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Introduction

CHINA'S INTERESTS IN APEC

ROSS GARNAUT, LIGANG SONG AND
PETER DRYSDALE

China's integration into the international economy since 1978 has presented an immense challenge for domestic and international economic policy, both in China and in its trading partners. China is so large that its trading interests and influence are global. But its interests and influence are disproportionately powerful in its immediate Western Pacific and Asia Pacific neighbourhoods. The evolution of China's economic relationships with its Asia Pacific partners, in which APEC came to play a significant role in the 1990s, is thus a central part of the story of China's rapidly growing and changing interaction with the global economy.

China's economic strategy and pattern of economic development was inward looking and isolated from the new currents of internationally-oriented growth that began to reshape the East Asian economies in the 1950s and 1960s. Sustained, internationally-oriented growth in Japan, Hong Kong, Singapore, Taiwan and Korea, and its beginnings in several of the ASEAN countries, was at first unconnected to Maoist China's emphasis on 'self-reliance', focus on capital-intensive development, and perception of foreign trade as an occasionally unfortunate necessity. The success of its East Asian neighbours and China's leaders' recognition of the adverse long-term strategic implications of economic under-performance were important influences on China's initially tentative steps towards greater contact with the international economy through the 1970s.

From the time of the Chinese Communist Party's commitment to reform and opening to the outside world in December 1978, the international orientation of Chinese economic strategy and policy was unequivocal. Expanding foreign trade was an integral part of development strategy. Loans from OECD governments and capital markets, development assistance from OECD governments and direct foreign investments from and into the OECD economies were allowed, and grew rapidly. Growth in output, trade and foreign investment was on average stronger than in any other substantial economy, with China emerging by the late 1990s as by far the world's largest trading economy and recipient of direct foreign investment amongst developing economies.

There was no blueprint for the new economic policy from 1978. Internationally-oriented reform became a practical matter of observing what

others were doing, experimenting with reform within China, and quickly deepening and widening the application of reforms that contributed positively to Chinese development. Interaction with Asia Pacific neighbours, especially in the Pacific Economic Cooperation Council (PECC) from the mid-1980s and APEC from the early 1990s, became an influential source of ideas, examples, and encouragement to political commitment.

There were always doubts about the open strategies in China. These had mainly ideological origins at first, as the strategy of internationally-oriented growth relying heavily on markets, associated with senior leader Deng Xiaoping, struggled with older Maoist commitments to self reliance. The success of the new policies in delivering economic growth, rising living standards and international *gravitas* became the decisive influences in the contest of ideologies.

By the early 1990s, the doubts about and resistances to China's deepening integration into the international economy were no longer mainly ideological, and were more familiar to people from other places, including the advanced capitalist economies of the West. There were familiar anxieties about the effects of structural change on employment and income distribution, and about the reliability of access to international markets.

China's size made the latter concerns acute. The internationalisation of the Chinese economy might be expected eventually to force larger structural change in the rest of the world than had been the case with Japanese growth in the 1960s or the newly industrialising economies in the 1970s and 1980s, and these developments had prompted important protectionist responses in the United States and Europe. Would not the reactions to China's internationally-oriented growth be even larger and more damaging, leaving China vulnerable to the political decisions of other countries? Concerns along these lines were reinforced by the increasing overlay of concerns about China's increasing strategic weight in American discussion of trade policy through the 1990s.

China's participation in the discussion of Asia Pacific economic cooperation was therefore a source of ideas and reassurance on policy, of practical examples of its implementation, and potentially of insurance against damage from foreign political responses to the expansion of China's economic relations with the rest of the world. The higher echelons of the Chinese political system focused on the emerging discussion of Asia Pacific economic cooperation through the academic exchanges between the Australian National University and the Chinese Academy of Social Sciences from 1979. China, with Chinese Taipei, was invited to the plenary session of the first PECC (then Pacific Community) conference at the Australian National University in 1980. China became a full member of the PECC in 1986 under a formula that allowed full membership by Taiwan as Chinese Taipei. Australian and Chinese officials were engaged in discussion of Chinese participation in the first APEC meeting when the declaration of martial

law on 19 May, 1989 and the tragedy of 4 June, disrupted China's official relations with the international community. A formula within which APEC officials met as economies and not countries allowed full membership by China and Chinese Taipei from 1991, in time for China's participation in APEC leaders' meetings from their inauguration in 1993.

