

# Chinas Move to Preferential Trading An Extension of Chinese Network Power?

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**China's Move to Preferential  
Trading: An Extension of Chinese  
Network Power?**

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**China's Move to Preferential Trading:  
An Extension of Chinese Network Power?**

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**ABSTRACT**

China is a latecomer to preferential trading agreements (PTAs), choosing to complete its accession to the WTO before embarking on negotiations for preferential agreements. Since 2001, China has become a very active player in such agreements, currently having concluded treaties or being in the process of negotiating them with close to 30 partners. China's approach to PTAs is characterized by pragmatism; rather than following the American and European practices of using a template for all partnerships, China has been willing to tailor agreements to the specific relationships it is pursuing. Like other governments, China has a mixture of motives in pursuing PTAs. In some relationships, diplomatic/strategic considerations are paramount. In others, China seeks to pursue various economic interests, one of the most significant of which has been security of supply of raw materials. China's various motivations in PTAs are examined through three case studies: the Closer Economic Partnership Agreement with Hong Kong; the China-ASEAN Free Trade Area; and the negotiation of a PTA with Australia.

**Keywords:** *China, preferential trading agreements, ASEAN, Australia.*

Participation in the global trading regime has been a major factor in the rise of Chinese economic power. China's accession to the WTO provided it with the relative security of market access that it had long sought and helped reinforce China's place in East Asian production networks.<sup>1</sup> Moreover, preparation for WTO entry as well as implementation of the terms of China's accession agreement, reflected principally in a slashing of tariffs and the removal of many non-tariff barriers, provided a significant stimulus to the competitiveness of the local economy (Lardy, 2002; Noble, Ravenhill and Doner, 2005).

China, however, was a latecomer to preferential trading agreements (PTAs).<sup>2</sup> Unlike other Northeast Asian economies, particularly Japan and Korea, China's reluctance to jump on board the preferential trade bandwagon owed little to concerns that these arrangements might undermine the multilateral trade framework. Rather, it was a pragmatic response to the sensitivities of negotiations over its WTO accession—Beijing was unwilling to embark on preferential negotiations until its entry to the WTO had been successfully concluded.

Pragmatism has remained the hallmark of China's economic diplomacy in the years since WTO entry. Countries use economic instruments to pursue a variety of foreign policy objectives—some of which may be far removed from securing domestic economic benefit, narrowly conceived. The negotiation of preferential trade agreements is no exception to this generalization. In East Asia over the last decade, countries have negotiated PTAs with relatively insignificant economic partners—sometimes because they wanted to gain experience in negotiating these agreements (for instance,

Singapore with New Zealand, Korea with Chile), or primarily for political reasons (most obviously in Taiwan's negotiation of PTAs with Guatemala and Nicaragua, two of the relatively small number of countries that accord Taiwan diplomatic recognition). But even where the other party is a relatively significant economic partner, the motivations for negotiating the agreement may be as much political-strategic as economic—seen, for instance, in Singapore's efforts to “anchor” its relationships with all of its major strategic partners—the United States, India, Japan, and China—by negotiating (often ‘unequal’) trade agreements with them. Preferential trade agreements thus are instruments that may facilitate the pursuit of multiple objectives—not necessarily as alternatives but sometimes simultaneously within a single agreement.

In this paper, we examine China's pursuit of PTAs in the period since 2001. Table One lists China's current activity in negotiating and implementing PTAs. As this table illustrates, China has become a very active player in negotiating PTAs in the brief period since its accession to the WTO. As the world's second largest and fastest growing economy, China is an attractive PTA partner for many governments, despite the potential threat that its exports may pose to their domestic manufacturing. The potential demand for PTAs with China from other countries therefore is likely to exceed China's capacity to negotiate these agreements—even before taking into consideration those agreements that China itself might want to initiate. The FTA division of MOFCOM, the Chinese government agency with principal responsibility for negotiating PTAs, has a professional staff of around 20, of

whom only a dozen in 2006 were experienced negotiators [Interviews, Beijing, June 2006]. The division's resources were already so severely stretched by 2005 that the Ministry's WTO division took responsibility for handling the PTA negotiations with Australia and New Zealand, the two industrialized economies with which China is currently negotiating.

