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China in the world economy: the FTA strategy

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China made a huge international and domestic effort in multilateral trade liberalisation in the years leading up to its accession to the WTO in 2001. It is therefore at first surprising that China is now engaged in a vigorous strategy of using Free Trade Agreements. The sharp turnaround is in response to perceptions in the Chinese leadership that other Asia Pacific economies were moving away from most favoured nation commitments.

At the end of 2001, China and ASEAN reached an agreement on a framework to establish a free trade area and have agreed on a tariff elimination program which includes agriculture products in the early harvest component and which could begin as early as 2003.

In June 2003, China and Hong Kong signed a Closer Economic Partnership Agreement which gives Hong Kong manufacturers duty free access in a large number of tariff lines in China and gives Hong Kong-incorporated services producers levels of access which exceed China's WTO commitments.^{1 2}

China joined the WTO at the end of 2001. China's strong growth over the last few years has been attributed in part to accession, to the liberalisation associated with it, and to its contribution to attracting foreign capital to China.

What extra does China hope to gain from the FTA route to reform? Political considerations may have influenced thinking among the Chinese leadership about the change in their trade policy portfolio.

Drysdale (2002) suggests that the ASEAN economies feared being crowded out by China's growth, a fear which could have been exaggerated by accession to the WTO. In the face of these uncertainties, China offered the FTA as way of providing some reassurance and as a vehicle for cooperation. Whether it does help resolve the uncertainties perceived in ASEAN is a question examined later.

The possibility of gains from preferential access by Chinese manufacturers into ASEAN markets may have been another motivation. From an ASEAN point of view, access to China's markets for raw materials or energy as well as manufactures could have been attractive. A free trade agreement involving all these economies, Zhang (2003) suggests, would also make the whole region more attractive to foreign investors—ASEAN members had been concerned about the effect of China's WTO entry on patterns of FDI flows.

According to some views, the reform program in ASEAN would also benefit from an FTA with China. The argument is that an agreement with China would accelerate ASEAN's own integration (the mechanism for this process is discussed in more detail below).

Zhang (2003) suggests that an agreement between China and ASEAN would hasten the efforts by Japan and Korea to form their own bilateral agreements with ASEAN, and push China, Korea and Japan themselves to make further progress on their own arrangements. A China–ASEAN FTA would therefore contribute to the building of agreements which can contribute to region wide cooperation. This process is similar to that of 'competitive liberalisation' promoted by US officials.

Zhang (2003) explains that a new interest in building regional cooperation emerged after the East Asian financial crisis. Drysdale (2002), in a similar vein, notes that another influence maybe the region's reaction to the role played by the United States in response to the crisis. Other factors he stresses that were driving new interest in smaller group regional cooperation in East Asia were the loss of faith in APEC's capacity to deal with the problems of that time and the failure to launch a new round of trade negotiations in the WTO at the Ministerial Meeting in Seattle.

Zhang (2003) attributes the first 'ASEAN plus three' meeting to this interest. Zhang stresses what he calls the vulnerability of market-based integration. He argues that the interest in a more formal institutional arrangement follows rationally from this concern but also from their emergence in Europe and the Americas.

The ASEAN plus three arrangement 'provides a framework for demonstrating East Asian leadership and influence on regional and international affairs' (Drysdale

2002:141). Zhang (2003) is more specific. He refers to the ASEAN plus three agenda as, in addition to the establishment of an East Asian Free Trade Area, cooperation on macroeconomic policy and financial market strengthening, joint action on the provision of regional public goods. He refers to common challenges such as drug trafficking, piracy, illegal migration, environmental disasters, money laundering, international terrorism and other trans-boundary issues. Beyond these topics, there might be interaction in relation to defence and military affairs but that cooperation involves an even longer time horizon.

The FTA strategy is designed, from this perspective, to contribute to China's capacity to 'form at some point a counter power comparable to the United States and Europe by unifying Asian countries'. It is interpreted as part of an attempt by China to build a 'strategic partnership' with ASEAN which could be used to 'work closely on regional and international issues'.³ Whether the FTA component is actually required to achieve this goal is a question of interest.

Zhang (2003) also notes that other tensions within East Asia and other commitments in relation to security would inhibit the institutional integration process. He stresses that it is too early for China to consider a full East Asian arrangement, given that China is, in his view, not ready to negotiate an agreement with Japan or Korea, and given that the region cannot confront the issues that would arise from the treatment of Taiwan in a larger arrangement. So the agenda in the immediate term is actually a sub-regional one, with the focus on China and ASEAN. Whether an agreement of that scope contributes to East Asian regional interests is a further question of interest.

