China’s External Economic Policy in Shifting Development Pattern

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Abstract

The Chinese economy, which continued to grow rapidly after the adoption of reforms and its opening-up initiatives, started to shift to a path of stable growth around the beginning of the 2010s. As a result of sustained high growth, the Chinese economy has been confronted with excessive savings, the deterioration of economic efficiency, a rise in factor prices, and the materialization of internal and external imbalances. For these reasons it must shift its development pattern from one that is growth driven by investment and export to one that is growth driven by consumption and domestic demand. As part of the change in its development pattern, China is shifting its external economic policy from export promotion and foreign capital utilization—on which emphasis has consistently been placed since the adoption of reforms and its opening-up policy—to import promotion and outward investment. China, which continues to develop as a great economic power, is rapidly increasing its presence in the international economic system. In particular, at a time when countries and regions around the world are trying to conclude free trade agreements (FTAs) amid the stalemate of the multilateral international trade system, China is establishing its position as an important player. Moreover, changes occurring as a result of the implementation of its external economic policies are working to promote the comprehensive deepening of China’s economic reforms.

Keywords: external economic policy, external imbalance, export promotion, FDI, WTO, FTA
JEL Classification: F13, F15, F21, F60

I. Introduction

After China made a drastic change in its economic development strategy at the end of the 1970s, it consistently pursued export-oriented industrialization based on export promotion and foreign capital utilization during the 1980s and 1990s. In so doing, its transition to a market economy also progressed quickly. Having succeeded in introducing a great amount of foreign capital and making use of its abundant labor force, China grew to be the “factory of the world” by the end of the 1990s. Entering into the 21st century, China achieved rapid economic growth by making use of a foreign direct investment (FDI)-trade nexus and by deeply engaging itself in production networks in East Asia.

Currently faced with rapid economic and social changes at home and abroad, however,
China’s economy has no choice but to shift its development pattern. What makes China’s economic development pattern shift? What impact does that have on its external economic policy? How does China respond to these impacts? Furthermore, while rapid economic growth is raising the international presence of China, what kind of attitude does it assume toward the international economic system?

The purpose of this chapter is to consider China’s shift in development pattern under the administration of Xi Jinping and that shift’s influence on external economic policies and multilateral trade systems.

II. Shifting Development Pattern

II-1. Eliminating the “Two-Gap”

For many developing countries aiming at economic growth, eliminating the “two-gap”—namely insufficient savings and a shortage of foreign currency—is a long-standing challenge. In the reform and opening-up period, China’s economy accomplished this difficult task in less than two decades. As a result of China’s domestic savings rate rapidly rising after the mid-1990s, it can currently cover huge domestic investment with its abundant savings. Entering the 21st century, China’s foreign exchange reserves also surged. In February 2006, it surpassed Japan in foreign exchange reserves to become the largest foreign exchange holder in the world (Figure 1).

Despite large-scale investments, China’s economic growth decreased gradually to the seven percent level in 2012. A very high investment rate combined with low economic growth means that China’s investment efficiency has been getting worse with time. In the 11th Five Year Plan (2006–10), China emphasized shifting its development pattern from “extensive growth” depending on high capital input to “intensive growth” focusing on stable growth through the improvement of economic efficiency and technology. Although the contribution of total factor productivity (TFP) to economic growth is properly recognized in China, the “extensive growth” pattern has, nevertheless, been maintained (Table 1).

In the system of national accounts (SNA), the difference between national savings and investment equals the current account balance. Excess savings over investment means that China has a large current account surplus.1 Thus, a shift in development pattern from growth driven by investment and export to growth driven by consumption and domestic demand is included in the 12th Five Year Plan (2011–15). Even today, however, China’s industrial structure is basically export-oriented and Chinese firms are still pursuing foreign currency acquisition.

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1 National Income (Y) = Consumption (C) + Savings (S), which can be also expressed as National Income (Y) = Consumption (C) + Investment (I) + [Export (X) – Import (M)]. Therefore, (S) – (I) = (X) – (M).
Despite large-scale investments, China's economic growth decreased gradually to the seven percent level in 2012. A very high investment rate combined with low economic growth means that China's investment efficiency has been getting worse with time. In the 11th Five Year Plan (2006–10), China emphasized shifting its development pattern from "extensive growth" depending on high capital input to "intensive growth" focusing on stable growth through the improvement of economic efficiency and technology. Although the contribution of total factor productivity (TFP) to economic growth is properly recognized in China, the "extensive growth" pattern has, nevertheless, been maintained (Table 1).

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### Table 1 Growth accounting
(Average annual rate of change as a percentage)

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<thead>
<tr>
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<tr>
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<tr>
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<tr>
<td>Contribution to growth</td>
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<tr>
<td>Capital</td>
<td>5.3</td>
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<tr>
<td>Labor</td>
<td>0.6</td>
<td>1.7</td>
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<tr>
<td>Productivity</td>
<td>3.0</td>
<td>2.8</td>
<td>2.3</td>
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<tr>
<td>Share of growth</td>
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<tr>
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<tr>
<td>Productivity</td>
<td>33.8</td>
<td>25.5</td>
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Note. For output outside agriculture and housing (as the output of the housing sector is poorly measured in Chinese national accounts), figures are calculated from log differences multiplied by 100.

II-2. Rising Factor Prices

Development of labor-intensive export industries has become a driving force of rapid economic growth in China. These industries have made immeasurable contributions to national economic growth through production, investment, export, tax revenue, and employment. Recently, as a result of rapid economic growth in the reform and opening-up period, terms and conditions enabling the development of labor-intensive export industries have drastically changed. Factor costs, such as those associated with labor, land, resources, environmental costs, and the exchange rate, have moved into a rapidly increasing phase. Among these costs, those of labor are rising at an unprecedentedly rapid pace. The “unlimited supplies of labor” once seen in China is almost at the point of disappearing. Demographic dividend also seems to be gradually fading away. Since a migrant “peasant labor shortage” (mingong huang) emerged in the Pearl River Delta in 2004, China’s economy has been faced with a labor crunch, a wage surge, and a rash of labor disputes. In the period of 2000–12, nominal wages for urban workers increased by 14.5 percent annually. Particularly, nominal wages for migrant peasant workers, who supported labor intensive industries, surged by 26.3 percent in 2008, when China’s Labor Contract Law was newly enforced. Since then, Chinese wages have been increasing at an exceptionally high pace. The minimum wage was also pulled up for the purpose of expanding domestic demand and increasing the purchasing power of Chinese households. China’s labor share, i.e. the compensation of employees, in terms of GDP, decreased from 54.4 percent in 1995 to 39.7 percent in 2007. After the Labor Contract Law was enforced in 2008, China’s labor share was on the rise and recovered at the 47.0 percent level in 2011.

II-3. In Search of High Value Added Production

Faced with rising factor costs, China places an emphasis on high value added goods by upgrading industries. In the early stage of development, processing trade played a very important role. Particularly, China’s labor intensive industries imported materials and intermediate goods from abroad, assembling and processing them with its abundant labor force before exporting them as final goods to foreign markets. Processing trade has been primarily undertaken by foreign affiliated firms located in China. In general, it continues to deal in low added value goods compared with ordinary trade, which is based on industrial chains formed in China and is also expected to move toward higher added value goods (Table 2). China is currently known as the world’s largest production and exporting country for the IT industry. However, these high tech products are mainly manufactured through processing.

2 Real wages deflated by urban consumer price index grew at an annual average growth rate of 17.1 percent in the same period.
3 Zhang et al. (2012), p. 22.
Driven by technical progress, the new energy industry has achieved remarkable growth as a strategic emerging industry (SEI) in search of higher value added production. In this context, the Chinese government selected the seven industries (energy efficient and environmental technologies, next generation information technology, biotechnology, advanced equipment manufacture, new energy, new materials, and new energy vehicles) as strategic emerging industries (SEIs) in the 12th Five Year Plan. They are expected to be leading industries in economic growth driven by technical progress.