China's participation in APEC since 1991 has proceeded against a backdrop of continual effort to enter the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). APEC has been supportive of these efforts, and in the meantime has provided an alternative avenue for some aspects of China's official interaction with major trade partners on international economic issues.

China's President Jiang Zemin participated in the 1994 Bogor APEC leaders' meeting, which generated the understanding on free and open trade and investment by 2010 (for developed countries) and 2020 (for developing economies). In 1995 (in Osaka) and 1996 (in Manila), China chose the APEC meetings for announcement of major new steps in trade and investment liberalisation, towards China's commitments in the Bogor Declaration. While the APEC commitments to free and open trade and investment were not a central focus of Chinese domestic discussion of trade liberalisation, they were taken seriously and respected. The APEC meetings, with their requirement of unilateral rather than reciprocal commitments, and their multilateral context, made it politically more palatable for the Chinese government to be able to announce liberalising steps, without domestic criticism for conceding to American power and bilateral pressure. The consistent support within APEC for deeper Chinese integration into the international economy, including through membership of the GATT/WTO, was helpful to Chinese leaders fighting domestic reaction to setbacks on entry into the WTO and recurring tension in relations with the United States. China shared in the general advantage to the Asia Pacific region of APEC discussions on the importance of resisting protectionist pressures to recovery from the Asian financial crisis.

Any really important policy development in a large country has many and complex causes. The extension and success of internationally-oriented policies in China through the 1990s also had many and complex causes. Would it have worked at all without APEC? Would it have worked as well?

All we can really say is that APEC provided helpful and significant support for reform and opening to the outside world. The subsequent chapters of this book explain in detail some of the ways in which APEC provided this support.

In Indonesia and the Philippines, at least, APEC was of greatest value to domestic policy reform in the years in which they hosted Leaders' meetings. They had the advantage of hosting APEC summits at times of rapid output, trade and investment expansion, and optimism about the future. Now in mid-

2000, it seems likely that China will enjoy favourable circumstances and opportunity when it hosts the 2001 APEC leaders' meeting in Shanghai. The careful contributions to this book will be helpful to defining China's and the world's continuing interests in APEC, and therefore in defining the 2001 opportunity.

In Chapter 1, Zhang Yunling reviews China's liberalisation program in the context of APEC and WTO, two important international vehicles for carrying the trade reform and liberalisation program forward. China's progress with economic liberalisation after embarking on reform in the late 1970s, sets the context for China's commitment to the APEC process. For China, APEC has the great virtue of flexibility in timing the implementation of liberalisation. Flexibility suits China's gradual approach to reform, liberalisation and the transition to an open market system. China's Individual Action Plan (IAP) provides the guideline for China's commitment to APEC trade and investment liberalisation. However, Zhang notes, the pressure for standardisation and revision of IAPs in APEC is intensifying because of the need to make their implementation more effective and comparable.

On the relationship between APEC and WTO, Zhang Yunling argues that China's agenda in APEC has been closely related to its agenda on accession to the WTO. China's strategy has been to press its claims for accession to the WTO through its commitment to liberalisation in APEC and, at the same time, to keep pace with APEC's 'WTO plus' initiatives even though China is not yet a member of the WTO. As he points out, the lengthy negotiations and pressure from contracting parties have in fact sped up the pace of liberalisation of the Chinese economy.

