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Contents

Introduction

The following papers by Steven Blockmans, Yasushi Kudo, and Igor Yurgens provided input into the panel presentations at the Council of Councils meeting in Singapore titled "Asia at the Crossroads: Regional Priorities for the Twenty-First Century." The Council of Councils is an international network of twenty-four premier policy institutions.

The future of the World Trade Organization, and the European Union's position within it, serve as the inspiration for Blockmans's analysis that makes clear bilateral trade agreements may not be a panacea. Yasushi Kudo focuses his piece on the brewing dispute in East Asia regarding the Senkaku Islands between Japan and China and lays out policy options to address other maritime issues in the region. Igor Yurgens suggests that stabilizing the global financial systems should remain the Group of Twenty's primary focus, and reflects on the special attention afforded to Asian economies and future risks, challenges, and opportunities in the region.

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EU Trade Policy: More Bilateralism, Less WTO?

Steven Blockmans
Center for European Policy Studies

As the world's largest trading bloc, the European Union (EU) is scrambling to maintain its position in international markets and increase its competitiveness. The rise of the BRICS (Brazil, Russia, India, China, and South Africa), the rebalancing act of the United States toward the Asia Pacific, and the protracted eurozone crisis have substantially weakened the EU's international profile. In the EU's own forecast, shifts in trade flows will mean that 90 percent of world growth will be generated outside the eurozone by 2015, mainly in Asia.[1] But the fact remains that China and other economic powerhouses will still want to export to the EU. At the same time, recent Eurostat figures show that EU exports continue to grow at the same pace as in previous years, at around 11 percent.[2] This demonstrates that European companies remain competitive in world markets. Thus, EU trade and investment policies continue to play an important role in shaping the global trading system. For the crisis-ridden EU, these policies offer an opportunity to revamp its battered image on the international stage.

GROWTH STRATEGY

It is worth noting that the ways and means the EU uses to push its trade agenda through negotiations are increasingly characterized by enhanced bilateralism (e.g., upgrading its bilateral trade deals). This may have consequences for the future of the World Trade Organization (WTO).

The EU—a member of the WTO and an actor that, according to its own rule book, should speak with one voice in all of its external trade and investment relations—continues to pay lip service to what it calls effective multilateralism; in reality, however, it has pursued a policy of economic diplomacy based on entering into preferential trade agreements (PTAs) at bilateral levels since the outbreak of the economic and financial crisis in 2006, when the European Commission published its commercially oriented "Global Europe" strategy. Economic instability and a stagnant system of multilateral negotiations, demonstrated by the collapse of the Doha Development Round, have strengthened the pursuit for bilateral trade relations. Though the EU has tried to conclude interregional PTAs, such as the Economic Partnership Agreement with Cariforum, it has had to shift gears to the bilateral track in several cases.[3] For instance, as a result of the slow pace in negotiations with the Andean Community and the Association of Southeast Asian Nations (ASEAN), the EU negotiated free trade agreements (FTAs) with Peru and Colombia and commenced bilateral FTA negotiations with Malaysia and Vietnam.[4] Globalization's profound influence on the EU's internal market will result in an increasingly complex spaghetti bowl of PTAs.

To boost global competitiveness of its industries, the EU is now pushing regulatory convergence as a policy objective in trade talks. If euro-skeptics and euro-federalists agree on one thing, it is to allow the EU to pursue an open market agenda premised on signing deep and comprehensive FTAs with emerging markets and industrialized nations alike. Increased standardization, harmonization of laws, and mutual recognition are important elements of such deep and comprehensive FTAs. With a continued drive toward regulatory convergence and interoperability, Brussels aims to secure EU market access in developing countries.

The first of this new generation of FTAs has already come into effect with the Republic of Korea. In addition to progressively eliminating duties on nearly all trade in goods, the EU-Korea FTA addresses nontariff barriers to trade, based on WTO technical barriers to trade alongside sanitary and phytosanitary agreements. It also includes provisions on issues such as the liberalization of services (including financial services and telecoms) and investment protection; competition (both antitrust and state aids); market access in public procurement; the protection of intellectual property rights (including patents and geographical indications); transparency in regulation; and sustainable development (including social, labor, and environmental standards). To ensure enforceability of commitments, the FTA includes strong clauses setting up mediation and dispute settlement mechanisms. Over time, this should lead to a new branch of FTA jurisprudence. The agreement also establishes various institutional bodies to monitor implementation, such as the EU-South Korea Trade Committee and a customs committee, underscoring the FTA's comprehensive approach to trade liberalization.

