voluntary export restraints) has been somewhat diminished by the increased use of contingent protection, especially antidumping measures. Hitherto there has been no major systematic effort by WTO to delineate and quantify major NTBs imposed by WTO member states. Table 1.5.6 provides an illustration of the use of antidumping duties and other NTBs gleaned from recent trade policy reviews¹³ of selected WTO members. It suggests that the NTB problem continues to be important.

Doha discussions on reforms addressing antidumping and countervailing duty procedures have not yet reached the negotiating stage, but such topics tend to be handled in the final negotiating phase.

Contingent protection could represent a growing threat to open trade. While, technically, antidumping measures and countervailing duties are justifiable in certain cases, in practice they have been used as a protectionist tool, all the more problematic because applications are

1.5.6 WTO notifications of nontariff barriers, selected economies

	Year of trade policy review	Import prohibition, restrictions	Import nontariff barriers			Technical barriers to trade	Sanitary, phytosan. measures	Government procurement	Export prohibition, restrictions, licensing	State-owned enterprises
			Safeguard	Antidumping	Countervailing					
Industrial economies										
Japan	2004	Low	Yes	0	0	Low	Low	Low	Low	Low
US	2003	—	Yes	85	23	High	High	High	High	Low
EU	2004	High	Yes	156	18	High	High	High	Average	Low
Canada	2003	—	No	43	10	High	Low	High	High	High
Australia	2002	Low	No	19	5	High	High	High	Average	—
New Zealand	2003	Low	Yes	0	0	High	Low	Low	Low	High
Developing economies										
Korea	2004	Low	Yes	21	0	Low	High	Average	Low	High
South Africa	1998	High	No	35	0	Low	Low	High	High	Low
Malaysia	2005	Low	No	12	0	High	Low	Low	Low	Low
Singapore	2004	Low	No	0	0	Low	High	Low	Low	High
Philippines	2005	High	Yes	5	0	Low	Low	Low	Low	Low
Thailand	2003	Low	No	26	0	Low	Low	Low	Low	Low
Brazil	2004	High	Yes	48	6	High	High	Low	Average	High
Mexico	2002	Low	No	90	1	High	Low	Low	Low	Low
Indonesia	2003	Low	No	7	0	Low	Average	Low	Average	Low
India	2002	High	Yes	131	0	Low	Low	Low	Low	High
Least-developed countries										
Bangladesh	2000	High	No	0	0	Low	Low	Low	Average	Low

Notes:

Country classification is based on the Integrated Tariff Analysis System.

— = no pages devoted to the particular NTB; Low = below average number of pages devoted to the particular NTB; High = above average number of pages devoted to the particular NTB; Average = equal to the average number of pages devoted to the particular NTB; Yes/No = has/has not applied safeguard measures.

For Singapore and Malaysia, state-owned enterprises refer to government-linked companies; for the columns referring to antidumping and countervailing measures, the figures refer to the number of measures in force.

Source: Trade Policy Reviews (various issues), available: www.wto.org/english/tratop_e/tpr_e/tpr_e.htm.

firm- or country-specific. Enforcement of rules governing contingent protection has also been relatively lax. Hence, discussions regarding the need to make contingent protection more transparent and symmetric between countries will likely become a significant issue at Doha, though it is not clear exactly what will be put forward. Still, the regulatory nature of this area, as well as the increasing use of contingent protection even by developing countries, will render progress difficult. Little progress is expected in this regard outside clarification of rules, as was basically the case during the Uruguay Round.

As is noted at length in Part 3, the trend toward the creation of preferential trade agreements (e.g., free trade areas or customs unions) has become increasingly important in driving international commercial policy over the past 10 years. By their very nature, these agreements discriminate in favor of partner countries, to the disadvantage of nonpartners. This is a violation of the heart and spirit of the GATT/WTO, i.e., most-favored-nation treatment, enshrined in Article I. However, Article XXIV allows for preferential trade agreements, provided that they meet certain general criteria. In GATT's early years, preferential trade agreements were relatively few in number. As of March 2006, however, almost 200 such agreements had been reported to WTO, double that of just a decade earlier. Many more are in the works; the vast majority of developing Asian countries are party to such agreements.