The trade and investment policy related components of the arrangements are seen as complementary to the interest in cooperation in the other fields. Cooperation starts in the economic area and spreads to other areas in this model. Zhang (2003:11) refers also to 'competitive regional cooperation' in which smaller groups of members in the region sign agreements which then 'help set up the legal foundation for regional institutional building'. These remarks highlight the view that a new legal and institutional framework is required to avoid the uncertainties of market-based integration.

What are the economic issues associated with the use of the FTA option, including its feedback onto the progress of the Doha Round? Does an FTA help resolve the uncertainties perceived in ASEAN about the emergence of China? Is an FTA component required to build institutions for cooperation on the provision of regional

public goods? What are the interests of China's trading partners in the Western Pacific in China's own strategic choices? These and other questions of interest are discussed in this chapter.

ISSUES

Two sets of issues are reviewed—one related to the structure of trade and the other the analysis of the dynamics of the competitive use of Free Trade Agreements.

Production networks

Garnaut and Findlay (2003), drawing on the Pacific Economic Cooperation Council's Pacific Economic Outlook (PEO) report,⁴ note that East Asia is again becoming increasingly interdependent in trade and growth. It was affected less by the international economic slowdown of 2001–02 than other world regions, with both exports and imports growing reasonably strongly in 2002. The period from mid 1980s through to the mid 1990s was characterised by increasing levels of regional integration. This period of growth in East Asian interdependence was driven by economic growth and structural change in Japan, supported by mutually reinforcing economic growth and trade liberalisation throughout the Western Pacific. The trend towards integration was broken temporarily by booming US markets in the mid and late 1990s. But now that earlier trend has been reinstated and is being driven by China's reform and growth.

There has been considerable relocation of the increment in production capacity to China from other economies which are losing competitiveness in labour-intensive manufacturing processes. This has created rapid growth in intermediate as well as final product exports to China.

Complex supply chains are likely to continue to change their character. New suppliers emerge to take over the positions vacated when established suppliers lose competitiveness in their original production and move to new niches. The transition of market shares supports the competitiveness of the region as a whole. The process of industrial restructuring associated with growth and changes in comparative advantage is a familiar theme in the literature on East Asian development.⁵

The risk is that the introduction of bilateral FTAs will retard the adjustment process. Sourcing may be diverted to institutionally preferred and away from commercially efficient partners. New suppliers may not have the opportunity to establish their market shares for either domestic market sales or re-export.⁶ This could be a special problem for the new members of ASEAN.

Another interpretation of the growth of intra-regional trade is that East Asia is now more 'self reliant'. This is used as a further argument in favour of regional and preferential free trade arrangements (since the risk of diversion is smaller if trading relationships are already intense). Athukorala (2003) also notes the growth of regional trade but separates out the contribution of component trade from that associated with the demand for final products. He stresses that the fragmentation of the supply chain leads to growth in trade of components. He concludes that the data he examines show that

in a context where fragmentation based trade is expanding rapidly, the standard trade flows analysis can lead to misleading inferences regarding the ongoing process of economic integration through trade. When data on assembly trade are excluded from trade flows, our estimates suggest that extra-regional trade is much more important than intra-regional trade for continued growth dynamism of East Asia, both including and excluding Japan. Thus, the ongoing process of product fragmentation seems to have strengthened the case for a global, rather than a regional, approach to trade and investment policy making (Athukorala 2003:n.p.).

Athukorala (2003) also reports data which reinforce earlier observations about the importance of world markets for China's growth and, by extension, continuing reform. He reports that exports to North America and the European Union accounted for about 41 per cent of China's manufactured exports in 2000, up from 34 per cent five years earlier. China's share of exports to East Asia fell over that period. Access to markets in the rest of the world continue, therefore, to be a priority goal for China. These data support the observation made by Drysdale that over time, while China will most likely become more important to its East Asian neighbours as a destination for exports, they will become less important to China as it 'extends its global reach' (2002:143). Like Athukorala, Drysdale takes the point from this observation that 'the protection of the WTO framework, and open regional arrangements, will assume far greater importance to China's partners in East Asia...' (2002:143).

The diversionary effects of free trade agreements are also important in markets for services. A free trade agreement has the effect of applying a particular sequence to the entry into markets for services. The first entrants may not be the world's most competitive suppliers but, once they are established, it becomes difficult to force them to exit the market, even if market access is made available on a non-preferential basis. This is because of the advantages of incumbency in services markets. The competitiveness of the rest of the economy suffers because of this effect of using FTAs to manage the sequence of entry.