The conclusion of this new-generation FTA is a crucial part of the EU's growth strategy and will be replicated for other trade partners. However, negotiating these deep and comprehensive deals has not proved an easy task. Talks with Singapore have been concluded, those with Canada are ongoing, and negotiations with Japan are expected to open soon. But proceedings in the two-decade negotiations with Mercosur were recently interrupted due to political problems and the suspension of Paraguay. An end date for negotiations with India also seems elusive. More than five years since they started, the talks hardly seem to move forward from a drawn-out final stage to conclusion.

A bilateral trade and investment agreement between the EU and India would be the largest globally, encompassing a quarter of the world's global population, and would substantially lower trade liberalization barriers across the board. But negotiations between a bloc of industrialized nations and a large country with wide income inequality are inherently asymmetrical. India is demanding duty exemptions for automobiles, wines, and spirits, as well as easier access to the EU market, in particular for fruit, vegetables, and fishery products. On the other hand, the EU is insisting on market access in public procurement, investment protection, legally binding sustainable development clauses regarding human rights, environmental issues, and labor standards. These competing interests mean that both sides will have to make major concessions in order to reach an agreement.

The EU also faces stumbling blocks in its efforts to strengthen trade relations with other strategic partners, notably its two biggest trading partners, China and the United States. The interest in deepening the EU-China trade relationship is mutual: the EU is the top export destination for Chinese goods, China is Europe's second largest export destination, and the EU has a strong desire to reduce Chinese trade irritants and inconsistencies in regulatory practices. Yet high-level discussions aimed at completing a comprehensive partnership and cooperation agreement have entered their sixth year and remain at an impasse due to entrenched positions on China's export restrictions on raw materials, a lack of enforcement of intellectual property rights, and the maintenance of nontariff barriers, among others.

Further trade liberalization with the United States has also been difficult for years. Although mutual recognition agreements aimed at creating transatlantic regulatory convergence in hitherto unregulated markets (such as nanotechnology, electronic vehicles, and e-health) are setting global thresholds in standardization, diverging regulatory philosophies, different risk assessment systems, and implementation disparities are holding back a trade boost between partners. Yet the most exciting trade prospects are still across the Atlantic. After all, no other trade relationship in the world is as integrated as that of the EU and the United States. A decision to start negotiations on a new transatlantic FTA in 2013 should therefore be welcomed.

Closer to home, the EU has initiated a deep and comprehensive free trade agreement with Ukraine but pushed back the decision to formally conclude the agreement until the Ukrainian authorities show more respect for values on which the EU is built like the rule of law (see, for instance, the anomalies in the trial of former prime minister Yulia Tymoshenko) and free and fair elections (in view of the irregularities accompanying the October 2012 parliamentary elections). Based on the same kind of conditionality, the EU foresees concluding similar agreements with other neighboring countries in eastern Europe (Armenia, Georgia, and Moldova) and south of the Mediterranean (Egypt, Jordan, Morocco, and Tunisia).

If the EU's bilateral free trade strategy were fully implemented by the end of this decade, it would give a moderate boost to trade, welfare, growth, and employment in the EU and—often to a larger degree—in partner countries. Whether this strategy is ultimately successful largely hinges on domestic politics in partner countries and in EU member states.

BILATERALISM AND THE WTO

The EU's strategy of enhanced bilateralism may have a considerable effect on the future of the WTO. As Jagdish Bhagwati has argued, the preference of WTO members to replace the multilateral, nondiscriminatory trade-liberalization negotiation system of the Doha Development Round with the conclusion of preferential trade agreements among small groups of countries may affect the other two pillars on which the WTO is built: its rule-making authority and its dispute settlement mechanism (DSM).[5]