Recognizing that this trend poses an important challenge to nondiscrimination, WTO members have been discussing the need to revamp the organization's policies toward regionalism. The 1994 Understanding on the Interpretation of Article XXIV of GATT was an attempt to enhance the compatibility of regionalism with multilateralism at a time when the trend was beginning to grow, but it did little to clarify the issues. Under the Doha Development Agenda, further revisions of interpretations of Article XXIV were to be part of its "single undertaking." But little was accomplished at the Ministerial Meeting in Hong Kong, China in this regard, except a commitment to improve the transparency of free trade areas and encouragement to negotiators to arrive at "appropriate outcomes" by the end of 2006.

Because the global trend toward bilateralism and regionalism is new and just about all WTO member countries are involved, it is unlikely that substantial progress will be made in this area at Doha, outside of some minor points on definitions and transparency. However, the problems that are being created by this trend—such as inevitable trade and investment diversion, "noodle bowl" (or "spaghetti bowl") issues, and the clear threat to the multilateral system—will become evident in time, and the threat to the multilateral system will be taken more seriously. This will no doubt be a key area of discussion in subsequent rounds, if not sooner.

Special and differential treatment and aid for trade

The 6 years between the ministerial meetings held in Seattle and Hong Kong, China witnessed an intense debate on whether and how developing countries should be granted special and differential treatment (SDT). Importantly, at the Ministerial Meeting in Hong Kong, China developed countries agreed to end tariffs and quotas on 97% of

the tariff lines exported by the LDCs by 2008. This was hailed as an important success. However, it has been criticized as not being extensive enough.¹⁴

To begin, it should be noted that the pursuit of SDT has often been counterproductive for developing countries. As noted above, countries tend to gain most from their own liberalization, and the quest for exclusions, drawn-out timetables for the implementation of reform, and lack of active participation in global trade talks (meaning that protection remains relatively high in LDCs) have postponed or even stifled liberalization. The possibility of a “round for free” was discussed earlier in the Doha talks, ostensibly suggesting that LDCs should be exempt from everything at Doha. This approach, though well meaning, would have been highly detrimental to LDC development, as it would have precluded the need for domestic reform and restructuring. Moreover, active participation ensures that the issues they really care about will be addressed. Some aspects of SDT can be useful, but in no way should it serve to exclude LDCs and developing countries more generally from being true partners in the global trading system.

Since the 1970s, SDT has been mostly delivered through preferential (low or zero) tariffs granted to a limited number of developing countries defined on an ad hoc basis by developed countries (on an individual basis). However, the value of SDT preferences has been falling over time. For example, beneficiaries are currently suffering from “preference erosion” and associated adjustment costs. During the last decade, the differences between the most-favored-nation tariff rates and the preferential tariff rates have been reduced by a long series of trade agreements, under the GATT/WTO and in regional trade agreements.

“Aid for trade” has become a buzzword in the Doha negotiations, and as a result, deserves to be defined with some precision. The preference erosion issue, for example, is often included under the aid for trade heading. What follows limits aid for trade to issues increasingly related to governance in general (and not necessarily to trade directly).

First, aid for trade can be linked to “trade facilitation,” that is, to the activities undertaken by customs and logistics procedures, e.g., improving the movement, release, and clearance of goods, including goods in transit. The Doha Development Agenda has a program of negotiations on trade facilitation intended to buttress developing-country capacity to implement trade liberalization and structural change in general. A particularly important aspect of this program relates to transit conditions (for example, fees, delays, and transparency), which is of prime importance to landlocked countries.

Second, as the above definition of trade facilitation is quite narrow (it covers only public governance at the borders), this approach could potentially be extended to all activities involved in the international movement of goods and services, such as building the corresponding infrastructure (ports, roads, and other transport facilities), or operating trade-related services (mail and parcels, telecoms, specialized legal and insurance services, storage, and the like). This “trade facilitation plus” concept is very close to services negotiations since de facto it relies on a cluster of services on which developing countries need to focus in order to reap effectively gains from trade liberalization.

Gauging the gains of Doha trade liberalization for the region

Viewed from a historical perspective, global free trade would appear an idealistic goal. As noted above, negotiations in the Doha Development Agenda have focused on a more modest agenda. To conjecture about the outcome in Doha, this section examines the economic impact in the context of a model that brings Asia into sharper relief. This exercise is conducted using an Asia- and trade-focused general equilibrium model (GEMAT), described more fully in Part 3.