Another feature of China's position in regional production networks is the value of China's WTO commitments leading to benchmarking of bureaucratic processes against global standards. As a result of accession, China has rewritten large amounts of legal and regulatory documents to match expectations of other WTO members. Areas covered include customs procedures, quarantine, regulation affecting the service sector and government procurement. To add another layer of complexity to this new structure would be to discard one of the most important benefits of accession. The extra layer of rules required to implement preferential arrangements would add to the potential for bureaucratic discretion. Greater degrees of complexity and higher risks associated with bureaucratic discretion are not outcomes that international business wants in China.

Dynamics of the competitive use of FTAs

The other major trading partners of ASEAN have taken their own initiatives for regional cooperation. Japan has stepped up its expressions of interest in agreements with ASEAN members. Findlay et al. (2003) note that Japan appears to be giving higher priority to bilateral free trade agreements with individual ASEAN countries. In the APEC meetings in Los Cabos in 2002, President Bush announced the Enterprise for ASEAN initiative. India is also currently negotiating a framework agreement for a free trade area with ASEAN along the same lines as China, although the sectoral coverage is not expected to be as comprehensive. The European Union has approached ASEAN on the possibility of regional cooperation, although it is not clear what form it will take.

Individual ASEAN members are also negotiating bilaterally with trading partners. The more extensive interest in this effort in East Asia has been led by the shift in attitude in Japan and Singapore and to their Economic Partnership Agreement. Singapore's agreement with New Zealand was also an important prompt for action by others. Australia too is an active participant, and has just concluded an FTA with Singapore. Thailand is following Singapore's lead and is aggressively pursuing a parallel bilateral approach including separate negotiations with China, Japan and Australia. Malaysia, in a significant shift in policy, has started talks with Japan.

The dynamic process of the independent use of FTAs is well underway. While no agreements of economic significance have been signed as yet, China's participation adds to the range of activity and the intensity of effort.

How might that process evolve? Is it automatic that the agreements made separately between members of a region will be sufficiently consistent to build to a region-wide arrangement? There are risks that this will not happen. The sectoral coverage of agreements is not likely to be consistent, given the variation in the sensitivity of various sectors. Rules of origin are likely to vary between agreements. Agreement up-front on consistency of rules is difficult to achieve in small group negotiations where the stakes are low.

The political economy effects are also complicated (Findlay et al. (2003) discuss these factors in more detail). The construction of regional agreements creates new interest groups that gain from preferential access to foreign markets. These groups may resist the extension of concessions to other economies, either in new FTAs or via the WTO negotiations. The dynamic effects within the FTA model are in other words uncertain and may undermine the political economy processes which are vital to success in the WTO process.

ASEAN responses⁷

Findlay et al. (2003) ask whether the extensive use of FTAs is a threat or opportunity for ASEAN. If ASEAN capitalises on this situation and becomes the hub of this set of agreements, it might be able to go even further and consolidate the regional agreements into one and so lead the response in the Western Pacific to any FTA development in the other hemisphere.

The problem is that ASEAN members may instead become the spokes rather than ASEAN as a whole being the hub. This can happen because of differences in sectoral coverage of agreements and differences in rules of origin. China (the hub) is a better choice of location for foreign investors than the spokes, since market access and sourcing is guaranteed with each spoke. Being located in a spoke provides less coverage. So one of the ASEAN's original motivations for stepping into this process with China would not be met, and China's relative competitiveness as a host for FDI might actually be even higher!

ASEAN is working on the specification of a new ASEAN Economic Community (AEC). The AEC can be seen as an attempt to maintain a coordinated approach to reform in the face of the risks posed by the hub and spoke structure with China. This is an example of the mechanism by which the agreement with China actually accelerates reform in ASEAN as a whole. Further assessment of the likelihood of that outcome will be possible after the Bali Summit of ASEAN Leaders later in

2003. In the meantime, the vigorous and independent pursuit of trade agreements with China by individual members suggests that the risks remain high.

What are the implications of lack of cohesion for ASEAN as a whole and its capacity to deal with the other issues on its agenda, including the provision of regional public goods?