Given these bureaucratic constraints, China's choice of negotiating partners gives a clear indication of the government's priorities in using PTAs as a foreign policy instrument. Those negotiations that Beijing itself chose to initiate provide the clearest evidence. But so too, given the range of keen partners, do the invitations that Beijing has chosen to accept from other countries. Table One indicates that China has initiated less than half of the PTA negotiations on which it has embarked. From this listing, we can deduce four categories of partnerships, and their various motivations, that China has chosen to pursue:

- those intended to facilitate Chinese production networks—the economic partnership agreements signed with Hong Kong and Macau;
- proposals for agreements with neighbouring states (ASEAN, India, Japan and Korea) that China has made, initially at least primarily out of diplomatic considerations (although potential economic benefits certainly should not be entirely discounted);
- relationships, primarily initiated by China, with resource-rich countries/regional groupings, intended to enhance China's security of supply of raw materials (Brazil, Gulf Cooperation Council, Southern African Customs Union);

- invitations for negotiations, initiated by relatively small, resource-rich industrialized economies (Australia and New Zealand), that China has accepted.

In the second half of this paper we examine three of these relationships in more detail—those with Hong Kong, ASEAN, and Australia. First we look at the more general influences on China's PTAs.

### **China's PTAs in Comparative Context**

We begin by highlighting a number of dimensions on which China's PTAs differ in their content and their motivations from those of other countries.

First, China, unlike particularly the United States and the EU, but also Japan, has no single template for its PTAs. Again, this is an indicator of the pragmatic approach that China has taken: its agreements negotiated to date vary substantially in their content. Some cover only trade in goods (and may have partial coverage of this trade), some include services and investment.

Second, China has been happy to sign vague framework agreements whose details have subsequently to be negotiated—behaviour that accords well with the practices of other states in East Asia, and brings to mind the caustic comment about the ASEAN Free Trade Area, namely that its acronym stood for “Agree First, Talk After”.

Third, China has shown no great concern for the compatibility of its agreements with WTO rules that permit regional trade agreement as an exception to the requirement that members should provide most-favoured-nation status to one another. Officials and academics have been content merely to state that the rules of the WTO clearly acknowledge the legitimacy



of regional trade agreements, and China should take advantage of the flexibility this entails.<sup>3</sup> This stance is in marked contrast to that of Japan and the EU, which have frequently resorted to tortuous reasoning in attempting to demonstrate the incomplete agreements they have negotiated are compatible with the requirement under Article XXIV that regional agreements must cover “substantially all the trade” between partners. In part, this relaxed attitude to WTO rules may be because agreements that China signs with other countries that classify themselves as “developing” in the WTO (which includes, for instance, its agreement with ASEAN) are not subject to Article XXIV but to the even laxer requirements of the “Enabling Clause”.

Fourth, unlike Japan where the Ministry of Economy, Trade and Industry has argued repeatedly that PTAs can be an important instrument for enhancing competitiveness in the domestic economy and, in particular, for exposing traditionally protected sectors, most notably agriculture, to international competition, the Chinese government in its official statements on PTA negotiations has made little reference to the potentially beneficial competitive effects of PTAs on the domestic economy.<sup>4</sup>

Fifth, again in marked contrast to the EU and the United States, whose PTAs frequently have a mercantilist character—being designed with the intention of opening foreign markets to their exports—the unequal character of the PTAs that Beijing has signed to date has been to the advantage of China’s partners. Again, this can be attributed both to China’s pragmatic approach and to its desire to use economic instruments for diplomatic advantage. The unequal obligations are particularly noticeable in the “Early

Harvest” provisions of the agreements with ASEAN and with Pakistan. In these instances, Beijing has chosen not to make use of the asymmetries in economic power between the parties to its own economic advantage, opting instead to use the PTAs as assurance mechanisms against fears by the weaker parties of Chinese economic domination. In the ASEAN agreement in particular, Beijing was willing to accept ASEAN exports of agricultural products fully cognizant that these would damage domestic producers in provinces bordering ASEAN. This reluctance to capitalize on its relative power has not carried over, however, to its negotiations with Australia and New Zealand, where Beijing has been insistent on minimizing damage to its vulnerable domestic sectors, particularly agriculture. And, of course, some will see Beijing’s willingness to agree to “unequal” treaties as merely an expedient approach in which some economic interests are sacrificed in the short-term in order to secure long-term gains.