According to Li Chunxia, who deals with one of the SEIs, however, it is almost impossible to identify any results of indigenous innovation in connection with wind power generation in the new energy industry. Showing rapid development in the second half of the 2000s, China’s wind power generation occupied more than 40 percent of new wind generation capacity in the world in 2011. But it remains to be a kind of processing trade industry that assembles imported parts and components based on designs purchased from foreign suppliers.

The driving force in developing China’s wind power generation industry is not indigenous innovation but rather governmental industrial policy. It has achieved remarkable growth as a new “subsidy industry,” and has recently fallen into a pattern of seriously excessive production.

### II-4. Correcting Imbalances

Rapid economic growth has brought various imbalances and distortions to China. As seen in the quannmian xiaokang shehui or “all-round well-off society” promoted by Jiang Zemin, and the hexie shehui or “harmonious society” proposed by the Hu Jingtao-Wen Jiabao administration, the Chinese government has shed new light on policy concerns including the correction of regional and income gaps, the improvement of labor relations, the expansion of

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5 Rassweiler (2009).
6 Li (2013).
social safety nets, and environmental preservation.

As for the correction of regional gaps, from the viewpoint of balanced economic development, the Chinese government launched a series of regional development policies including the China Western Development, the Revitalize Northeast China, and the Rise of Central China plans. In this context, opening-up inland areas holds the key to the implementation of these regional development policies. As seen in coastal areas in the early 1980s, opening-up is regarded as a driving force in developing inland areas.

First of all, policy measures to guide foreign capital to inland areas was implemented when the government released the State Council-approved “Catalogue of Priority Industries for Foreign Investment in the Central and Western Regions.” Then, Economic and Technological Development Zones (ETDZs)—bases to absorb foreign capital and to accelerate economic growth—were also established in inland areas. The ETDZs first founded in 14 coastal cities in 1984 increased in number to 210 in 2013. At more than half, 107 ETDZs have been established in western and central China. In the newly established ETDZs, both “construction of ecological civilizations” and “green development” are strongly emphasized from the viewpoint of environmental preservation. As mentioned later, export bans and control measures have been applied to lianggao yizi (“high energy consumption, high pollutant emission, and resource consumption”) items/industries in foreign trade. These industries are also under strict control in foreign capital utilization.

The growth rate of foreign capital utilization in western and central areas is much higher than that of the coastal area. The former areas accounted for 15.0 percent of total foreign capital utilization in China in 2010 and the rate rose to 21.5 percent in 2013. In addition to foreign capital utilization, the shifting of manufacturing industries located in coastal areas to inland areas plays a larger role in economic development in western and central China. In recent years, the service sector has accounted for more than half of total foreign investment in major cities in coastal areas. Faced with a deteriorating investment environment, manufacturers in coastal areas are accelerating the transfer of their production plants to inland areas, while inland local authorities are establishing a number of industrial parks to accept these industrial transfers.

Improvements in working conditions and social security impose additional burdens due to increased production costs for employers. Unless they undertake these constructive actions, however, they would be unable to recruit new workers amidst a chronic labor shortage. Increasing incomes for the household sector is a prerequisite condition for expanding domestic demand. From a macro-economic viewpoint, increased precautionary savings by the household sector due to an insufficient social safety net is surely the main reason for China’s excessive savings, sluggish consumption, enlarging savings-investment gap, and consequently intensifying external imbalance.

II-5. Coping with External Imbalance

Imbalances and distortions caused by rapid economic growth also extend to the external
China’s economy in its search for export promotion and foreign capital utilization has had “twin surpluses” in current and capital accounts since the mid-1990s. Currently, it also holds huge foreign currency reserves. In addition, as a result of the large-scale inflow of foreign capital anticipating a booming economy, excessive liquidity occurred in China. Due to overheating investments, excessive production, and soaring asset prices caused by excessive liquidity, it is very difficult on a practical level to manage and control China’s domestic economy.

It is a pressing task for China to cope with trade friction. China’s exports have expanded via triangular trade and China has been importing intermediate goods from neighboring East Asian countries and areas, assembling and processing them with its abundant labor force into final goods, and exporting them to the U.S. and European Union (EU) markets. In other words, China’s trade surplus was mainly generated by foreign affiliated firms located in China where they engaged in processing trade. Based on the rule of origin, however, China’s current trade surplus vis-à-vis the U.S. and the EU is boosted by its aggressive export activities and import impediments. Obviously, these problems exist against the background of trade friction between China and its overseas markets.

From the establishment of the World Trade Organization (WTO) in 1995 until 2013, the initiations of anti-dumping investigations amounted to 4,519 cases in total—989 cases of which were targeted at China’s exports. These anti-dumping investigations are made by not only the U.S. and the EU but also by emerging countries such as India, Argentina, and Brazil, which are competing with China in the area of certain industrial products.

III. Changes in External Economic Policy

Both export promotion and foreign capital utilization have been consistently pursued in China’s external economic policies during the reform and opening-up period. Faced with changing environments at home and abroad, as mentioned above, China is being pressed to reexamine its external economic policy. New moves toward policy change have gained momentum since the mid-2000s.

III-1. Reappraisal of Export Promotion

III-1-1. Export restraint measures

In trade policy, China gives preference to export restraint measures over export promotion.

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7 On China’s trade friction, see Ohashi (1998) and (2011b).
8 Calculating the bilateral trade balance between the U.S. and China based on the OECD-WTO Trade in Value-Added Initiative (TiVA), the U.S. trade deficit decreased by a third to US$ 126 billion, while the U.S. customs statistics showed a trade surplus of US$ 189 billion with China in the same year. Sposi and Koech (2013).
9 WTO (2014).
At first, due to the above-mentioned export ban and control measures for lianggao yizi products, export industries were extensively restructured. These measures were applied to low value added and low-tech labor intensive products, over-capacity products, and ‘symbolic items’ of trade friction.

Then, the following export restraint measures were taken:10

First, the tax rebate system for export promotion was effectively adjusted to lower the refund rate of export-related value added tax.11 It was launched as an export incentive with a 17 percent tax refund rate in 1994. The tax rebate system definitely contributed to export expansion, but the tax refunds were beyond the government’s fiscal capacity. As a result, the Chinese government decided to lower the tax refund rate in 1995. In the following years, 1996–97, however, China’s exports slowed down and the Asian financial crisis occurred. Faced with these changes, China raised the tax refund rate steadily for export promotion in 1998–99. After China’s accession to the WTO, when its export surged, the government was forced to once again adjust the tax refund rate. In the mid-2000s, the adjustment of the tax refund rate was regarded as a disincentive designed to curb export expansion and to cope with the strengthening Chinese currency, the renminbi (RMB). In particular, the tax refund rate adjustment for certain export items in September 2006 turned out to be a symbolic measure in changing export promotion policy.12 In July 2007, the tax refund rates of 2831 export items—37 percent of all customs clearance items—were lowered, and the targets were then extended to the remainder of all export items.13

Second, processing trade, a primary factor in trade surpluses, was considerably restrained. In the reform and opening-up period, processing trade played a leading role in China’s manufacturing industries and created a massive number of employment opportunities. A wide range of downstream industries engaged in processing trade have induced the formation of upstream industries through the backward linkage effect. Their value added rates have been rising recently.14 Currently, however, processing trade draws harsh criticism in China.

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10 China’s trade policies are posted on the following websites: Ministry of Commerce (http://www.tdb.org.cn), Ministry of Finance (http://www.mof.gov.cn), and General Administration of Customs (http://www1.customs.gov.cn).

11 On China’s export-related tax rebate system, see Ohashi (2014), pp. 189–96.


13 “Circular of the Ministry of Finance and General Administration of Taxation on Adjusting Tax Refund Rates of Some Export Commodities,” June 19, 2007, including 1) the exclusion of 553 items from the tax rebate system, 2) a reduction in the tax refund rates of 2,268 items likely to cause trade friction, and 3) the switching of measures from tax refund to export tax exemption for 10 artwork items.