With regard to the WTO's rule-making authority, if indeed the PTAs are the only game in town, then the broad templates established by big trading powers like the EU in agreements with economically weaker countries will increasingly carry the day. Whereas big emerging economies like Brazil, China, India, and South Africa were able to insist on rejecting additional demands (that is, extending beyond conventional trade issues to areas like labor and environmental standards) when made as part of the multilateral Doha round, the EU and the United States may more effectively push for including such issues in bilateral negotiations. In their public relations campaigns, both the EU and the United States are selling their deep and comprehensive agreements (e.g., with Ukraine) and high standard agreements (for instance, the Trans-Pacific Partnership) as "trade agreements for the twenty-first century." Indeed, "who could possibly be against the twenty-first century?" Proponents of such agreements, however, maintain that the bilateral practice of the EU refines WTO rules and may even influence the development of special branches of international law.[6]

With respect to the dispute-settlement mechanism, the so-called pride of the WTO, the proponents of the new generation of FTAs contend that the DCFTA rules on arbitration "follow the letter and the spirit of the WTO Panel system to a very large degree."[7] Conversely, one can argue that the adjudication of disputes through the PTA-based dispute settlement mechanisms will reflect asymmetries of power that benefit the stronger trade partner, in particular, because the economically weaker countries will have little bargaining leverage.

As Bhagwati has argued, the way forward can be found by going back to basics. In the interest of an impartial and binding multilateral trade system, and in the absence of EU or U.S. leadership, a coalition of emerging economies like Brazil, China, and South Africa and industrialized countries such as Australia and Japan should engage in plurilateral trade liberalization talks with each other. The agreement should remain faithful to WTO objectives, focus on important trade issues (e.g., agricultural protection), rely on the dispute settlement mechanism established by the WTO, and remain open to other WTO members wishing to join in the future. Efforts toward more ambitious goals for trade liberalization should only be undertaken once the main stumbling blocks to system-wide rules have been cleared. Through its power of attraction, such a plurilateral agreement would widen the geographical remit in which WTO-compliant free trade rules are applied. If the EU is serious about pursuing a twin-track approach toward the removal of tariff and nontariff barriers, then it should complement its current strategy of enhanced bilateralism by embracing plurilateral efforts at trade negotiations by others.

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Managing and Containing the Senkaku Islands Dispute

Yasushi Kudo
Genron NPO

The dispute over the Senkaku (Diaoyu in Chinese) Islands is becoming a source of grave conflict between Japan and China. Achieving a peaceful solution to it is critical to Asia and to the rest of the world. There is real concern that a conflict between Japan and China would have a significant effect on peace and development in the region and decisive influence on the world economy. If a conflict should arise, the immediate and pressing challenge would be to manage and isolate the dispute from Japan-China relations more broadly.

The official position of the Japanese government is that the Senkaku Islands are under the effective control of Japan and, as a result, there is no issue of territorial sovereignty. While it is true that the islands are under the valid control of the Japanese government, it is debatable that there has never been an issue of territorial sovereignty. If China insists on the legitimacy of its sovereignty claim, it should take the case to the International Court of Justice. Seeking a peaceful solution to such territorial disputes on the basis of international law should be a fundamental and universal rule. Should China take the case to the International Court of Justice, Japan should comply with the proposal by changing its conventional position. However, it is not likely that China will do so.

Recently, the Genron NPO conducted a survey on the Senkaku Islands dispute among a population of five hundred Japanese opinion leaders. Only 20 percent of the respondents welcomed the government's purchase of the islands, and slightly more than 50 percent supported the government's decision. In addition, 40 percent did not believe that the dispute would be resolved through bilateral negotiations. Finally, approximately 60 percent were pessimistic about an immediate solution and suggested that Japan's priority should be to improve bilateral relations and avoid any military clashes.

The survey findings represent the consensus view among Japan's opinion leaders. What needs to be asked now is not how to resolve the territorial issue, but how to contain the dispute without sparking a military clash.