Since the parameters (and, indeed, likelihood) of an agreement at Doha remains uncertain, the simulations adopt the ambitious assumptions about Doha outcomes that have been made by Anderson et al. (2006b) (Box 1.5.4). While a successful Doha package could spur further multilateral liberalization initiatives, these are not considered here.

Under the “Deep Doha” scenario, world income rises by \$155.2 billion in 2025, measured in 2001 prices (Table 1.5.7). However, liberalization benefits developing Asia disproportionately. Around 70% of the estimated gains from Deep Doha accrue to Asia (including Japan). Box 1.5.5 compares ADB current estimates with those of earlier World Bank studies. Caveats about these exercises and their estimates are set out in Part 3. Importantly, as is further discussed in Part 3, the absolute values of these estimates tend to have a strong downward bias, and, of course, are a function of the assumptions and parameters underlying the model. Hence, the absolute values are arguably less important than the *rank ordering* of the results and the *relative* magnitudes.

As Table 1.5.7 shows, the estimated gains from Doha are not evenly distributed either globally or within Asia. The disproportionately large gains accruing to Asia follow from Asia’s openness and larger initial trade shares, as well as the assumption of a significant reduction in Asian import protection, especially in agriculture. Japan and Korea, which are large economies in absolute size, capture the bulk of the gains. Relative to income, Korea and Thailand gain most. Korea benefits significantly from a sharp reduction in its own agricultural tariffs as well as from growing export opportunities in the PRC. Thailand benefits as its agricultural exports are boosted by reduced distortions in the global agricultural trading system.

Although Deep Doha is a positive sum game, there are prospective losers as well as winners. In Asia, Bangladesh and Viet Nam would appear to face the prospect of income losses. And Deep Doha would appear to offer no benefits to the Philippines and few to the PRC. As the possibility of prospective losses may impede or slow multilateral liberalization initiatives, it is important to look behind these results.

An important aspect of the Doha negotiations, reflected in this scenario, is that negotiations are about reductions in members’ legally bound tariffs, not the actual tariffs that they apply. Therefore, where there is water in the tariffs, nominal reductions in bound tariffs may mean little or no reduction in actual levels. In the Deep Doha scenario assumptions presented here, this is the case for both Bangladesh and the Philippines. An important result from standard economic theory is that liberalization

1.5.7 Welfare gains from Deep Doha (change compared to baseline in 2025)

	Real income (\$ billion)	Real income (% of GDP)
Japan	21.26	0.33
China, People’s Rep. of	11.57	0.21
Korea	36.76	3.49
Hong Kong, China	4.90	1.19
Taipei, China	5.32	0.79
Indonesia	2.98	0.57
Malaysia	3.20	1.09
Philippines	0.22	0.09
Singapore	3.47	1.67
Thailand	8.47	2.14
Viet Nam	-0.79	-0.58
Bangladesh	-0.03	-0.02
India	12.50	0.67
Sri Lanka	0.24	0.54
Developing Asia	88.81	0.76
Asia including Japan	110.07	0.61
United States	8.13	0.04
Europe 19	32.56	0.24
Australia and New Zealand	3.43	0.38
Latin America	2.15	0.05
Rest of the world	-1.13	-0.02
World Total	155.20	0.24

Note: Europe 19 comprises 15 countries of the EU plus Iceland, Liechtenstein, Norway, and Switzerland.

Source: Staff estimates.

1.5.4 Various Doha scenarios

Deep Doha. This is essentially scenario 5 in Anderson et al. (2006).¹ It assumes significant agreement in Doha by 2006 in a number of areas: nonagricultural tariff bindings are cut by 50%, and agricultural tariffs are cut using a tiered formula. The marginal cut is set at 45% for agricultural tariffs below 15%, 70% for tariffs within the 15–90% bracket, and 75% for tariffs above 90%.² Agricultural export subsidies are eliminated for all countries. Domestic support for agriculture is also cut for the United States (by 28%), the European Union (by 16%), and Australia and New Zealand (by 10%). Special and differential treatment (SDT) is not applied and developing countries are assumed to liberalize to the same degree as developed countries. All these trade reforms are phased in over the 5-year period of 2007–2011. Possible reforms in services sector and trade facilitation are not incorporated in this scenario.