14 The value added rate of processing trade is generally shown in China as follows:

Value Added Rate = Processing Trade Export – Processing Trade Import / Processing Trade Export x 100

This increased from 25.7 percent to 79.3 percent during the 1992–2012 period. Ohashi (2014), p. 188.
For example, processing trade dominated by foreign affiliated firms is generally low tech and low value added. It is also a driving force for a soaring trade surplus. Foreign affiliated firms are likely to accumulate vast wealth through international transfer pricing, while Chinese domestic firms engaged in processing trade only receive small processing fees. As a result, a “Catalogue of Prohibited Commodities for Processing Trade” for 804 items was announced in November 2006. A “List of Commodity Restricted for Processing Trade” for 1,853 items was published in August 2007.

Third, export duties were introduced. In November 2006, China imposed export taxes on 110 items including rare metals and coal. This mainly targeted export items the country could not afford to export due to soaring domestic demand. The Chinese government gained effective export control over certain steel products, “symbolic” items of trade friction, by implementing the above-mentioned combined measures. First, the export rebate system of export-related value added tax for 83 steel products was lifted in April 2007. Then, the export license system was introduced for certain steel products in May 2007. Finally, export duties were imposed on 142 items of energy-intensive steel and rare metal products.

These export restraint measures were applied not only to items in observation of international treaties but also for: those that they could not afford to export due to rising domestic demand; certain “symbolic items” of trade friction; and, items that are excessively produced in China. While curbing export, the Chinese government has made efforts to increase imports by improving market access and by dispatching trade missions to the U.S. and the EU.

It is true, however, that these export restraint measures show China’s efforts to ease trade friction, but they made little contribution to reducing its massive current account surplus. The export restraint and import promotion measures may temporarily decrease the trade surplus, but in the mid-long term, both measures tend to lead to a reduction in the real exchange rate and become export promoting factors in the long term. So far as the savings-investment balance is relatively stable from the macro-economic viewpoint, these policy adjustments will not contribute to a reduction in the current account surplus. The Chinese government therefore must take positive policy measures to affect the savings-investment balance by eliminating excessive savings and boosting domestic consumption.

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18 When China was confronted with Japan over the Senkaku Islands in autumn 2010, it took measures to curb the export of rare earth, which was an extension of this policy measure.
III-1-2. Exchange rate adjustment

Exchange rate adjustment has been often proposed as an effective measure for redressing a current account balance. As seen in the cases of the so-called Nixon shock in 1971 and the Plaza Accord in 1985, however, it made little contribution to improving the current account deficit in the U.S. Unless the savings-investment imbalance is effectively corrected, it is impossible to improve the current account deficit. As then-Chairman Greenspan of the Federal Reserve Board (FED) of the U.S. stressed, “a revaluation of the RMB would have limited consequences for overall U.S. imports,” and “U.S. imports of textiles, light manufactures, assembled computers, toys, and similar products would in part shift from China as the final assembler to other emerging-market economies in Asia and, perhaps, in Latin America as well.”

China has maintained a negative attitude toward capital liberalization. In the contemporary international economy where financial deals substantially exceed real demands, developing countries with an immature financial sector are likely to encounter heightened risks in liberating capital accounts. China could avoid ill effects of the Asian financial crisis by preventing capital account liberalization.

In international economics, there is a hypothesis well known as the “impossible trinity” according to which it is impossible to have all three of the following at the same time: a fixed exchange rate, free capital movement, and an independent monetary policy. China has ensured an independent monetary policy by maintaining a de facto dollar-pegged exchange rate and by limiting capital movement. But, after China’s accession to the WTO, surging trade activities increased capital movement throughout China. It was forced to adopt a more flexible exchange rate in order to maintain independent monetary policy. Since China has also maintained a dollar-pegged exchange rate, it could not help staying attuned to the U.S. monetary policy and has been subject to various restrictions in implementing domestic economic policies.

Under these conditions, the People’s Bank of China (PBC) launched RMB reforms in July 2005 by revaluing the RMB toward the U.S. dollar by two percent and shifting from a dollar-pegged exchange rate to a managed floating system. After the reforms, the RMB rose by 35 percent against the U.S. dollar by the end of 2013. China accepted a stronger RMB during that period. Probably this is mainly due to China’s having given priority to the maintenance of independent monetary policies in managing inflation in the same period.

From the RMB reforms in 2005 until the Lehman shock in 2008, however, China continued to increase its exports to the U.S. under the stronger RMB. There were some indications that Chinese firms producing exports were cutting their margins in order to avoid passing through the RMB appreciation, although available evidence does not support this view. It would be reasonable to contend that the productivity gains in Chinese export industries were large enough to absorb the adverse effect of the rising value of the RMB.

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III-2. Reassessment of Foreign Capital Utilization

III-2-1. Debate over foreign capital utilization

Since the mid-2000s, China has begun to reconsider the role of foreign capital utilization in the economy, reflecting the fact that its current account surplus could be attributed to the soaring exports of foreign affiliated firms. In the reform and opening-up period, great debates over how to utilize foreign capital were often repeated in China.21 In one such debate in the mid-2000s, the following points were in question.22 Does China absorb too much foreign capital? Does foreign capital make a positive contribution to China’s economy? Does it increase employment opportunities? Do foreign affiliated firms monopolize and dominate the Chinese market? Does foreign capital utilization lead China to “Latin Americanization”? Does it hinder indigenous innovation in China? Do foreign affiliated firms damage Chinese national brands? What does M&A by foreign firms bring to China? Is it necessary to maintain preferential treatment systems for foreign affiliated firms?

More specifically, China was concerned about “Latin Americanization” in foreign capital utilization, including the following issues.23 Foreign affiliated firms move their profits abroad via preferential taxation systems. Increasing current account surplus and foreign currency reserves caused by their surging exports put additional upward pressure on the exchange rate and inflation in China. Their dominance in domestic markets prevents Chinese firms from healthy development. Technologies transferred by them to Chinese domestic firms are not necessarily advanced. They also move pollution-producing industries to China.

The surge of such criticism has changed China’s foreign capital utilization policy. Considering the fact that foreign affiliated firms seemed to have reached a saturation point in some industries and regions, China finally adopted more selective industrial and regional policies in introducing foreign capital.

III-2-2. Selective foreign capital utilization policy

China’s basic policy toward foreign capital utilization is reflected in the “Catalogue for the Guidance of Foreign Investment Industries.” In the “Catalogue 2011 Amendment,” the following two points are emphasized.24

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20 “Despite 9 percent appreciation of the renminbi vis-à-vis the US dollar between June 2005 and August 2007, the price of Chinese goods imported into the U.S. was basically unchanged,” and “The most likely explanation is that productivity growth in those industries exporting to the U.S. was sufficiently large that firms could more than absorb the adverse effect of the rising value of the renminbi on their earnings.” Goldstein and Lardy (2009), pp. 23-24.
21 On the debate over foreign capital utilization, see Ohashi (2006) and (2008).
The first point is to guide foreign investment to specific areas according to shifts in development patterns and structural adjustments of the economy. A central focus is placed on upgrading/restructuring manufacturing and advanced manufacturing as key industries. Strategic emerging industries mentioned above are also encouraged. Investment in modern service industries is promoted and the opening-up of the service sector is to be gradually advanced. Geographically, regional balanced development is to be pursued through industrial transfer to inland areas based on the China Western Development, the Revitalize Northeast China, and the Rise of Central China plans.

The second point is to accelerate a wider range of opening-up policies and to push forth a sweeping relaxation of regulations on foreign affiliated firms. In the “Catalogue 2011 Amendment” consisting of 473 items, there are three categories, including encouraged, restricted, and prohibited industries (354, 80, and 39 items respectively) as seen in the previous catalogues. Compared with the “Catalogue 2007 Amendment,” encouraged industries increased three items, while restricted and prohibited industries decreased seven and one items respectively. In addition, industries under foreign equity restrictions decreased 11 items, including investment in new power-generation facilities.