The latest territorial row between Japan and China was triggered by the Japanese government's purchase of the Senkaku Islands. The purchase was not in and of itself an illegal act. Its timing, however, is another matter. Japan would have been better advised to have explained its reasons to China carefully and diplomatically beforehand. On September 11, Japan decided to purchase the islands—only two days after an Asia-Pacific Economic Cooperation (APEC) meeting, during which Chinese president Hu Jintao lodged a direct protest with Japanese prime minister Yoshihiko Noda over the proposal. Given the imminent change of the top Chinese leadership, it may have been imprudent to purchase the islands at the time, but circumstances described below led to this decision. Before and during World War II, the Senkaku Islands were privately owned. After the U.S. reversion of the administrative rights over the islands to Japan, the Japanese government leased the islands from the owner to ensure long-term, peaceful, and stable management. Apparently for economic reasons, the owner indicated an intention to sell, prompting the former—and outspoken—governor of Tokyo, Shintaro Ishihara, to declare in early 2012 that the Tokyo Metropolitan Government would purchase three of the islands. One billion yen was donated to the Tokyo government from private citizens to fund the planned purchase.

The national government was unable to block the governor's planned purchase of the islands, which is an ordinary transaction of property under domestic law. As a result, the Japanese government had no option but to buy the islands. This purchase neither nullifies private ownership nor enhances government control, so it would not be an overt act of nationalization. Unfortunately, however, the confrontation is what many nationalists in both China and Japan have anxiously anticipated.

The Senkaku Islands have been under Japan's effective control since the nineteenth century. The islands have been marked on Chinese maps as a part of the Ryukyu chain since 1970. In 1971, the Chinese government began to question sovereignty of the islands. Administrative rights were returned to Japan in 1972 by the United States at the time of Okinawa's reversion. In the process of normalizing Japan-China diplomatic relations in 1972, this territorial issue was virtually shelved. Although the Japanese government does not acknowledge it as an official diplomatic agreement, at the time the top Chinese leaders offered to leave the matter to future generations. Their Japanese counterparts accepted the offer in a posture of benign neglect.

From the beginning, the settlement of the issue was difficult for Japanese and Chinese citizens to understand. In both countries, the governments attempted to quell public discontent by glossing over the territorial dispute issue. In the wake of the latest confrontation, however, many have become aware of the dispute, exacerbating tensions between the two countries. The subtle agreement is beginning to collapse.

In 1992, China enacted a territorial waters law asserting that both the Diaoyu (Senkaku) Islands and the disputed island chains in the South China Sea were Chinese territory. By 2010, emerging as an economic and military superpower, China began to take provocative measures against Japan. In one such incident, a Chinese fishing vessel hit two Japanese patrol ships inside Japanese territorial waters near the Senkaku Islands.

Every year, the Genron NPO carries out a joint opinion survey on Chinese and Japanese attitudes on bilateral ties with the other country. As anticipated, Japanese perception of China reached a nadir in this year's poll. Against such a backdrop, anti-China nationalistic sentiment in Japan has been surging as well.

In reaction to the Japanese government's purchase of the islands, the Chinese government drew new territorial markers, or baselines, around the Senkaku Islands and submitted them to the United Nations. In waters surrounding the islands, Chinese law enforcement vessels constantly square off with Japanese coast guard patrol boats. The stark reality is that a territorial dispute is developing between Japan and China, and there is a real risk it could develop into a military clash.

In light of the imminent leadership changes in both countries, new moves to forge a breakthrough in the stalemate may emerge. In Japan, a general election is expected to be called in the near future, leading to a change in the prime minister. Both countries, however, would be well advised to promptly begin bilateral consultations on the matter.

One concern is the lack of a maritime contact mechanism between the two governments to avert an accidental incident in the ocean (China is apparently refusing to sign the document). Another and perhaps more serious concern is the grave economic repercussions should the stalemate continue. Mobs have attacked Japanese enterprises in China, and there is an ongoing boycott campaign against Japanese products, including automobiles. The negative effect on trade is undeniable. Today, the Chinese economy is slowing in the wake of the financial crisis in the eurozone. At the same time, long-term capital investment in China is sustained by an increase in Japanese investment, although many Japanese businesses are reviewing their Chinese investment policies.

Should the stalemate continue or, in a worst-case scenario, Japan and China clash militarily, the Asian economy and the world economy would suffer grave repercussions. To avoid such a critical situation, the Japanese government should enter into consultations with the Chinese government without preconditions. In any territorial dispute, the party that desires to change the status quo should avoid the use of physical force and refrain from provocative actions. The party that maintains effective control of the disputed area should also accede to the other party's demand for talks without conditions. At the same time, the parties involved should reach accords to avert unnecessary clashes and manage the risks involved. They should explore the wisdom in preventing the dispute from negatively affecting relations as a whole.