Doha-SDT. This scenario examines the consequences of including SDT. Specifically, there are four agricultural tariff brackets for developing countries, with inflexion points placed at tariff levels of 20%, 60%, and 120%. Their marginal rates of reduction are 35%, 40%, 50%, and 60% within each of

the four bands. On NAMA, the cut in nonagricultural tariff bindings for developing countries is 33%. Least-developed countries are not required to undertake any reduction commitment. On the other hand, the required reductions in both agriculture and nonagriculture sectors for developed countries are the same as that in the Deep Doha scenario. The assumption regarding cuts in domestic support and export subsidies are also the same as those in Deep Doha.

Doha-SDT excluding sensitive agricultural products. Building on Doha-SDT, this “Doha Light” scenario further assumes a less ambitious agricultural agenda that excludes sensitive farm products. The developed countries are assumed to treat 2% of their HS6 agricultural tariff lines as sensitive and subject to just a 15% tariff cut. For developing countries, the corresponding figure is 4%.

¹ See Anderson et al. (2006b) for the details of the design of this Doha scenario. The Doha scenario used here corresponds to their “Doha-All” scenario.

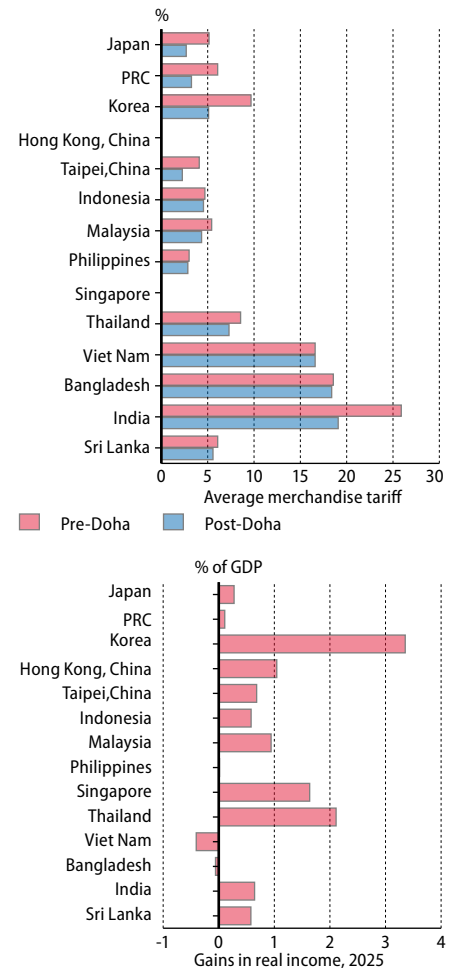
² Since the cut is applied on bound tariffs, the cuts in applied rate may be small for some developing countries due to binding overhang.

gains depend largely on the boosts to efficiency and productivity that occur when countries liberalize their own trade (Figure 1.5.1), not from tariff reductions by their trade partners. By volunteering cuts in bound tariff rates that would lower applied tariffs, countries such as Bangladesh and the Philippines would also benefit. The negotiating approaches of WTO obfuscate this fundamental point.

Of course, even if countries do reduce their own tariffs, multilateral liberalization may not lead to gains in all cases. If liberalization means that a country loses preferential access to important markets, or export subsidies are removed on goods that have a large weight in the import basket, or subsidized entry into other markets is halted (as, for example, in the case of the Fiji Islands’ sugar exports to the EU), countries may face the prospect of significant losses. The model suggests that the erosion of preferential access for clothing and textiles to the EU, with the EU lowering its most-favored-nation tariffs, could dampen Bangladesh’s exports, resulting in losses in income and terms of trade. Bangladesh also loses from terms-of-trade effects driven by higher agricultural prices (including cotton). Also, given that the PRC already has substantially reduced its tariffs on merchandise trade, a deterioration of its terms of trade may be needed to sustain fast export growth. The case of Viet Nam, which is not yet a member of WTO, illustrates another point. In the Doha scenario, levels of protection in nonmember countries are assumed unchanged. Consequently, as WTO member countries liberalize, nonmember countries such as Viet Nam suffer from a diversion of their trade to other locations where costs are now lower. If Viet Nam successfully concludes negotiations to enter WTO, it too would benefit from Doha, raising estimated impacts.

