

Significance of China's FTAs/EPAs with Asian Neighbors

By KE Long



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The Chinese economy has been integrated into the global economy rapidly since its entry into the WTO in 2001. The Chinese government promised to open its market completely to foreign companies by the end of 2006. We find that the Chinese economy has been globalized much more than was expected.

Meanwhile, China approached ASEAN countries to create a framework for free trade agreements (FTAs). These countries promised that they would sign agreements to liberalize international trade and lower tariffs for imported goods to zero by 2010. Since then, Asian countries, including Japan and South Korea, have turned very active to create FTAs. Generally, it is considered that there are two backdrops against which Asian countries have changed their attitude about the issue.

First is the lesson learned from the 1997 Asian currency crisis. It taught us that we could not expect to sustain economic development only depending on exports to the United States. Second is the success story of the EU's integration. This has encouraged Asian countries to believe we can work together.

In Asia, most countries have been preparing to conclude FTAs or EPAs regionally. Regarding the Wall Street-originating financial crisis, regional economic integration and cooperation could be helpful to overcome the credit crunch that erupted in the United States and swept the global economy.

Here, I have to point out we are still facing some difficulties about the issue. For example, Japan, China and South Korea in Northeast Asia have not started to work together to create FTAs. Although Japan has provided a huge amount of ODA to East Asian countries, including China, over the past decades, it seems they still consider each other as rivals. How to create a partnership between these countries is therefore definitely and absolutely important. There are some conflicts in the region over natural resources like LNG and crude oil. Moreover, China and Japan are still arguing about the territorial rights to the "Senkaku" islands (Diaoyudao in China), while South Korea and Japan are clashing over the rights to "Takeshima" island (Dokdo in South Korea).

But here I want to say it is important to take the first step towards

regional cooperation. And main players should take leadership roles in this process.

1. FTA Not a Dilemma

At the start of the 1990s, the Cold War was over. Since then, the international economy has been globalized rapidly, and economic interdependence has been strengthened, especially in North America and Europe because of NAFTA and the EU. In the EU, the share of intraregional trade in the region's global trade has reached more than 60% because of regional integration, while in North America the share stands at around 50% because of the North American Free Trade Agreement.

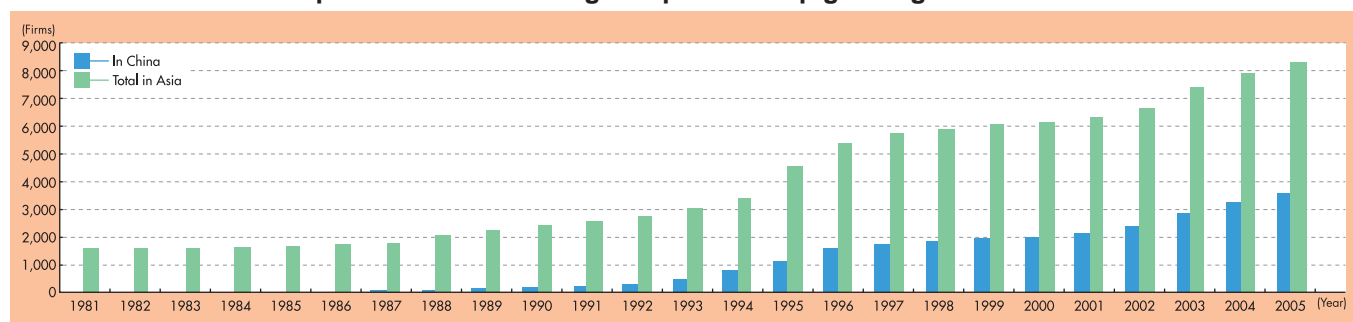
Actually, in Asia we also enjoy an increasing trend of intraregional trade, though we have not realized a regional FTA. The share of trade in this region going up to around 55% can be attributed to very active direct investment by Japanese firms over the past three decades (*Chart 1*). It is easy to see that Japanese conglomerates have established many factories in Asian countries. Eventually, they have concentrated parts manufacturers in China's coastal areas, and have established many assembly factories there. China supplies very cheap labor and high-quality distribution systems in Shenzhen, Shanghai, Qingdao, Tianjin and Dalian. As a result, we find there are many Japanese assembly factories in these big cities.

But here I must point out it is not enough that Asian intraregional trade has increased through direct investment by Japanese companies. The cost of international transactions under the current system is very expensive, and this means that regional trade is not productive and regional companies' competitiveness is limited.

We also find that protectionism in this region is still widespread. To block the import of foreign products such as automobiles, electronic products and even food, most Asian countries still levy tariffs ranging from 30% to 100% on foreign products.

Protectionism was supported in Asian countries because each country wanted to improve domestic industry development. And they were afraid of the impact from foreign products. In some ways protection-

CHART 1
Asian subsidiaries of Japanese manufacturing companies keep growing



Source: "White Paper on International Economy and Trade 2007" (METI, Japan)

ism is a kind of nationalism. But in a globalized era we cannot realize economic development without opening markets to foreign companies.

According to the classic “prisoners’ dilemma theory,” the arrested prisoners only can maximize benefits through cooperation, not “selling out.” Here is a detailed explanation of the game theory.