Such talks might not generate a direct breakthrough in the deadlock, but they are a necessary step for the containment of the Senkaku dispute. To overcome diverse difficulties associated with consultations of this kind, it is important to emphasize the necessity of involving private sector dialogue at the level of Track 2 diplomacy. The Genron NPO maintains a high-level private sector channel of dialogue called the Tokyo-Beijing Forum, which falls in the category of Track 1.5 diplomacy.

In July 2012, the eighth annual meeting of the Tokyo-Beijing Forum was held in Tokyo. There, one hundred Japanese and Chinese analysts reached an important consensus on the Senkaku issue—the first of its kind. The agreement is called the Tokyo Consensus, and it focuses on managing the Senkaku issue to prevent the territorial conflict from increasing nationalism and to control clashes over the disputed islands. To this end, it was agreed to start a public and open debate on the issue and set up a forum attended by experts.

Now that the actuality of the dispute has been brought into full public awareness, the aim should remain finding a clear and tangible solution.

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Stabilizing the Global Financial System

Igor Yurgens
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The long-held perceptions about the sustainability of economic success are now questioned in light of the serious problems looming over the global economy. The indisputable result of the Asian "economic miracles"—more equitable distribution of global gross domestic product (GDP) as Asia returns to the position it held before the industrial revolution—could be undermined by a new wave of technology, including nanotechnology, information technology, biotechnology, solar energy, nuclear energy, composites, and shape-memory alloys. This wave is emerging in developed economies and is capable of inducing a large-scale devaluation of assets, particularly industrial assets.

Without a doubt, the most successful Asian economies are intertwined in the global chain of producing goods, rendering services, and facilitating delivery. It follows that the massive diffusion of innovations will also reach this region. However, there is also good reason to question the extent of this diffusion; the global chain is formed by the relative competitive advantages of particular countries and regulatory arbitrage, that is, the difference in the level of comfort of countries' respective business climates.

However, certain limiting factors begin to play a role here: progressive urbanization leading to higher labor costs; an aging population; substantial increases in social expenditures (e.g., pensions and health care); and elimination of preferential incentives for foreign investment (in China, for example, during the height of the global crisis a decision was made to levy identical taxes for domestic and foreign companies). At the same time, a new institutional environment appropriate for the knowledge-based economy of the future requires not so much expansion of state investment as profound structural reforms both in economies and in political systems.

One of the main causes of this reexamination of Asian risks is the clear sign of exhaustion of the long-term potential of the Chinese economic model. This conclusion was put forward in a World Bank report released in early 2012, and events over the course of the year only reinforced this outlook. Growth is approaching the stated target of 7.5 percent, which is the lowest level witnessed in twenty-two years.

The next round of reassessment of values, sparked by the need to transition to an economic model with an emphasis on domestic demand, will evidently begin following the change in Chinese leadership in the coming months. However, this path to a new model will be more difficult and carry greater social and political risks than previously imagined.

All major Asian economies will have to face the problems that will inevitably arise during the transition to a new development model. In addition to national specifics, all countries face common challenges, including a growing deficit of drinking water, inadequate food resources, low living standards (one in six Asians lives in the slums), and underdeveloped education and health-care systems.

At the same time, countries are showing a propensity toward continuing existing economic policy by other means—from periodic outbursts of patriotic nationalism to projecting gunboat diplomacy 2.0 (as in the island and resource disputes in the South China Sea and East China Sea). It seems that such phenomena are becoming predictable side effects of state-capitalist Asian economies expanding in influence, which only increases the need for new collective security initiatives in the region.

In economic and financial analysis, globalization has been broadly defined as the competition between market and state institutions. On the one hand, an important feature of this process is the growing diversity of institutions—including regulatory regimes and mechanisms—within certain countries. On the other, there is also a trend toward standardization of business practices and development of common rules for the behavior of governments and monetary authorities with the aim of not disrupting the equality of conditions in the global competitive environment. This has become the main focus of international economic coordination, which has grown much more intensive in recent years.

These efforts have resulted in widespread recognition that the resolution of the financial problems accumulating in national economies and integration alliances is a fundamental element of fair competition in the global economy. This resolution is also closely linked with the rebalancing of global demand. Such rebalancing is increasingly becoming the driver of transformation in the economic models of Asian countries.