Under the scenario of Doha-SDT (Table 1.5.8), the global gain in 2025 shrinks by around 30% in comparison with the Deep Doha scenario, to

1.5.1 Tariff reductions and income gains



Sources: GTAP database 6.05; CEPII scenarios; staff estimates.

\$110.6 billion. But for developing countries,¹⁵ the gain would be only \$56.4 billion, only 63% of that in the Deep Doha scenario. If higher-income Asian countries (Hong Kong, China; Korea; Singapore; and Taipei, China) are excluded, the gain of developing countries is only \$19.3 billion, or less than half of that in the Deep Doha scenario (Figure 1.5.2). This exercise suggests that no regions (as defined) would be better off from the introduction of SDT, even for LDCs like Bangladesh. This result squares with the theoretical proposition that developing countries need to cut their own trade protection to reap the benefits of multilateral trade liberalization. SDT does not serve the interests of developing countries.

If the Doha-SDT scenario is further weakened by assuming that the sensitive agricultural products are subject to lower tariff cuts, global gains in 2025 would be reduced to \$68.4 billion, reflecting the importance of agricultural liberalization in the Doha trade liberalization agenda. In Asia, the exception of sensitive agricultural products are important for Japan, Korea, Thailand, and, to a lesser extent, Viet Nam, given their high interests in agricultural trade liberalization. However, for other Asian economies, the exception of sensitive agricultural products only have marginal impacts on their welfare gains from Doha.

Beyond Doha

The outcome at Doha is uncertain. It is hard to predict at this point whether there will be a successful package that emerges in time for the April 2006 deadline, whether the deadline will be extended and subsequently completed, or whether the negotiations will fail. Moreover, it is unclear what the package will look like. Will it be a comprehensive set of liberalization initiatives or “Doha Light”?

In terms of economics, Doha Light could potentially be worse than a failure at Doha. For example, a “flexible” package under NAMA in which many sensitive products are excluded, minimal “value added” in terms of progress in agriculture, and mere rhetoric in services and “rules,” with some compensation under “aid for trade,” is not an inconceivable outcome. However, it would be regrettable. First, nonuniform tariff cuts could lead to distortions in the value-added chain that could potentially negate any gains from liberalization. Mere patchwork in agriculture would repeat the mistakes of previous GATT/WTO rounds, since it would thwart necessary structural reform in developed and developing countries, and would leave much for future rounds (discussed below). And lack of progress in reforming contingent protection rules would leave fully loaded an important (and increasingly dangerous) protectionist weapon.

From a political perspective, Doha Light might be considered preferable to no agreement at all, as it would at least be a “success”

1.5.8 Welfare gains from two less ambitious Doha scenarios (change compared to baseline in 2025, real income)

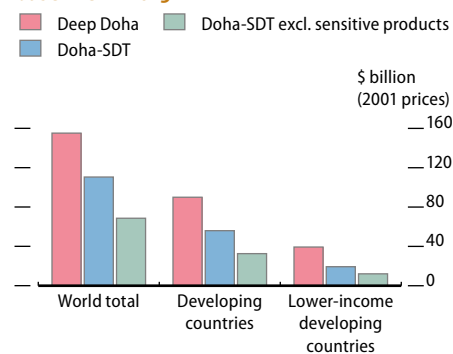
	Doha-SDT		Doha-SDT excluding sensitive farm products	
	(\$ billion)	(% of GDP)	(\$ billion)	(% of GDP)
Japan	18.57	0.29	7.86	0.12
China, People's Rep. of	10.11	0.18	9.00	0.16
Korea	26.93	2.55	10.69	1.01
Hong Kong, China	3.52	0.85	3.42	0.83
Taipei, China	4.00	0.59	3.89	0.58
Indonesia	2.08	0.40	2.10	0.40
Malaysia	1.67	0.57	1.47	0.50
Philippines	0.15	0.06	0.11	0.05
Singapore	2.57	1.24	2.53	1.22
Thailand	5.87	1.49	3.71	0.94
Viet Nam	-0.71	-0.52	-0.48	-0.35
Bangladesh	-0.10	-0.07	-0.08	-0.06
India	6.32	0.34	6.25	0.33
Sri Lanka	0.13	0.29	0.06	0.14
Developing Asia	62.52	0.54	42.67	0.37
Asia including Japan	81.09	0.45	50.53	0.28
United States	6.81	0.03	6.82	0.03
Europe 19	26.09	0.19	19.61	0.15
Australia and New Zealand	2.74	0.31	1.69	0.19
Latin America	-0.45	-0.01	-1.14	-0.03
Rest of the world	-5.72	-0.08	-8.88	-0.12
World Total	110.56	0.17	68.64	0.11

SDT = special and differential treatment.