Peter Drysdale deals with the strategic relationship between the principle of open regionalism, APEC and China's international trade strategies in Chapter 2. He argues that the idea of open regionalism is deeply rooted in the history of the evolution of APEC based on an understanding among many East Asian economies of their stake in the strength and continuity of an open trading system. Such understanding is at the core of three key issues facing the regional economies. First, the trading interests of East Asian and Pacific economies extend beyond APEC. Second, trade discrimination involves the unnecessary cost of trade diversion, complicated in the Asia Pacific region by the likelihood of high associated political costs both within and outside the region. Third, there is the sheer impracticability of undertaking regional trade liberalisation via a conventional discriminatory free trade area of the kind sanctioned by the WTO in such a diverse region.

On the implications of participation in APEC and accession to the WTO, Drysdale argues that such international commitments underwrite China's credibility in respect of the continuity and reliability of policy behaviour. These

international commitments serve to limit opportunistic behaviour and to reduce the likelihood of distortionary interventions in trade and other international transactions both by China and by China's trading partners. Equally important, they bind policy and the evolution of policy in a way that affects the behaviour of domestic and foreign firms operating in China.

Drysdale highlights the importance of linking China's trade liberalisation to its domestic reform program. He observes that China's trade policy strategy is inextricably linked with other aspects of reform, such as the management of the state enterprise sector and financial market reform and macroeconomic policy reform. He argues that policy leaders, both inside and outside China, have a very substantial interest in forcing the pace of change. Accession to the WTO would entrench these reforms and help to maintain their momentum and APEC has been a critical vehicle through which China could re-position and maintain the momentum of its claim to WTO membership.

Drysdale also identifies conflicting paradigms across the Pacific in the approach to open regionalism, resolving the 'free rider' problem and dealing with 'sensitive sectors'. He concludes that APEC provides a useful vehicle for active and continuing trade and investment liberalisation by China and among the Asia Pacific economies..

In Chapter 3, Zhang Jianjun provides a critical review of the functions of APEC. He argues that APEC has developed a number of unique features and decision-making processes that differentiate it from other international or regional forums, such as its non-formal processes, the diversity of member countries, emphasis on consensus and concerted unilateralism and top-down direction. These features have allowed APEC to make remarkable progress through both voluntary and unilateral actions as well as collective initiatives on trade and investment liberalisation and facilitation. Member countries have lowered their average tariff levels by almost half. Greater transparency on non-tariff measures has been enhanced through identification and removal exercises. Member countries have voluntarily included investment liberalisation in their IAPs. Progress has been made in liberalising service sectors, establishing customs procedures and dispute mediation, formulating competition policy, and protecting intellectual property rights.

Zhang also notes the weaknesses in APEC: its inability to deal with the regional economic crisis; lack of effective mechanisms for implementing policies; lack of tangible outcomes from its policy initiatives including economic and technical cooperation (ecotech) and the early voluntary sectoral liberalisation (EVSL) initiative and lack of focus. Despite these problems, China has taken a positive stand on APEC's trade and investment agenda, recognising its role in managing the trends of globalisation and an open international trading environment. While China is unlikely to obtain from APEC badly needed capital, technology

and managerial skills, APEC can act as an important information source for China, a platform for policy discussion and a stimulant in pursuing more liberal international trade and investment policies.

Zhang argues that, to cope with changing circumstances, APEC must further consolidate its position on trade and investment, develop a more effective implementation mechanism, and find better ways to carry out its ecotech agenda. Its leaders should act together to produce more focused and results-oriented outcomes. He also argues that APEC should work more closely with the business community and broaden its outreach to involve a wider segment of the business sector. He believes that these are crucial elements in ensuring healthy and sustainable development from APEC's endeavours.