III-3. Revival of Export Promotion Policy

In 2008, the above-mentioned export restraint measures were once again temporarily shelved. In addition to a critical change in export environment caused by the subprime loan crisis in the U.S., China’s export industries were faced with a deteriorating production environment including a rising RMB, increasing wages, and intensifying material and energy prices. Furthermore, both a high real interest rate and tightening policies under growing inflationary pressure made them cash-strapped. In particular, small and medium-sized enterprises (SMEs), a mainstay of export production, fell into stagnation due to a serious shortage of funds. The Chinese government took immediate action to raise the refund rate for export-related value added tax once again on July 30, 2008. The Lehman shock in September precipitated the partial revival of export promotion policies.

In order to spur exports, the Chinese government raised the tax refund rate seven times in total by June 8, 2009. Stating clearly “in addition to expanding domestic demand, foreign demand creates job opportunities, promotes enterprises’ development, expands domestic consumption, and provides favorable conditions for economic structural adjustment and shifts in the development pattern.” It also launched six policy measures to support export industries on May 27, 2009.

These measures include: 1) an export credit guarantee of RMB 84 billion; 2) export promotion via preferential taxation for both labor intensive and high tech products, and

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25 On the refund rates for individual items announced by the State Administration of Taxation under the Ministry of Finance, see Ohashi (2010), p. 231.
26 Guowuyuan Changwu Huiyi (2009).
export controls for the above-mentioned lianggan yizi products; 3) an enlargement of mortgages for export industries through central funds, the encouragement of export financing, the implementation of RMB settlement, and the stabilization of the RMB at a reasonable level; 4) a reduction in export industries’ burdens by eliminating and consolidating duties and charges related to distribution processes, and by streamlining legal inspections, 5) a reassessment of processing trade policies by way of facilitating taxation and customs clearance, opening-up domestic markets, and creating reductions and exemptions for customs and import duties and value added taxes on imported machinery and equipment; and, 6) a buyer’s credit granting of RMB 10 billion and the encouragement of export industries’ overseas operations by simplifying procedures.

In order to cope with export industries’ difficulties, the Chinese government changed direction to promote exports of labor intensive products and processing trade. This was to maintain a stable RMB exchange rate and to exempt some industries from “restricted” and “prohibited” items. Behind these policy changes, there was the fact that a number of export industries were closed and bankrupt, resulting in 20 million jobless migrant peasant workers.\(^{27}\) Since the Chinese government gave first priority to “social stability,” it was forced to decide again on the promotion of export-oriented SMEs directly contributing to job security.

III-4. Shift to Import Promotion and External Balance

China overcame the ill effects of the Lehman shock much earlier than other major economies by launching large-scale measures targeted at boosting the economy. The growth rate recovered from 6.6 percent to 11.4 percent from the first to the fourth quarter of 2009. China’s external economic policy at that time is explicitly reflected in the “Study on China’s Foreign Trade Development Strategy in the Post-crisis Era” published by the Chinese Academy of International Trade and Economic Cooperation under the Ministry of Commerce.\(^{28}\) The main ideas expressed in the study were summarized and elaborated on in the “Guidance on Accelerate the Transformation of Foreign Trade Development Mode” announced under the joint names of 10 government agencies headed by the Ministry of Commerce.\(^{29}\)

In the “Guidance,” the following measures were put forward: 1) reasonable regional arrangement of overseas markets and export industries; 2) construction of foreign trade bases, platforms, and international sales networks; 3) improvement of export brands and product quality; 4) grade-up of processing trade; 5) acceleration of foreign trade accompanied by outward investments; 6) development of border trade; 7) development of service trade; 8)

\(^{27}\) Renminwang (People’s Daily Online), March 2, 2009.


\(^{29}\) Shangwubu et al. (2012).
promotion of balanced trade; and, 9) improvement of trade facilitation. Based on the “Guidance,” the Ministry of Commerce announced “The 12th Five Year Plan in Foreign Trade Development (2011–15)” in April 2012.\(^{30}\)

In April 2012, the State Council published the “Guiding Opinions on Strengthening Import and Promoting Balanced Development of Foreign Trade.” The “Guiding Opinions” clarified the significance of imports by stating that “further strengthening imports to promote the balanced development of foreign trade is of great strategic significance in: utilizing both domestic and international markets and resources both at home and abroad on the basis of overall planning; alleviating bottlenecks in resources and environment; accelerating scientific-technological progress and innovation; improving the standard of consumption by residents; and, reducing trade frictions.”\(^{31}\) At the same time, the following measures were adopted to attempt to affect a shift in development patterns: 1) alleviation of resources and environmental pressure by reducing tariffs on imports of energy and materials; 2) progress and development of science and technology by reducing tariffs on imports of advanced technology and key components and parts; 3) improvement of consumption level by reducing tariffs on imports of certain daily commodities; and, 4) relaxation of trade friction.

The “Guiding Opinions” evidently demonstrated a fundamental shift in China’s external economic policy from export promotion to import promotion. Furthermore, the “Guiding Opinions” also emphasized the need to reassess the policy stance in order to encourage export and to curb import. The Chinese government currently takes a neutral stance toward both export and import.

Since then, this policy stance in regard to external economic policy has been maintained. Faced with a drop in exports caused by economic slumps in the EU countries, the Chinese government launched a series of policy measures to support foreign trade by issuing the “Several Opinions on Promoting Steady Growth in Foreign Trade” in September 2012.\(^{32}\) But, they were quite different from the previous relief measures. They did not include such measures as direct support by subsidies and adjustments in refund rates for export-related value added tax. Most of them were set out in the form of institutional changes and indirect support, including: the speed-up of tax rebate procedures; the expansion of trade finance; the reduction of borrowing costs; an increase in the coverage of export credit insurance; the introduction of paperless customs procedures and reductions in legal inspections; support for SMEs’ overseas operations and development in emerging markets; and, the accelerating of opening-up initiatives in western and central China. The “Several Opinions” also advocated other supporting measures to protect legitimate interests of China’s exporting firms, to take trade remedy actions, and to encourage the regional trade agreement (RTA) including the FTAs.

In the “Several Opinions,” the phrase “promoting the steady increase in foreign trade”

\(^{30}\) Shangwubu Waimaosi (2012).
\(^{31}\) Guowuyuan Bangongting (2012a).
\(^{32}\) Guowuyuan Bangongting (2012b).
does not imply any policy measures intended to relieve exporting firms in a slump. The basic principles and policies of the 12th Five Year Plan are also reflected in the “Several Opinions.” The Lehman shock temporarily revived China’s export promotion policy. But, its current external economic policies cannot be easily reassessed due to their being based on a shift in China’s development pattern.

III-5. From “Bringing-in” to “Going Global”

The Chinese government has given preference to foreign capital utilization over outward investment. At the end of the 1990s, when excessive savings in contrast to investment became increasingly apparent, this encouraged outward investment (going global) as well as foreign capital utilization (bringing-in). Faced with difficulties in macro-economic management due to excessive liquidity partly caused by the massive inflow of foreign capital with an eye to a strengthening RMB, China reconsidered its foreign capital utilization policy. There were two policy options as immediate countermeasures, namely revaluation of the RMB and outward investment promotion. Considering protections on domestic industries, it was very difficult to take the former option. So, the Chinese government selected the policy option of deregulation to encourage capital outflows and outward investments.

Chinese firms embarked on overseas operations in search of overseas markets, natural resources, advanced technologies, and management efficiency. Some of them also invested abroad to avoid trade friction. Multinational enterprises (MNEs) with competitive advantages in advanced countries tend to make asset-exploiting investments, while Chinese firms are likely to engage in asset-augmenting investments in order to seize competitive advantage. And, the fact that their overseas investments are targeted at avoiding the government’s regulations and controls could be reasonably explained by the internalization theory.\(^{33}\)

China’s outward investment rapidly increased in the mid-2000s, ranking third in the world after the U.S. and Japan in 2012 (Figure 2).\(^ {34}\) After publishing the “Statistical Bulletin of China’s Outward Foreign Direct Investment” in 2003, it is possible to summarize China’s outward investment more systematically.\(^ {35}\) But the “Statistical Bulletin” simply provides the direction of investment on a registered basis. The so-called tax havens such as Hong Kong, the British Virgin Islands, and the Cayman Islands have been dominant in China’s outward investment by country/area. Therefore, the service sector has accounted for more than half of its investments by industry. In other words, the “Statistical Bulletin” only shows the major transit points for final destinations of China’s outward investment. Its investment in service sectors of these tax havens would often turn out to be an investment in the manufacturing

\(^{33}\) For a study of China’s outward investment from the viewpoint of late-comer MNEs, see Yuan (2014).