Note: Europe 19 comprises 15 countries of the EU plus Iceland, Liechtenstein, Norway, and Switzerland.

Source: Staff estimates.

1.5.2 Gains from Doha scenarios: Real income changes relative to baseline in 2025



Source: Staff estimates.

1.5.5 Gains from Doha: A Comparison with other quantitative estimates

Care needs to be taken in comparing different estimates of the potential benefits of the Doha Development Agenda. Over the years, the World Bank has revised its estimates of Doha benefits significantly downward. The estimate here is also lower than earlier World Bank estimates (2001 and 2004). An important reason for this is that use of the GTAP V6 (Global Trade Analysis Project) database implies a reduction in baseline trade protection compared to the earlier GTAP datasets used in the initial World Bank studies. The benefits of the cessation of quotas on textiles and clothing and the entry of the People's Republic of China into the World Trade Organization are now embedded in the baseline, so Doha assumptions now remove fewer distortions (van der Mensbrugge 2006).

But there are also technical differences between the estimate of the General Equilibrium Model of Asian Trade (GEMAT) and more recent World Bank estimates. These differences illustrate the sensitivity of model estimates to differences in technological and behavioral specifications, and parametric assumptions. In particular, estimated benefits are sensitive to assumptions about trade price elasticities (Armington elasticities), returns to scale and product variety, and to sector and geographic aggregation.

The most recent World Bank estimates are based on trade price elasticities that are about one third higher than those used here. The elasticities in GEMAT are closer to the traditional GTAP values, which have been estimated econometrically (Hertel et al. 2003). This difference in parameter assumptions tends to boost the World Bank's estimates of trade benefits.

On the other side of the coin, GEMAT's assumption of increasing returns and imperfect competition generates larger benefits than those derived in a perfect competition model with constant returns technology, such as that used by the World Bank. Aggregation also matters. Higher commodity and geographic aggregation in GEMAT cuts estimated benefits. For essentially an identical scenario, GEMAT's construction trims about 15% of the global benefits reported in recent World Bank studies.¹

A recent study by the International Food Policy Research Institute shows that ambitious Doha round trade liberalization can induce a global real income gain

of \$104 billion in 2019, around 0.19% of world GDP in 2019. This study was conducted using MIRAGE, a global computable general equilibrium (CGE) model which also incorporates scale economy and firm-level productivity variety (Bchir et al. 2002). The lower estimates, in comparison with the GEMAT results, may be due to its assumption about the imperfect mobility of unskilled labor between agricultural and nonagricultural activities, which limits the gains from more efficient resource reallocation.

Another recent study by Polaski (2006) (the "Carnegie model"), using a static global CGE model, estimates global gains of \$58.6 billion, or 0.19% of 2001 world GDP, according to its Central Doha scenario. This gain is larger than the equivalent static impact in GEMAT. The difference may be found in scenario design and model specification. The Central Doha scenario in Polaski (2006) assumes relatively modest agricultural trade liberalization and more ambitious manufacturing trade liberalization, which would induce larger gains from manufacturing liberalization and smaller gains from agricultural liberalization. Moreover, Polaski (2006) assumes unemployment in the urban unskilled labor market and a rural-urban wage differential in developing countries. This further magnifies the gains of some developing countries from manufacturing trade liberalization, as their manufacturing sector expands following the increased export opportunities induced by trade liberalization, but may induce losses for developing countries from Doha agricultural liberalization, which diverts unskilled labor away from manufacturing and into agriculture.

Simulation approaches clearly have limitations and until there is better information, estimates of the benefits of trade liberalization will necessarily be subject to important qualifications. However, the relative magnitude of the welfare impacts and the sources of gains and losses obtained from these modeling exercises do provide useful insights for policy analysis.