A consensus on rebalancing has already been articulated in many documents of the Group of Twenty (G20), Financial Stability Board, and International Monetary Fund (IMF). The APEC countries are, as a group, also making a contribution. For example, the joint statement from the APEC financial ministerial meeting this summer declares: "We agree to intensify our efforts to implement reforms to bolster financial sector stability. We remain committed to reducing imbalances by strengthening deficit economies' public finances with sound and sustainable policies that take into account evolving economic conditions and, in economies with large current account surpluses, by strengthening domestic demand and moving toward greater exchange rate flexibility."

This statement implies that the developed APEC countries, primarily the United States and Japan, should develop and put forward urbi et orbi budget consolidations plans for the medium term that would stabilize expectations for their economic policies.

As far as the emerging market countries of Asia (China, India, Indonesia, Malaysia, and the Philippines) are concerned, their tasks are the adoption of tax, budgetary, and other stimulus measures aimed at boosting domestic demand, the formation of market-based currency exchange systems reinforcing motivation for open trade, and dampening appetite for various types of protectionism.

APEC economies are also cooperating in a number of other areas in the economic sphere. Poor budget discipline in many countries gave rise to the need to monitor, on an ongoing basis, the contingent commitments of governments—in particular, the state guarantees extended to major banks and financial organizations. The decision to monitor private debt and agree on preventive measures to keep it below the red line was also important. Prospects are also good for cooperation in such areas as the modernization of treasury systems, the implementation of national programs, and projects to boost financial literacy.

Fundamental progress has been made in the collective management of financial risks. At the APEC summit, a decision was made to develop and adopt guidelines for responses from financial authorities to natural disasters as a part of integrated risk management policies. These policies would focus on planning and preparation by financial authorities, including the maintenance of effective and resilient payment systems and, where appropriate, the introduction or expansion of risk-sharing and risk-transfer market products. It seems reasonable that the mechanisms in this area could also be applied in other areas.

All of this, however, represents just the first small step toward identifying the profound financial imbalances of Asian economies and controlling their dynamics. Transformation in the substance of economic development models harbors new risks. For example, according to the Asian Development Bank, the infrastructure financing needs of Asian APEC countries over the next ten years reach $55 trillion. Considering these obligations, the question arises as to where to find sources of financing for economic growth.

Seeing that the origins of the financial crisis were rooted in imbalances in the financial sectors of developed countries, it follows that institutions of international economic coordination—the G20, above all—should focus their attention primarily on these countries. At the same time, as the world witnesses a global economic slowdown, which could include a recession in the eurozone, developing countries also have their own areas of responsibility.

The broadest area of responsibility is in the Asian region, where state-capitalist countries have evidently passed the point of no return in their transformations. Their risks—financial and otherwise—will assume an increasingly global dimension moving forward, which clearly should be reflected in the revision of formats and approaches to effective risk management under the collective economic leadership of the G20. The principle of equal treatment should be applied to all potential sources of instability in the global economy without exception.

Igor Yurgens is executive chairman of the Institute for Contemporary Development (INSOR).

Endnotes

1. European Commission, "Trade, Growth, and World Affairs: Trade Policy as a Core Component of the EU's 2020 Strategy," November 2010.
2. Data available at http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Extra-EU_trade_in_goods. See also Robert Schuman Foundation, interview with Karel De Gucht, European commissioner for trade, September 17, 2012.
3. So far, the Association Agreement with Central America (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama) is the EU's only region-to-region association agreement that relies on three mutually reinforcing pillars, namely political dialogue, cooperation, and a trade agreement. The European Parliament gave its backing to the agreement on December 11, 2012.
4. An agreement with Korea has already entered into force; negotiations on an FTA with Singapore have recently been concluded.
5. Jagdish N. Bhagwati, "The Broken Legs of Global Trade," *Project Syndicate*, May 29, 2012.
6. See, for example, F. Hoffmeister, "The Deep and Comprehensive Free Trade Agreements of the European Union: Concept and Challenges," in T. Takács and D. Kleimann, *Trade Liberalisation and Standardisation: New Directions in the "Low Politics" of EU Foreign Policy*, Joint EUI-CLEER working paper, forthcoming.
7. Ibid.