\(^{34}\) On a stock basis, however, China’s outward investment is only at the 10 percent level of the U.S. and at a half of Japan. Shangwubu et al. (2013), p. 4.

\(^{35}\) Shangwubu et al. (2013). On China’s early stage outward investments, see Ohashi (2003b), pp. 163–82.
As a matter of fact, according to Wang’s study focusing on over 1,500 of China’s outward investments in 2003–11, mining and manufacturing industries accounted for 52 percent and 23 percent respectively on an accumulated value basis. In terms of the number of investments, however, mining and manufacturing industries represented 32 percent and 42 percent respectively. More than 60 percent of the total number of investments were directed to advanced countries, and 53 percent of the total number of large investment projects were also located in advanced countries. But 58 percent of the total number of outward investments by the SMEs in Zhejiang were made in neighboring countries including Vietnam and Cambodia.

Other studies including the “Annual Survey on Chinese firms’ Outward Investment” conducted by the China Council for the Promotion of International Trade since 2008 and the database on China’s outward investments compiled by the American Enterprise Institute (AEI) and the Heritage Foundation since 2005 also show these tendencies.

With increasing investments by Chinese firms, however, new international investment

Note: Non-financial investment only in 2013

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36 In 2012, China’s outward investments in the U.S. amounted to US$ 4.48 billion—an increase of 2.2 times over the previous year—while investments in the British Virgin Islands and the Cayman Islands decreased by 72.5 percent to US$ 3.67 billion. This implies that China’s direct investments in the U.S. are increasing at the expense of the tax havens, reflecting the reality that they are under growing international criticism for their tax avoidance measures.


frictions become evident. In the U.S., the investments of two Chinese telecom giants, Huawei and ZTE, are often regarded as security threats.\footnote{U.S. House of Representatives (2012).} In developing countries, Chinese firms’ corporate ethics is sometimes questioned due to extravagant behavior when pursuing interests and efficiencies. In some African countries, therefore, quite a number of Chinese workers have come under attack and in some cases have been kidnapped. Employment and tax payment are just clues to their contribution to local communities. In addition to operating safety and risk management, Chinese firms overseas are now required to behave in a friendly manner based on the guidelines of corporate social responsibility (CSR).\footnote{On the Chinese government’s response to these issues, see Ohashi (2013a), pp. 81–81.}

**III-6 Basic Directions in External Economic Policy**

III-6-1. The 12th Five Year Plan

China’s basic direction in external economic policies is reflected in the 12th Five Year Plan adopted at the Fourth Session of the 11th National People’s Congress in March 2011. The current “Five Year Plan” sets forth the plans for “mutual beneficial and win-win, improving the opening up” in Part XII.\footnote{Guojia Fazhan he Gaige Weiyuanhui (2011).}

In this part, first, the role of opening-up in stimulating domestic demand is highly emphasized by promoting opening-up in inland areas (Chapter 50: “Improve Regional Opening-up Pattern”).

Second, in shifting the foreign trade development pattern from volume-increasing to quality improving, moves were proposed for improving the quality of labor intensive export products; transferring labor intensive industries to inland areas; and, promoting service trade focusing on business process outsourcing (BPO) and intellectual property rights (IPR) industries. The role of importing is also emphasized in inducing a shift in the overall development pattern (Chapter 51: “Optimize Foreign Trade Structure”).

Third, in the FDI, as mentioned above, both foreign capital utilization and outward investment are encouraged (Chapter 52: “Coordinate ‘Bring in’ and ‘Going Global’”).

Fourth, China stresses it positive commitment to global governance and multilateral relations for the first time, as mentioned below (Chapter 53: “Actively Participate in Global Economic Governance and Regional Cooperation”).

III-6-2. “383” Reform Proposal

The basic direction of economic policies under the Xi Jinping administration is summarized in the adopted “Decision” at the Third Plenary Session of the 18th Communist Party Central Committee in November 2013. Just before the Plenary Session, the Research
Trinity of main reform issues

1. Consolidating market systems.
2. Transforming government functions.
3. Innovating corporate systems.

Eight important reform domains

1. Deepening reforms of government and administration management systems by: implementing administrative procedures based on law; improving transparency and openness; and, substantially reducing inspections and simplifying approval procedures.
2. Accelerating the reformation of basic industries by breaking down oligopolistic structures, promoting competition, and restructuring administration and management.
3. Deepening land reforms by enhancing equality, openness, and fairness.
4. Promoting the reform of the financial system by relaxing terms and conditions for participating in the financial sector and boosting the marketization of interest and exchange rates.
5. Launching reforms for a new fiscal system by adjusting authority and responsibility and redistributing fiscal strength.
6. Deepening reforms of state-owned asset management systems by defining the boundaries of authority and responsibility and capitalizing state-owned assets.
7. Encouraging innovative and green development by making the environment more competitive and creating incentive mechanisms.
8. Deepening the reform of external economic systems by opening-up the service sector.

Three combinations of related reforms

1. Opening-up, introducing external investors, and encouraging competition.
2. Deepening the social security system and establishing national basic social security.

Source: Guowuyuan Fazhan Yanjiu Zhongxin (2013).

Group of the Development Center of the State Council released the “383 Reform Proposal” (Trinity of main reform issues, eight important reform domains, and three combinations of related reforms). It is needless to say that this is not an official document, but it is a very important manuscript in clarifying the direction in which reforms are being comprehensively deepened (Table 3).

In the “Reform Proposal,” it clearly gives first priority to domestic reform and gives secondary precedence to opening-up. Reformation of the external economic system is placed last on the list of eight important reform domains. Concerning the external economy, the opening-up of the service sector is primarily put forth because it is directly related to the expansion of domestic demand and consumption.

In particular, first, the “Reform Proposal” aims at encouraging the comprehensive deepening of reforms by opening-up the energy, telecommunications, and financial sectors in order to introduce competition. Second, it boosts the FDI by simplifying procedures,
encourages high-end industries to utilize foreign capital, and stresses the protection of Chinese firms’ rights and interests in their outward investments. Third, in regard to foreign trade, it emphasizes the adding of value to export goods, FTAs, and a positive commitment to global governance. These proposals are set forth in accordance with the basic directions of the 12th Five Year Plan.

III-6-3. “Decision on Comprehensively Deepening the Reform”

The “Decision on Major Issues Concerning Comprehensively Deepening Reforms” adopted at the Third Plenary Session in November 2013 proposes, in Part VII: “building a new open economic system,” consisting of relaxing control over investment access (Chapter 24); the speeding up of the construction of free trade zones (Chapter 25); and, the further opening up of inland and border areas (Chapter 26) from the three viewpoints of comprehensively deepening reforms, following a multilateral international trade regime, and supporting domestic regional development. The “Decision” also places priority on domestic reform and regards opening-up as a tail wind for deepening reforms.

The basic directions of this “Decision” can be seen in the China (Shanghai) Pilot Free Trade Zone established on September 29, 2013. The idea of setting up a free trade zone within China has been proposed by major coastal cities such as Shanghai, Shenzhen, and Tianjin, which considered the upgrading of their bonded zones in the mid-2000s. Since then, the National Development and Reform Commission and the Development Center of the State Council have studied the feasibility of a free trade zone in Beijing, while the Shanghai municipal government officially declared the establishment of a Free Trade Zone in November 2011.