Christopher Findlay and Chen Chunlai discuss Australia's APEC agenda and its implications for Australia and China in Chapter 4. The discussion of Australia's APEC agenda centres on the main features of the IAP for Australia and its implications for the reduction of Australian tariffs. It also includes Australia's proposal for the EVSL and its implications for trade between China and Australia. The discussion underlines the role of government in reducing the costs of doing business between Australia and China. They point out that the commitments on tariff reductions by the Australian government extend so far only to the year 2005, rather than 2010, the target date for developed countries' liberalisation under the Bogor goals. There are exceptions in some sensitive sectors such as passenger motor vehicles (PMV) and textiles, clothing and footwear (TCF). In addition, there are 'pauses' in the schedules of tariff reductions between 2000 and 2005. According to Findlay and Chen, these pauses and the manner in which were decided may make it difficult, in the process of reviewing tariffs beyond 2005, to commit to further schedules of reductions.

On the implications for Australia-China bilateral trade, Findlay and Chen show that the structure of remaining Australian protection is highly biased against China. The average tariff rate faced by Chinese exporters to Australia is much higher than that faced by exporters from other APEC members. Therefore, the tariff reductions scheduled by 2005 in Australia will create scope for gains from trade between the two countries. But a higher degree of integration would have occurred sooner if Australia had maintained its earlier commitments to continuous and steady reductions in tariffs—on TCF products in particular. Thus, APEC commitments may serve to constrain tariff rate setting in Australia and be useful in realising the potential for growth that still exists in the bilateral relationship between Australia and China. In particular, the bias they identify in Australian trade policy against China suggests the gains from liberalisation will be quite substantial.

In discussing the shared objectives in APEC and the international economic system, Andrew Elek points out in Chapter 5 that Asia Pacific economies cannot expect to realise their potential for development in isolation from the rest of the

world. That is why APEC has consistently sought to promote global, not just regional, objectives by pursuing open regionalism. APEC also needs to ensure that new arrangements do not create new sources of discrimination, thereby fragmenting, rather than integrating regional markets.

Elek sets out a conceptual framework for development cooperation within APEC. He emphasises that economic and technical cooperation (ecotech) among APEC governments needs to be conducted on the basis of mutual respect, including respect for diversity, autonomy, mutual benefit, genuine partnership and consensus-building. Cooperative activities need to promote a working partnership with the private sector and the community in general, to ensure that cooperation is consistent with market principles and the efficient allocation of resources. He also proposes thinking ahead in the development of a strategy for global action to deal with 'sensitive sectors' which are less likely to be opened up through unilateral, voluntary decisions by individual governments.

Elek highlights several issues that need to be considered in designing cooperative arrangements among APEC economies. They include trade in goods and services, harmonising administrative procedures, mutual recognition of standards, technical cooperation, transparency and non-discrimination. He suggests that Australia and China might work together in promoting ways of addressing these issues.

In Chapter 6 Yongzheng Yang and Yiping Huang raise the question: How important is APEC to China? Using a global general equilibrium model, they evaluate the impact of APEC trade liberalisation on the Chinese economy. They find that under a scenario of comprehensive APEC trade liberalisation, there is a positive impact on China's real GDP growth. The large expansion of domestic production reflects the extent of trade distortion in China. Their results show that, measured in terms of equivalent variation, the welfare gain to China is not as significant as the increase in domestic production suggests mainly due to a substantial decline in China's terms of trade. However, they emphasise that the large efficiency gain from trade liberalisation more than compensates for the loss through the terms of trade effect. Further decomposition of the allocative efficiency gain indicates that a big expansion of imports is largely responsible for the higher efficiency, although export expansion also contributes significantly. They conclude that it is China's own liberalisation that is most important in enhancing Chinese welfare through the APEC process.

Their results reveal that if agriculture is excluded from APEC trade liberalisation, the increase in China's GDP is only slightly lower, but the overall welfare gain to China is reduced by nearly one-third. Furthermore, not only is the efficiency gain smaller, but the adverse terms of trade effect is larger. APEC trade liberalisation without agriculture is therefore a less desirable option for China than comprehensive trade liberalisation. They also find that welfare benefits

to China from global trade liberalisation are larger than the gains from both APEC liberalisation and unilateral trade liberalisation. These findings support their view that APEC and the WTO are mutually re-enforcing in facilitating Chinese trade liberalisation. APEC prepares China for the WTO and WTO accession pushes China to be proactive in the APEC process. Both APEC and WTO accession propel China's domestic reform.