The provision of goods or services in which all members of a region have a common interest involves cooperation between those affected, but usually hinges on a leadership role being played by one or a sub-group of members. They do so because they reap a larger share of the benefits and, according to this assessment, they are willing to bear a larger share of the costs. Economies taking that decision are more likely to contribute in this way if they understand that in other closely related matters they will have the opportunity to ride on the contributions of others. The right agenda of activities supports the contribution of the package of activities, whereas the isolated treatment of any one issue may fail to yield a result.

Success in cooperation on these issues depends on a common understanding of the scope of the relevant agenda, and on a continuing discussion to refine that agenda. It also depends on the expectation that on different occasions various members will step into the leadership role so that over time, for any one member of the group, the benefits are more likely to exceed the costs of membership. It depends in other words on the development of trust in this behaviour by others. That trust is the basis of a grand bargain on regional economic cooperation.

ASEAN may not be exactly the right membership for any one issue of this type. Some may be dealt with effectively by smaller groups. Others require wider participation. But the proximity of ASEAN members, as well as common use of sea and air space, suggest that for many issues the membership is relevant.

A group like ASEAN is more likely to maintain its cohesion for these purposes when members commit not to take independent actions as a result of which other members incur a cost. The willingness of any one member to consider such an action could also lead others to question the commitment of that economy to the 'grand bargain'.

The FTA approach has been incorporated into this agenda of economic policy cooperation in the region. It may or may not generate benefits for the two parties involved, but it challenges the conditions for successful regional cooperation involving a larger group. The uncoordinated use of FTAs diverts trade and investment from non-members. It is not adding value from all members' points of view but instead

imposes a cost on others. The willingness to adopt an independent approach to trade and investment policy may also affect the perceptions of members of the group about their ability to work together on other issues. It is not clear, therefore, that the FTA agenda will contribute to the capacity of the group to continue to commit to the agenda of cooperation.

Benefits from cooperation among the ASEAN economies are not confined to those economies. Work on piracy or terrorism or public health for example benefits others trading partners, including China. While China may have some other short term economic interests in fragmentation in ASEAN, as noted above, China too may also lose from a diminished capacity of ASEAN to continue to produce regional public goods.

Reactions by other economies

China and ASEAN are not the only relevant players in the FTA game. How will others react and how will their reactions affect the cooperation within ASEAN and feedback on the structure of agreements between China and ASEAN? Others will certainly react to the actions of such a big and growing economy, to avoid the risk of economic loss through the price effects of the diversion of trade. They may also be concerned about how to respond to the implications for them of any change in the political relationships between China and each of the ASEAN partners. Will the reactions of others take a form which offsets the challenges to ASEAN cohesion?

Findlay et al. (2003) note that the big economies in the Western Pacific could tussle to become the lead hub in the region. China would be the favourite to win that particular race. Japan currently has less to offer in terms of long-term market growth potential or as a host for FDI from relocating industry. The United States, indeed, may rank above Japan as a partner for ASEAN, particular as some members have established security ties with the United States. As Zhang (2003) notes, the development of a more specific institutional form of cooperation in East Asia may be constrained by these commitments with the United States.

Both the United States and Japan have taken their own FTA-related initiatives in East Asia, not with China, but with individual ASEAN countries. As noted above, Japan appears to be seeking a series of bilateral agreements that will give it the capacity to isolate its own sensitive sectors from the agreements.

In the Enterprise for ASEAN initiative, the United States and individual ASEAN members will together determine if they are ready to launch FTA negotiations. The

United States expects potential FTA partners to be members of the WTO already (which excludes Cambodia, Laos and Vietnam) and to have concluded a Trade and Investment Framework Agreement (TIFA) with the United States (already in place for Indonesia, the Philippines, Brunei and Thailand). On 19 November 2002, the United States reached agreement with Singapore.

Japan and the United States therefore appear set to react to China's initiative, but to do so by signing separate agreements with individual ASEAN members. Apparently their actions are not a force for consolidation in ASEAN.

TWO PATHS

As noted, the downside risks in the scenarios examined here are largest with ASEAN. There are however also some risks for China in the fragmentation of the trading system, which in the short term means lack of progress in the Doha Round. There are also challenges for other economies with economic and political interests in the region, Japan in particular but also the United States.

Leadership by either ASEAN or China, not just with respect to agreements between them but with others in East Asia, could help solve the problem. However the dilemma is that the FTA strategy itself has weakened the capacity of ASEAN members to cooperate to avoid the risks that it poses. The weight of expectation is therefore placed more firmly on China but it too faces constraints on playing that role.

There are two tracks to resolving these issues, one within the institutional approach to regional cooperation and other involving a rediscovery of the market based approach.