¹ For Asian countries, the estimated income gains from GEMAT are generally larger than the World Bank estimates, reflecting that the impacts of low trade elasticities are more than offset by the introduction of scale and variety effects.

and could keep momentum going for the next round, an important consideration given the rise in regionalism. However, this is purported to be a *development* round; lack of progress in comparative-advantage areas for developing countries would reinforce the impression in some circles that the international trading system is rigged against the poor. Enthusiasm for global trade could wane, and the regionalism trend could actually be reinforced.

But a comprehensive Doha package would likely do wonders for the global trading system. What such a package would look like is

outlined above: a balanced Swiss formula applied to both NAMA and agriculture with as few excluded sectors as possible; some progress in services, particularly in terms of Mode 3 and Mode 4; fairer and more transparent rules on contingent protection; better definitions and rules on transparency in regional trade agreements, as well as commitments to develop means to ensure that Article XXIV agreements will be consistent with multilateralism; and generous offers in terms of “aid for trade” and “trade facilitation plus.” Certainly, this scenario is far more sensitive at the national political level.

Perhaps the negotiated outcome will be a combination of these two scenarios. Given the stakes for Asia, the region’s WTO member countries should be proactive in molding the negotiations in favor of the latter scenario. Above it is argued that the unique situation of Asia suggests that it has strong leadership potential. Hopefully, the political will to assume such a role will be forthcoming.

What will the global trading system need to tackle in future WTO rounds? As the Doha outcome is still unknown, prediction is doubly difficult. However, it is suggested that the following six areas will be important features of the next round:

1. As the Swiss formula under NAMA will likely achieve a good deal of progress, it will be the least controversial area, at least relative to earlier rounds. Average tariffs are already quite low; Doha should reduce them further and create greater symmetry. Mega-tariffs should be a thing of the past. Hence, reductions in tariffs in manufactures will likely be on the agenda but will not be as important as in previous rounds. Could a complete phaseout of tariffs in developed countries be a goal? And perhaps 10% maximum tariffs in developing countries?

2. Regardless of the outcome of current negotiations, agriculture will still be important. How important will depend on progress made at Doha. Export subsidies will be gone, but tariffs will continue to be high and domestic support trade-inhibiting. The next round will seek to lower tariffs and put further constraints on domestic support. This sector will continue to be difficult; reform of the EU’s Common Agricultural Policy will be particularly significant in defining the next round’s potential.

3. Given the importance of the services sector and the fact that it will likely see modest progress at best at Doha, this will be one of the most important focus areas at the next round. It will require significant preparation, as trade in services is extremely complex. But as a priority, it should receive considerable attention. And its potential to stimulate trade appears to be even greater than that in agriculture and manufactures.

4. Trade and investment issues, trade and competition policy, government procurement, and trade facilitation will also be a high priority on the negotiation agenda. These were known prior to Cancun as the “Singapore issues.” However, they proved too controversial for the Doha Development Agenda. Indeed, the failure at Cancun was blamed on them (and lack of progress in agriculture) and they were subsequently dropped, with the exception of trade facilitation. Look for them to be reincorporated, particularly since they continue to be a high priority for developed countries (as is evident by their incorporation in bilateral free trade areas with developing countries). Aid for trade, in particular trade facilitation, will also become a more salient feature of the global talks.

5. Contingent protection will also receive much higher priority in the future. Since there is not much hope that significant progress will be reached in controlling (particularly) antidumping and countervailing duties, countries will no doubt try to use them in order to protect sectors facing significant structural change due to liberalization in agriculture and manufactures. Moreover, by the next round, the PRC's transition period will be over (precluding the imposition of import quotas on its exports of textiles and clothing, recently applied so firmly by, especially, the EU and US) and new, labor-abundant, competitive economies like Viet Nam should be full-fledged members. The trend toward greater usage of contingent protection will surely continue, and its threat to international trade will become increasingly significant.

6. The most important area will probably pertain to regional and bilateral free trade areas. As noted above and more extensively documented in Part 3 of *Asian Development Outlook 2006*, regionalism has been growing rapidly, with Asia becoming an active and enthusiastic participant. This trend will likely continue for at least another few years. At that time, the trade effects of these agreements will start to be felt, and the costs associated with the "spaghetti bowl" will be increasingly recognized. The need for more effective rules and best-practices will become increasingly evident.