Sun Xuegong deals with the relationship between APEC investment and trade liberalisation and China's structural reforms in Chapter 7. The benefits and challenges from trade and investment liberalisation focus on three areas: reform of the state-owned enterprises (SOEs); rationalisation of industrial organisation; and reform of the grain sector. He argues that SOE reform has lagged behind trade liberalisation and has become an increasing impediment to further liberalisation. Synchronising SOE reform and trade liberalisation will lead to smoother and less costly adjustment. Thus, speeding up SOE reform rather than slowing the pace of liberalisation appears to be the logical solution.

Inefficiencies in the structure of Chinese industrial organisation mean that, even in areas of fundamental comparative advantage, liberalisation will entail considerable adjustment costs. One solution is to exploit increasing returns to scale through the rationalisation and merger of domestic firms. Sun observes that some mergers have been taking place in China in recent years. To complement structural policies, he argues that China needs to improve its legal system and strengthen the enforcement of competition policy.

Sun points out that it is only a matter of time before China loses its comparative advantage in the grain market and that adjustment in this sector is inevitable. The prospect is that China will eventually liberalise its grain sector and integrate into the world grain market. There are several aspects associated with structural adjustment in this area. China's grain production is still likely to grow as the sector becomes more open to import competition as productivity improves. The pace of grain trade liberalisation will clearly depend on the preparedness of China's trading partners to open their markets to China's labour-intensive exports, including more labour-intensive agricultural products. And the food security issue will need to be settled before China takes dramatic steps to liberalise the grain sector.

The next two chapters deal with the liberalisation of three key sectors in the Chinese economy. In Chapter 8, Li Kai analyses the costs of protection in the automobile and textile industries. Li quantifies the protective effects of taxes and fees on automobile and textile products. Using these data, he calculates the costs of trade protection in both sectors and the impact of lower tariffs on the national economy.

Li concludes that reduction of the current nominal tariffs will not have a significant influence on the Chinese economy because of the gap between nominal

tariffs and tariff rates that are actually applied. This situation gives the Chinese government room to push tariff reduction and ease non-tariff measures. High levels of protection have actually hindered the inflow of advanced technology and slowed the development of the domestic automobile industry. In the case of textiles, Li argues that low tariffs and the importance of the processing trade means that there is little real protection of the domestic textile industry. Thus the textile sector is an early candidate for early sectoral liberalisation.

Sun discusses the international competitiveness of China's chemical sector in Chapter 9. His estimates show that the chemical sector in China still has weak competitiveness due to high input costs. In some cases the price of chemical products is as much as twice the international market price. Furthermore, the quality, variety and grade of chemical products in China are inferior to those of other countries. Low labour productivity compared with Japan and the United States and the social burdens of SOEs offset the Chinese industry's advantage in cheap labour costs.

Given the industry's weak competitive position, China's participation in early sectoral liberalisation of the trade in chemical products would inevitably involve big adjustment shocks. Sun's regression results show that the most affected sectors of the industry are those whose products are highly substitutable with products from overseas. The early liberalisation of the chemical industry would also have repercussions on other sectors of the national economy with links to it. However, there are some factors which may recommend liberalisation for the industry. The chemical industry cannot satisfy domestic demand for chemical products and there is evidence that the competitive position of some parts of the domestic industry has strengthened following substantial tariff reductions. Sun concludes that China should continue trade liberalisation in accordance with its IAP commitments. Trade policy measures should be directed to the twin objectives of satisfying domestic demand and improving the competitiveness of China's chemical sector.

Andrew Elek and Hadi Soesastro argue in Chapter 10 that ecotech is at the heart of the APEC process. While trade and investment issues remain important, it has become evident that economic cooperation needs to be a central feature of the APEC agenda to nurture a sense of community among member economies. At the heart of the issue is capacity-building in the Asia Pacific region. To accomplish this goal, they advocate an integrated view of the APEC process within which all cooperative activities are seen as ways to strengthen the capacity of Asia Pacific economies in reaching their full potential for sustainable economic growth.