In response to Shanghai’s decision, the Chinese government gave instructions to establish the pilot free trade zone in March 2013, when Premier Li Keqiang visited Shanghai. The Executive Meeting of the State Council approved the “Framework Plan for the China (Shanghai) Pilot Free Trade Zone” in July 2013. The Pilot Free Trade Zone was ratified on September 18 (in operation on September 29) and the “Framework Plan” was published on September 27 (enforced on October 1). It launched reforms in finance, investment, legislation, and public administration, which doubled as experimental trials for comprehensively deepening reforms (Table 4).

It is currently reported that more than 20 provinces and cities already applied to the central government to establish this kind of pilot zone, and Tianjin and Guangzhou are regarded as promising candidates among them.43

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42 Xinhua (2013).
43 Zhongguo Xinwenwang (Chinanews.com), March 9, 2014.
Table 4 Framework plan for the China (Shanghai) pilot free trade zone

<table>
<thead>
<tr>
<th>Accelerating the functional transformation of government</th>
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<tr>
<td>- Deepened reform in administration system. The focus of administrative management procedures will shift from prior approval to mid-event control and subsequent supervision. An online information platform will be established to consolidate information and improve information sharing amongst various departments.</td>
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<th>Opening-up of investment sectors</th>
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<tr>
<td>- Opening-up of service sectors. 18 service sectors (banking services, specialized health and medical insurance, financial leasing, ocean transportation, international ship management, value-added telecommunications, entertainment and gaming consoles sales and services, lawyer services, credit inquiries, tourism companies, human resources services, investment management, engineering design, construction services, entertainment artist agencies, entertainment facilities, education and training, vocational skills training, and medical services) are selected to be enlarged and opened.</td>
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<tr>
<td>- Exploring the “Negative List” administrative approach. A “Negative List” mechanism will be implemented.</td>
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<td>- Setting up a system to support outbound investment administration. A filing system will be implemented.</td>
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<th>Promoting the transformation of trade development approach</th>
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<tr>
<td>- Promoting the transformation and upgrading of trade. Multinational companies are encouraged to set up their Asia-Pacific regional headquarters and/or operation centers with comprehensive functions of trading, logistics, settlement, etc.</td>
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<tr>
<td>- Elevating the capacity of shipping services. The application process for permitting international shipping will be simplified to create a more efficient ship registration system.</td>
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<th>Deepening innovation and opening-up of financial services</th>
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<tr>
<td>- Accelerating innovations in the financial system. Under proper risk control, the Free Trade Zone will pilot RMB capital account convertibility, interest liberalization, and the cross-border use of the RMB.</td>
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<tr>
<td>- Enhancing financial service functions. The finance sector will be fully opened to private investors and foreign invested financial institutions. The cross-border RMB reinsurance business is also encouraged to cultivate reinsurance markets.</td>
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<th>Improving regulatory supporting systems</th>
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<tr>
<td>- Strengthening protection through regulatory system enhancements. Some administrative regulations and provisions in the State Council documents will be terminated. Certain administrative examination and approval requirements under the “Law of the People's Republic of China on Wholly Foreign Owned Enterprises,” the “Law of the People's Republic of China on Sino-Foreign Equity Joint Venture Companies,” and the “Law of the People's Republic of China on Sino-Foreign Cooperative Joint Venture Companies” will be temporarily adjusted and such adjustment will be tentatively implemented in the next three years starting from 1 October 2013.</td>
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Source: Guowuyuan Bangongting (2013).
IV. China and International Economic System

With its rapid economic growth and an enlargement of its opening-up, China has increased its presence in the world. In analyzing China’s external economic policy comprehensively, it is necessary to consider the rise of China in the international economic system. In this section, China’s attitude toward the multilateral trade regime is to be reviewed.

IV-1. Application for the GATT

After assuming its seat in the International Monetary Fund (IMF) and the World Bank in 1980, China gave formal notice of its desire to participate fully in the General Agreement of Tariff and Trade (GATT) in July 1986. China became an observer in 1982 and a party to GATT’s Multifibre Agreement (MFA) in 1984, which was the first multilateral international agreement China joined in the reform and opening-up period.

The Chinese government envisioned a number of benefits from full participation in the GATT, as follows: 44

- It would complete China’s entry into the key international organizations.
- It would provide China greater defenses against protectionist and discriminatory tendencies.
- It would reinforce China’s right to receive unconditional most-favored-nation (MFN) treatment. 45
- It would enable China to receive preferential tariff treatment under the U.S. Generalized System of Preferences (GSP).
- It would give China access to GATT’s dispute settlement mechanisms.
- It would involve China in a series of international obligations that could be used to reinforce reforms and to make them irreversible.

In the early 1980s, above all, China regarded its participation in the GATT an important diplomatic issue of representation in international organizations and multilateral agreements.

At the same time, there were persistent counterarguments in China to oppose participation in the GATT because it would be obliged to open its domestic market and eliminate trade barriers. GATT members raised questions about China’s participation because China’s

45 China was accorded MFN treatment in principle by major trading partners based on bilateral trade agreements by 1980. Since the Jackson-Vanik amendment to the U.S. Trade Act of 1974 affects U.S. trade relations with communist or former communist countries that restrict freedom of emigration and other human rights, however, the provision of MFN treatment to China should not be renewed without any annual re-examination. China’s trade with the U.S. was burdened by such uncertainty. China’s participation in the GATT could reduce it. Furthermore, the U.S. made it a rule to grant GSP only to GATT and IMF members. Ohashi (1998), pp. 14–47.
economy with the remnants of planned economy is fundamentally inconsistent with the market-oriented GATT system. It eventually took 15 years for China to secure participation in the World Trade Organization (WTO) as a successor organization of the GATT.

**IV-2. Accession to the WTO**

China’s traditional diplomacy has been based on the bilateral relations of the classical sovereign state system. To cope with the liberalization and facilitation of trade and investment launched under Asia-Pacific Economic Cooperation (APEC) initiatives and the after-effects of the Asian financial crisis in the late 1990s, China took its initial step toward economic diplomacy, which covered not only bilateral but also multilateral relations.

After accession to the WTO, China paid more attention to the multilateral trade regime. In the reform and opening-up period, China has adapted itself to this sort of trade system at a large cost of time and money. China was not able to engage in the initial stages of building the post-war international economic order known as the Bretton Woods regime. China has also made efforts to comply with all related international rules and agreements although it had little involvement in the multilateral talks in the GATT/WTO system. Although China is currently the country that imports the largest amount of natural resources, it has been unable to actively influence import prices.

In this way, China has been frustrated with the existing international economic system, although it correctly perceives the unrealistic nature of the New International Economic Order (NIEO) proposed in the Mao Zedong era. In response to various existing international regimes, however, China cannot help but resort to the reasonable options of “exit, voice, and loyalty”\(^\text{46}\) in reaction to the adjustment of costs. In relatively hard international regimes such as trade and monetary systems, it is practically impossible for China to create another regime or to reorganize the existing regimes because it cannot bear the costs of reconstructing the current international economic order on its own. In making new international trade rules, therefore, China seems to seek for considerable influence over the decision-making, on the one hand, but tries for substantial reductions in fulfilling its responsibilities and duties under the expected new rules, on the other.

In this context, China made efforts to position itself so that it can exercise considerable influence over decision-making in the WTO. In the decision-making process of the WTO, there is the following hierarchy of meetings: 1) a general council meeting, 2) an unofficial meeting, 3) a green room meeting, and 4) a small group meeting. Major decisions are initially agreed on in a small group meeting of key players. In the 20\(^{th}\) century, the small group was known as the QUAD (the U.S., the EU, Canada, and Japan). After the Doha Round in the 21\(^{st}\) century, it was called G-6, in reference to its six key players (the U.S., the EU, Japan, Australia, Brazil, and India).\(^\text{47}\) China became a member of the small group as the second largest trading country at the unofficial Ministerial Conference in July 2008. The small group

\(^{46}\) Hirschman (1970).
currently consists of G-7 countries.

China has received a wide range of support from developing countries as a leading country in the G-77 and G-20 of major developing countries in the WTO. In addition, since China became a member of the WTO’s G-7, it has sought to enhance its international status and to protect its interests on the global stage by making positive commitments to: rule-making in international trade systems; support for countries in economic crisis; the provision of assistance to developing countries; and, structural reforms for international organizations.