To conclude, much is at stake at Doha for Asia and the world. Much is riding on a successful outcome. The negotiators have their hands full, as the issues are complex and controversial in some quarters. But with the right leadership and political will, a successful conclusion to the Doha Development Agenda is certainly feasible.

Two final remarks on the strategies of developing Asia in Doha. First, there is no "round for free"; active participation is not an option but a necessary condition to reap the gains from multilateral negotiations. This is because offering to liberalize hitherto protected sectors allows not only for concessions in exchange but also for gains from trade. Countries tend to gain most from their own liberalization. Second, developing member countries of ADB that are not yet members of WTO need to focus on accession. Without WTO membership, they will never fully be able to take advantage of the new trade architecture that is being created. Even if they receive most-favored-nation status or even preferential treatment from key trading partners, they are still outside the system. And one cannot change the system from outside. Moreover, a focus on WTO accession means that negotiating capacities—often limited in the developing member countries—should not be diverted to other areas, for example, in negotiating bilateral and regional trade agreements. The opportunity cost is too high.

Endnotes

- 1 For example, tariff cuts on capital goods imports have been very successful in past rounds, whereas textiles and clothing remain highly protected in countries that do not have a comparative advantage in this area. Since textiles and clothing use capital goods in the production process, this reduction in input costs will have the tendency to increase the protection of value added in the textile and clothing industry, thereby creating an incentive

for additional resources to be allocated to this inefficient sector. This is known as the problem of the “effective rate of protection” in economics.

- 2 Per capita income will be the most likely criterion used to determine whether a country should benefit from “special and differential treatment.”
- 3 More specifically, the G10 is opposed to substantial opening in agriculture; the G33 supports easy exceptions from liberalization, e.g., via the notions of special products or safeguards; the G20 focuses on the opening of the farm markets of developed countries; and the Cairns Group is dedicated to global opening of agricultural markets.
- 4 As the welfare costs of tariffs increase disproportionately as the tariff level rises, larger reductions in the highest tariffs have a more than proportional positive effect on efficiency and welfare.
- 5 In general, moderate tariffs provide larger revenues than high tariffs. This is in large part due to the decrease in import volume associated with high import prices generated by steep protection. The fiscal aspect of the tariff is particularly important for developing countries with a narrow domestic tax base.
- 6 “Bound” tariff rates for individual products are those that a WTO member has committed not to exceed in past GATT rounds or as part of their protocol of accession.
- 7 First, exclusions of sectors give an advantage to countries with better negotiators, creating an advantage for developed countries over many developing countries. Second, countries will likely exclude the sectors with the largest potential for trade creation. And third, the symmetry of liberalization imposed by the Swiss formula would be distorted.
- 8 It should be noted that Australia and New Zealand have liberal farm policies already in place.
- 9 The EU is by far the main user of this instrument; it accounts for more than 80% of all global export subsidies in agriculture.
- 10 Subsidies are used in order to maintain a certain standard of living for farmers. If tariffs are cut, either the country needs to increase subsidies to maintain those standards, or allow for a reduction in living standards. The former policy would in part negate any gains from liberalization, whereas the latter would help achieve the necessary structural adjustment. In any event, if the decision is made to maintain standards by increasing subsidies, this is more “transparent” than tariff protection because it comes at a quantifiable fiscal cost.
- 11 Arguably this happened in certain cases at the Uruguay Round, when import quotas had to undergo “tariffication”.
- 12 Among other things, plurilateral negotiations facilitate negotiations by allowing a critical mass of like-minded countries to pursue liberalization in areas that would be difficult for other countries. This approach has already been used with success in the complex 1996 WTO Information Technology Agreement.
- 13 Trade policy reviews involve periodic assessments of the trade policies of WTO member states.
- 14 There are at least three major criticisms. First, it represents no additional commitment for the EU, as part of its Everything But Arms initiative has a 100% coverage, and a very marginal one for the US, which grants duty-free and quota-free access to its market for 83% of imports from LDCs. Second, the remaining 3% of tariff lines (roughly 300–400 lines) could easily cover all the crucial exports of most LDCs, which tend to have a limited range of exportable products. Third, the agreement covers only the LDCs, so excluding many poor countries that are not classified as LDCs.
- 15 Developing countries here refer to Asian developing economies, Latin America, and the rest of the world.

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