Their recommendations for implementing ecotech focus on strengthening the economic policy framework in member economies. Technical cooperation should focus on a small number of well-defined priorities and APEC governments

should be encouraged to include commitments to promote technical cooperation programs endorsed by APEC leaders as a significant part of their IAPs.

Chen Luzhi presents a Chinese view on how to promote ecotech in Chapter 11. Referring to the Manila Declaration of 1996, he stresses that the ecotech agenda needs to be goal-oriented, with explicit objectives, milestones and performance criteria. It also requires that the public sector create a suitable environment for private sector initiatives. Thus ecotech activities should combine government action, private sector projects and joint public-private activities and should draw on voluntary contributions commensurate with member economies' capabilities. They should also generate direct and broadly-shared benefits among member economies and aim to reduce economic disparities.

Since ecotech is now defined as action-oriented cooperation for development with explicit objectives, tasks, measures and results, its implementation needs to be based on an effective mechanism which suits the nature of APEC.

In Chapter 12, Zhou Xiaobing and Zhao Jianglin emphasise the importance of creating an environment which is conducive to economic and technical cooperation among APEC countries. They identify several problems in APEC economic and technical cooperation including a lack of real progress in facilitating technical cooperation; lack of action in implementing proposals; insufficient start-up capital; and lack of operating models for project implementation. The diversity of APEC's membership also exacerbates the difficulties of cooperation.

Zhou Xiaobing assesses the impact of capital inflows and technology transfer on the Chinese economy in Chapter 13. After reviewing trends in foreign capital inflows and technology transfers into China, he discusses the role of foreign-invested enterprises in the Chinese economy and the challenges caused by the massive inflow of foreign capital. Problems include lack of a valuation system for state assets, high concentration of foreign capital in certain industries, lack of enforcement of regulations (such as pollution controls), and lack of social insurance for local employees. Problems associated with technology transfer include difficulties in accessing frontier technologies and an inability to assimilate advanced technology due to the lack of R&D expenditure. He points out that the APEC framework can play an important role in promoting the transfer of technology to China and that APEC technological cooperation could help to resolve these problems.

The last two chapters of the book deal with trade and trade efficiency issues in the Asia Pacific economies. In Chapter 14, Zhou Xiaobing and Ligang Song provide preliminary evidence on how the trade performance of the East Asian economies has been related to changes exchange rates—particularly the major currencies such as the US dollar and Japanese yen. Their policy discussion highlights the relationship between structural adjustment in China and the other East Asian economies. Since the export structures of China and some of the

ASEAN economies are very similar, competition in third country markets is inevitable.

Export competition among the East Asian economies recommends continuous industrial upgrading and trade transformation. This strategy requires accumulation of physical and human capital and secure export markets. Hence, mutually re-inforcing liberalisation of trade among APEC economies assumes considerable importance to East Asian economies, heavily dependent as they are on intra-regional trade growth.

In the final chapter of the book, Peter Drysdale, Yiping Huang and Kali Kalirajan use a stochastic gravity model framework to evaluate the efficiency of China's bilateral trade. Trade efficiency indexes are calculated for each pair in a sample of 57 trading countries. An equation is estimated separately to examine the efficiency of China's bilateral trade.

The results reveal that average trade efficiency for China was not only lower than that of the other East Asian economies as a group but also below the average of the whole sample. There appears to be a huge potential for improving efficiency in China's trade and greatly expanding both exports and imports. Trade efficiency may be improved through appropriate trade reform. Increasing economic freedom, for example, including through lowering the level of trade taxes, would enhance trade efficiency. A freer economic environment in China's trade partners also promotes efficiency in trade with China, a point which underlines the importance of the APEC process to China's trade prospects, since China's most important economic partners are within the Asia Pacific region.