Two suspects are arrested by police. The police have insufficient evidence for a conviction, and, having separated both prisoners, visit each of them to offer the same deal. If one testifies (“defects”) for the prosecution against the other and the other remains silent, the betrayer goes free and the silent accomplice receives a full 10-year sentence. If both remain silent, they are sentenced to only six months in jail for a minor charge. If each betrays the other, each receives a five-year sentence. Each prisoner must choose to betray the other or to remain silent. Each one is assured that the other would not know about the betrayal before the end of the investigation.

How should the prisoners act? If we assume that each player prefers shorter sentences to longer ones, and that each gets no utility out of lowering the other player’s sentence, and there are no reputation effects from a player’s decision, then the prisoner’s dilemma forms a non-zero-sum game in which two players may each “cooperate” with or “defect” from (i.e., betray) the other player. In this game, as in all game theories, the only concern of each individual player (“prisoner”) is maximizing his/her own payoff, without any concern for the other player’s payoff. The unique equilibrium for this game is a Pareto-suboptimal solution — that is, a rational choice leads the two players to both “defect” even though each player’s individual reward would be greater if they both cooperated.

Now Japan and China are facing a dilemma. They cannot treat each other to maximize the benefit of international trade(Chart 2). That is to create an FTA framework as soon as possible.

CHART 2
The dilemma for Japan-China cooperation

Japan \ China	Cooperate	Defect
Cooperate	(20,20)	(0,30)
Defect	(30,0)	(10,10)

Source : Author

2. Hu Administration’s FTA Strategy

China entered into the WTO in 2001, and promised it would open its markets, including the financial sector, to foreign companies by the end of 2006. Such an open-door policy is considered to strengthen Chinese companies’ competitiveness and promote domestic economic system reform such as privatization of state-owned enterprises.

This open-door policy, however, impacted some industries such as agriculture and small and medium-size manufacturing because those industries and enterprises are not strong enough in global competition. Then we will ask why China still wanted to realize WTO membership and furthermore create FTAs with Asian countries. In 2001, former Premier Zhu Rongji announced efforts to create an FTA with ASEAN, and to build a common market regionally. In addition, China would cooperate with ASEAN to develop the Mekong River Delta to build an effective distribution system in the area.

In this way, 2001 was a significant year not only for China but also for the world, especially ASEAN. This was a turning point for China to become more active in working with its Asian neighbors. Also, the Chinese agriculture industry is still quite weak and is unable to compete with foreign companies. Zhu still promised to open the market to import fruit and other agricultural products from ASEAN

countries under an FTA framework. Of course, this does not mean there have been no opposition activities in China domestically. It is the importance of leadership that matters.

As a result of opening the market to foreign companies, the domestic agriculture industry has come to face some difficulties. For example, in some areas farmers go to cities to work in manufacturing industries instead of remaining in agriculture production because of its weak competitiveness. This movement has sent food prices up since the second half of 2007. To overcome these difficulties, the Chinese government decided to stop levying agriculture tax while also paying more than 50 billion yuan to farmers as subsidies. The goal is to encourage farmers to produce more products such as rice, corn and wheat. It is not a policy against foreign companies.

3. FTAs Could Sustain Regional Economic Growth

The world economy is facing a serious global financial crisis, perhaps the most serious crisis in 100 years. As a result, the world economy has slowed down since the first half of 2008, including the well-performing Chinese economy. According to the Chinese national statistic bureau’s report, the Chinese economic growth ratio peaked out at 11.9% in 2007 and dipped to 9.0% in the third quarter of 2008. And Japan could record 0.3% growth in 2008. South Korea is facing a serious recession, with its currency falling to the same level as 15 years ago.

The Asian economy is basically considered to be operating very well because of its good fundamentals. We experienced the currency crisis in 1997, but since then regional countries endeavored greatly to strengthen foreign reserves in order to overcome potential international payment risks. Now we have the largest foreign reserves ever, and we have created the Chiang Mai Initiative (CMI = a currency swap agreement by ASEAN+3) to address the international payment risks.

But here I have to point out that the CMI is a bilateral currency swap framework established in response to the 1997 currency crisis, and it will not function under the situation of the current global financial crisis. This crisis will not only damage the global financial system, but will fundamentally affect the real economy as well.

Fortunately we find that many countries in the region have started to discuss creating bilateral FTAs, the first step towards regional economic cooperation. China started to approach ASEAN countries to create FTAs in 2001. Japan has changed its attitude towards opening the domestic market to ASEAN countries in order to create an FTA framework.

Under the current situation, I want to recommend to all Asian countries the following: We must create a comprehensive economic cooperation framework not only concerning international trade, but also including the financial service sector as soon as possible. Meanwhile, we need to create a regional early-warning system for economic crises. Finally, we need to build a regional financial bond market to reallocate income regionally instead of investment in New York or London.

Personally, I believe that Asian countries can sustain economic growth in the coming years because we have the greatest potential market and the most advanced technology. In addition, we have most well-educated laborers who are supporting our manufacturing industries. The only weakness is our financial system. **JS**

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