China was willing to join the WTO, but reluctantly became a member as a non-market economy. Since then, China has been treated differently from the other members for 15 years after its accession to the WTO—which supposedly assumes non-discrimination as one of its basic principles. Therefore, it is one of China’s main objectives in its WTO diplomacy to obtain a market economy status.

IV-3. ASEAN-China FTA

China has considerably benefited from trade liberalization since accession to the WTO. Fortunately, it suffered less ill effects of participating in the WTO system than expected. In addition to the Doha Round in deadlocked negotiations, however, a number of anti-dumping and countervailing duty investigations have been targeted at Chinese export products. Dealing with them effectively, China has shown increasing interest in FTAs.

China’s first FTA was concluded as a framework agreement with the Association of Southeast Asian Nations (ASEAN) in November 2002. The ASEAN-China FTA (ACFTA) was fully enforced through a number of formalities on January 1, 2010. China’s average tariff rates on imports from ASEAN-6 excluding Cambodia, Laos, Myanmar, and Vietnam (CLMV) were reduced from 9.8 percent to 0.1 percent. ASEAN-6’s average tariff rate on imports from China was also lowered from 12.8 percent to 0.6 percent. The CLMV plans to apply zero-tariff rates to Chinese goods by 2015. As a result, more than 90 percent of items are currently traded on a basis of zero-tariffs between China and ASEAN-6.

China initiated ACFTA negotiations for the following reasons.

First, China needed to build mutual confidence with neighboring countries to cope with the “China threat.” In addition to territorial disputes, ASEAN countries were under an

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47 G-6 countries are all the de facto leaders of the negotiation groups within the WTO: the U.S. and the EU in advanced industrial countries, Brazil and India in developing countries, Australia in the Cairns Group of agricultural exporting countries, and Japan in advanced industrial countries and G-10 countries lobbying for agriculture to be treated as diverse and special.

48 In the U.S., for example, dumping margins of exported products from China are calculated without any reference to their domestic prices because fair prices are not correctly reflected in a non-market economy. The Chinese government complains that heavier anti-dumping duties are recurrently imposed on Chinese exporting products, and it regards them as reflecting discriminatory treatment. Ohashi (1998), pp. 133–56.


50 On the background of ACFTA, see Ohashi (2003a).
economic threat from China and faced a massive inflow of Chinese products into their domestic markets and large scale diversion of FDI to China. China also succeeded in regaining trust by eliminating concerns over devaluation of the RMB exchange rate during the period of the Asian financial crisis.

Second, China made positive commitments to regional cooperation. Financial crises are an example of issues that were not typically treated in the framework of traditional bilateral relations. By increasing involvement in these issues, China began to play a more constructive role in multilateral regional cooperation. In addition, needless to say, China intended to disturb Taiwan’s “go south” policy by drawing closer to the ASEAN countries.

Third, China aimed at diversifying its export and investment markets. Intensifying trade disputes with the U.S. and the EU and increasing protectionism all over the world induced China to take a strong interest in ASEAN’s emerging markets.

Fourth, China placed the ACFTA in the context of regional development in inland areas. It tried to link China Western Development with Greater Mekong Subregion (GMS) economic cooperation. This policy stance is basically reflected in the China-ASEAN Expo (CAEXPO) annually held in Nanning, Guangxi.

Fifth, China also expected FTAs including the ACFTA to support the momentum of market-oriented reforms in the post-WTO period.

**IV-4. Engagement in FTAs**

The ASEAN Free Trade Agreement (AFTA) was the only RTA in East Asia by the end of 1990s. At the turn of the century, however, most East Asian countries showed strong interests in FTAs. This is mainly because the multilateral WTO system became dysfunctional. Furthermore, the production network in East Asia requires a FTA to facilitate borderless transactions.

Modular products such as information technology (IT) products played a leading role in rapid industrialization in East Asia. Product architecture of these products has wholly changed the international division of labor in manufacturing industries throughout the world.

Because of standardized parts and simplified interfaces between them, the integrated production processes of modular products can be fragmented into smaller production blocks located in the most suitable places for each process. Remarkable development of telecommunications and transportation can sharply reduce the service link costs between production blocks and between industrial clusters. In this way, a wide range of production networks are closely established in East Asia, in which China is located as a final assembling...

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51 For example, the WTO has major difficulties in decision-making by consensus due to an increasing number of members and expanding negotiation domains.

52 On the revolutionary changes in product architecture that enabled the rise of China in modular products, see Fujimoto (2004).
and processing base.\textsuperscript{53} Therefore, it is critically important for China to be involved in the seamless production networks based on FTAs for the smooth movement of production factors beyond borders.

China’s FTA strategy is founded on comprehensive diplomatic considerations as well as economic requirements. China’s main FTA partners can be classified as follows.

- Closer Economic Partnership Arrangements (CEPA) with Hong Kong and Macau, and an Economic Cooperation Framework Agreement (ECFA) with Taiwan for the unification of Greater China.
- FTAs with neighboring countries (ASEAN, Korea, and Pakistan) for eliminating the “China threat” and strengthening mutually confident relations.
- FTAs with the Gulf Cooperation Council (GCC), the Southern African Customs Union (SACU), the Shanghai Cooperation Organization, Latin American countries, and Australia for securing resource supply.
- FTAs with Iceland and Switzerland for entering the EU market.

The RTA should take into account GATT Article XXIV and the Enabling Clause.\textsuperscript{54} As a developing country, however, China is in a sense allowed to conclude the FTA even if it does not completely fulfill the following requirements: 1) the substantial elimination of all tariffs and non-tariff barriers in the free trade areas; 2) the prevention of increased tariffs and non-tariff barriers to trading partners outside the free trade areas; and, 3) the establishment of free trade areas within a reasonable period of time and on a reasonable schedule. China’s FTAs, and AFTA as well, are agreed under relatively loose conditions. It has a tendency to put forward some exceptional items for exemption from trade liberalization, create special schedules for specific industries, and make rules of origin to its advantage.

China tends to sign a framework agreement at an early stage, as shown in the case of ACFTA, and then proceed to upgrade the FTA on a step-by-step basis. In contrast with China’s gradual approach, for example, Japan is inclined to pursue a comprehensive agreement with detailed accounts over the course of repeated negotiations. China engages flexibly in FTA negotiations by proposing lower tariff rates and by suggesting exceptional items. And, because of its huge domestic market, China is able to advance FTA negotiations dominantly.

China’s unique approach to FTAs is very effective for developing countries in East Asia. It gives priority to East Asian FTAs, including those of ASEAN+3 (China, Japan and Korea), China-Japan-Korea (CJKFTA), ASEAN+6 (adding Australia, New Zealand and India to ASEAN+3), and the Regional Comprehensive Economic Partnership in East Asia (RCEP).\textsuperscript{55} Particularly, China expects possible economic effects from the CJKFTA, whose negotiation

\textsuperscript{53} On the international division of labor in this context, see Ando and Kimura (2010).
\textsuperscript{54} On developing countries’ RTAs and the Enabling Clause, see Tsukui (1993), pp. 21 and 184–86.
\textsuperscript{55} The ASEAN+6 turned into the RCEP at the East Asian Summit (EAS) in November 2012.
started in March 2013, but which has had its conclusion forestalled by current political tensions.

IV-5. Response to the TPP

IV-5-1. Critical Attitudes Toward the TPP

President Obama’s decision to participate in the Trans-Pacific Strategic Economic Partnership Agreement (TPP) in November 2009 had a great impact on China which had developed its own FTA strategy in East Asia.

At first, China grew concerned about a TPP led by the U.S. From the viewpoint of classical geopolitics, it was regarded as a coalition against China. It seemed to China that the U.S. expressed interest in participating in the TPP for the following reasons. First, the U.S. wants to develop Asia-Pacific emerging markets to achieve President Obama’s goal to double U.S. exports under the National Export Initiative. Second, it intends to restore leadership in the Asia-Pacific region based on the “return to Asia” strategy. Third, it aims at restraining China’s expansion and diluting China-led FTAs in East Asia by reinforcing the TPP. According to another more realistic view, the U.S.’s real intention in participating in the TPP is to secure status as a rule-maker in the regional trade regime so that U.S. firms might benefit from economic development in the Asia-Pacific region.