The option which maintains the focus on formal institution building would be to strengthen the rules. This could involve seeking to specify what is meant by a 'good' FTA—that is, what constitutes a well-designed regional arrangement which would maximise the benefits and minimise downside risks already outlined. This framework would then be used for all negotiations. Likely features would be comprehensive coverage, a clear and bold tariff reduction program, a commitment to apply (according to some timetable) the tariff cuts on a non-discriminatory basis, standard, liberal rules of origin, recognition of the importance of non-tariff barriers, and inclusion of the normally sensitive agriculture sector (even if not immediately but according to schedule).

The problem is that it is not clear that the political economy of small group negotiations supports the maintenance of a tight set of rules. The actual outcome

will more likely involve a hub and spoke structure, a series of agreements which do not mesh together, and a structure in which accession of new members stalls while interest in the WTO wanes. An 'ideal' agreement, including one with open accession, could be specified. Whether it can be implemented is not clear.

The alternative, even now that the FTA game is well underway, is to try to rediscover market-based integration. The key to that approach is an immediate commitment to apply any reductions in protection to all trading partners. An MFN application of reductions in tariffs would also remove the need to negotiate on rules of origin, compliance with which is likely to be the major source of higher transaction costs in the regional trading system. Coverage is also less of an issue (though on efficiency grounds a top-down approach is desirable). APEC principles of liberalisation are based on this approach.

This strategy is equivalent to a return to a market-based approach to regional integration. Commitments to reform under this approach are made at a global level in the WTO process. The relevant institutional structures for institutionalised cooperation on trade and investment policy lie in the WTO. New institutions at the regional level are not required for these purposes. Regional cooperation, both in APEC and at the level of smaller groups, is then designed to complement efforts at the global level. Issues are allocated to the best forum for consideration.

Meanwhile, patterns of trade and investment are worked out in market processes at the regional level. Business decisionmaking in a non-discriminatory rather than a preferential environment determines the patterns of trade and investment.

The expectations of leadership are greater on China. China could take such a position by confirming its interest in applying its tariff reduction schedule with ASEAN on an MFN basis. Application of cuts in all forms of protection as a result of regional arrangements on which basis is the best way to avoid the risks just described.

The market-based approach to cooperation on trade and investment does not rule out institutionalised cooperation on other matters. Those institutions may be specific to issues (for example, public health or the environment) or they may be established to run across a range of issues. The institution of 'ASEAN plus three' continues to play a role of projecting an East Asian position on current issues, especially with respect to cooperation on financial market development.

CONCLUSION

These issues are not just matters of concern for China and ASEAN but for all the Western Pacific economies, because of the intensity of the trading relationships between them and because of the features of the supply chain in which they are all connected.

The the weight of leadership on these issues is expected to lie with China. At the same time, there are constraints on the capacity of China to take that role, given its stage of development and, as Zhang (2003) notes, its position in relation to other economies in the region. The political constraints faced by China in combination with the common economic interests in a regional approach to managing the risks associated with the FTA route to reform all suggest cooperation among a wider group of economies. Drysdale (2002) explains the value of APEC to China in that context.

The immediate focus of that cooperation could be work in the Doha Round. This could include a willingness to work on common positions on issues of interest to other WTO members, investment for example. But most importantly it means that the application of any reductions in protection negotiated at a regional level would be made part of a package of MFN measures which would later be bound in the Doha Round. Work on the scope and detail of this agenda is the priority for cooperation in the rejuvenation of the market based approach to regional economic integration.

NOTES

- ¹ More detail on this agreement including the rules of origin applied to the services exports are available at www.tid.gov.hk/english.cepta
- ² The Australian press made much of the Australian Prime Minister's statement on a visit to China in July, 2003, that the Chinese government had agreed to examine the merits of discussions on an Australia-China Free Trade Agreement. However, there has been no public reference to this matter by a Chinese official or in the Chinese media.
- ³ Naoko Munakata from the Research Institute of Economy, Trade and Industry (RIETI) in Tokyo, quoted in the *Far Eastern Economic Review*, 17 July 2003, p. 29.
- ⁴ For more information on the PEO, see www.pacificeconomicoutlook.com

- ⁵ Findlay (2001) provides information on changes in the patterns of China's participation in world markets for labour-, capital- and technology-intensive products.
- ⁶ The significance of this effect also depends on the use of rebate schemes applied to intermediate products imported for re-export.
- ⁷ This section is based on Findlay, Hafiah and Pangestu (2003).

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