China has maintained a negative attitude toward the TPP. First, it is very difficult for China to accept the framework of TPP because it aims at a higher level of trade liberalization. Second, the TPP negotiations would be inevitably prolonged due to their covering a very wide range of trade issues and including various countries at different levels of economic development. Third, China might underestimate the intentions of East Asian countries in participating in the TPP. It had regarded their behavior as a kind of risk reduction measure to decrease their dependence on China’s economy.

The TPP would have a serious impact on China-led economic integration in East Asia. First, it divides an existing framework of regional integration because there are two parties in East Asia, participants and non-participants in TPP negotiations. Second, it retards economic integration in East Asia because it is likely to disperse resources and efforts for regional integration carried out thus far. Third, it makes it more difficult to achieve regional integration because the TPP pursues a higher level of trade liberalization and existing frameworks will also have to raise the level of regional integration in accordance with TPP requirements.

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56 Du (2011).
57 Wei and Zhang (2010).
IV-5-2. Approaching the TPP

Under Secretary Francisco Sanchez, U.S. Department of Commerce, stated during his visit to Japan in May 2013 that the U.S. would welcome China’s participation in the TPP under the condition that China is essentially obliged to observe TPP agreements in regard to a high level of trade liberalization.\(^{59}\) Ministry of Commerce spokesman Shen Danyang responded to the U.S. proposal, stating that China has insisted on open, inclusive, and transparent principles in building FTAs, which should be flexible particularly with economies at different levels of development, and stated also that it is necessary for those economies to have more choices in regard to the process of integration. He added that China has carefully observed the development of TPP negotiations, has held a series of hearings regarding the TPP with representatives from a wide range of domestic sectors and industries, has studied both advantages and disadvantages of participation in the TPP on the basis of equality and mutual benefit principles, and that it planned to exchange information and undergo consultation with TPP members.\(^{60}\) China’s positive response to the TPP attracted worldwide attention.

In the first half of 2013, China made a subtle change in its attitude to the TPP in connection with three events. First, the pace of TPP negotiations was accelerated. Second, Premier Abe announced Japan’s proposed participation in the TPP on March 15, 2013.\(^{61}\) Third, China also changed its approach to the U.S. by proposing a “new model of major power relations” at the summit meeting between President Obama and President Xi Jinping on June 7–8, 2013.

There seems to have been a substantial change in China’s perception of the TPP.

First, if both the U.S. and Japan participate in the TPP, China would suffer a lost opportunity in not joining. The participation of these countries may have revised China’s perception of the TPP.

Second, a TPP without China—the second largest economy in the world—would be significantly less attractive. China might realize that the U.S. does not have any intention to exclude it from the TPP but rather has a keen interest in opening up its domestic markets. China’s approach to the TPP indicates its intention to break part of what it considers to be an “anti-China coalition.”

Third, China tries to place the TPP in the context of a “new model of major power relations” proposed by President Xi Jinping. China’s approval of a U.S.-led TPP would lead to a mutual respect for the U.S.’s existing interests and China’s core interests in East Asia. Under the current international trade regime, the WTO often adopts the existing business customs of a major RTA as a global rule. Participation in a mega FTA like the TPP would imply that China in cooperation with the U.S. could make positive commitments to rule-

\(^{59}\) *Nikkei Shimbun (Morning Edition)*, May 17, 2013.

\(^{60}\) *Shangwubu Xinwen Bangongshi* (2013).

\(^{61}\) Canada approved the entry of Japan into TPP negotiations on April 20, 2013. All members approved Japan’s participation in TPP talks. *Nikkei Shimbun (Evening Edition)*, April 20, 2013.
making in the international trade regime.

At the U.S.-China Strategic and Economic Dialogue (S&ED) in May 2013, the two countries agreed to advance negotiations on the bilateral investment treaty (BIT), which first began in 2008 but which was subsequently temporarily shelved due to the international financial crisis. The two countries agreed to the BIT talks on the basis of pre-establishment national treatment (PENT) and a negative list approach. The PENT means that foreign investors and their investments will be accorded national treatment in the pre-establishment phase of their businesses. The BIT has much in common with the experimental trials of the Pilot Free Trade Zone in Shanghai. At the World Economic Forum in Davos in January 2014, U.S. Trade Representative Michael Froman clearly stated that the U.S. wanted progress on BIT talks with China before it would consider expanding the TPP to include China. His statement implicitly suggests the possibility and the limitation of China’s participation in the TPP.

V. Concluding Remarks

On his trip to the ASEAN countries in October 2013, President Xi Jinping proposed the establishment of the Asia Infrastructure Development Bank (AIIB) to promote infrastructure improvement in developing countries in Asia. In March 2014, China’s Finance Ministry announced that it began to make preparations for establishing the AIIB with a capital of US$ 50 billion. As the Asian Development Bank (ADB) indicated, in the process of recovery from the Lehman shock Asian countries would generate considerable demand for infrastructure investment over a long period and that sustained growth could not be achieved without infrastructure improvement. China’s proposal of establishing the AIIB, as seen in the case of the BRICS (Brazil, Russia, India, China, and South Africa) Development Bank for developing countries, should bring new challenge for its external economic policies. AIIB is firmly placed in the context of China’s diplomacy with neighboring countries. According to a Chinese opinion leader, as Japan increased its influence over the world and acquired its current international position by establishing the ADB and the Overseas Economic Cooperation Fund (OECF), a provider of Yen loans and the predecessor of Japan Bank for International Cooperation (JBIC), the AIIB would serve as a means of transforming China’s economic power into political and diplomatic influence.

The AIIB would provide an opportunity for China to play a positive role in establishing international economic order and rules. It also would indirectly support Chinese businesses

64 According to the study of ADB and ADBI (2008), approximately US$ 8 trillion is to be required for improvement of the infrastructure during the period between 2010 and 2020 for Asia to show a potential growth power in the future.
in developing their new markets with vast demand for infrastructure improvement in neighboring countries. Infrastructure development would lead not only to an expansion of export and investment but also to an increase of service trades, such as construction and “build-operate-transfer (BOT) businesses. This expansion would be in accordance with the basic principles of China’s external economic policy in encouraging service trades and outward investment. As seen in the proposals for establishing the BRICS Development Bank and the AIIB, China has kept a certain position in the international economic system. It is strengthening its positive commitments to multilateral international economic relations.

There is another side to external economic policy in promoting domestic reform. At the Third Plenary Session in 2013, China decided to take new deregulation measures such as open access to state dominant sectors of petroleum, railroad, electric power, and telecommunications. Considering there still remain a number of restrictions on private companies’ market entry and investment ratio, it is surely too early to evaluate the policy effects of such deregulation measures. China launched comprehensively deepening reforms. In the Shanghai Pilot Free Trade Zone, the liberalization and deregulation in international transactions of the RMB and the opening-up of the service sector are in progress as scheduled. In the early stages of reform and opening-up, successful experiments in the special economic zones (SEZs) spread nationwide. The Shanghai Pilot Free Trade Zone is expected to play a similar role as the SEZs did in the 1980s. Since Deng Xiaoping’s southern tour in 1992, however, China has accelerated market transition. The current economic structure is more complicated and institutionalized than ever. In this context, the Shanghai Pilot Free Trade Zone at present would have less presence than the SEZs did in the 1980s.

TPP negotiations without China would have considerable impact on its comprehensively deepening reforms and the Shanghai Pilot Free Trade Zone. There are some common features in the basic direction, scale, timing, and sequencing between the TPP negotiations and the structural reforms in China. Certainly, external economic policy would have less impact on economic reforms than it used to in the 1980s–90s, but it could provide necessary and sufficient conditions for China to comprehensively deepen its reforms.

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