China’s willingness to accept agreements that discriminate against its interests is the classical behaviour of a benevolent hegemonic power, reminiscent of the US tolerance of discrimination against its exports by its European and Northeast Asian allies in the period after 1945. One consideration in China’s policies has been rivalry over leadership of the East Asian region, the area to which China gives top priority in its diplomacy. China has attempted to position itself advantageously vis-à-vis Japan in its dealings with smaller economies in the region. In its negotiations with ASEAN economies, Japan’s behaviour has resembled that of the EU and the US in their negotiations with weaker parties—Tokyo has been very reluctant to

make any concessions that would adversely affect domestic interests. Japan's agreement with Singapore was markedly unequal, with the latter having to agree to far greater openness of its market than Japan was prepared to offer to secure an agreement. Beijing's concessions on imports of agricultural products through the Early Harvest provisions of the ASEAN agreement placed it in a particularly favourable light compared with Tokyo's (and Seoul's) unwillingness to make concessions on agricultural imports in the PTAs they have negotiated with ASEAN states. Beijing is acutely aware of the alternative designs for East Asian regionalism that have been put forward, and believes that it alone—through the CAFTA Agreement—has implemented a practical mechanism for moving regional cooperation forward.<sup>5</sup> Beyond reassuring regional states about its intentions, China's pragmatic stance on PTAs is intended to reinforce its claims to be the natural leader of a developing country coalition within the global economic system, with the potential benefit of enhancing its bargaining position within the WTO.

### ***The Economic Dimension***

Even in those instances where China's proposals for PTAs were initially driven primarily by diplomatic/strategic considerations, as in the CAFTA relationship, economic considerations inevitably were not entirely absent—and came into greater prominence once negotiations on the agreements began.

A primary economic objective in China's negotiation of PTAs is to ensure better treatment than Beijing enjoys within the WTO, where it has been disadvantaged in part because of the concessions that it was forced to

make in the accession negotiations. Foremost here is the desire to be treated as a market economy by its trading partners, a status that would render Chinese exports less vulnerable to arbitrary anti-dumping actions. Partners' recognition of China as a market economy has been a non-negotiable precondition for the opening of PTA negotiations. The desire to gain recognition as a market economy appears to have influenced the choice of invitations for PTAs that Beijing has accepted. It is probably no coincidence that China's first negotiation of a PTA with an industrialized economy was with New Zealand, the third smallest of the OECD economies (after Iceland and Luxembourg)—and therefore a relationship in which the asymmetry in economic power was most marked. Once New Zealand conceded recognition of market economy status, Australia, the next industrialized economy to enter negotiations, had no alternative but to follow suit. China's next choice of industrialized economies as a PTA partner was the smallest of the OECD members, Iceland. One reason for the delay in the opening of negotiations of the proposed PTA between China and India has been the reluctance of the latter to accord China market economy status.

A second factor dominant in many of the negotiations that Beijing has initiated, and in its choice of proposals for PTAs it has accepted, has been the desire to enhance China's access to raw materials. China's sustained rapid economic growth has rested on enormous increases in imports of raw materials and particularly of energy.<sup>6</sup> China's increasing dependence on imports has led to a dramatic expansion of the country's economic diplomacy with all parts of the global economy. Beijing's forays in Africa have attracted a

great deal of critical attention but it has been equally active in resource diplomacy in Latin America, the Middle East and in Central Asia. From 2004 to 2006, the National Development and Reforms Commission (NDRC) released a series of policy notices on the measures to support “important projects encouraged by the government”. The measures include giving preference in granting licenses by the NDRC, as well as providing loans and financial insurance, financing support, and establishing risk security mechanism through the China Import & Export Bank, the China Export & Credit Insurance Corporation (SinoSure), and the China Development Bank.

PTAs have been part of the arsenal of diplomatic weapons that China has brought to bear in its quest to enhance its resource security. At the very least, signature of a PTA, assuming a reasonably non-confrontational process of negotiation, can be expected to provide an improved context for the operations of China’s major resource corporations. Here it is not a matter so much of facilitating production networks but the operations of giant vertically-integrated corporations. More specifically, China has sought to ensure that PTAs will end any discrimination against its resource investments and deliver at least most favoured nation treatment in its partner economies—the Australian case, discussed below, provides a good example. And China has sought to include provisions in its PTAs that enable its resource companies to bring in Chinese labour to staff its resource projects. Beyond these specific measures, it is not clear what PTAs can deliver to China, and whether Beijing’s expectations are realistic—it has referred, for instance, in the PTA negotiations with Australia to securing access to resources at “reasonable”

prices. The Australian government had explained that prices in the resource were set by private company decisions, which was not controlled by the state because Australia was a market economy. Nonetheless, Chinese officials believed the Australian government should still have been able to restrain such company behaviour.<sup>7</sup> In a world in which natural resource extraction is often controlled by global transnational corporations, usually headquartered outside of the country in which the resource extraction is taking place, the capacity of inter-governmental agreements to affect the allocation and pricing of minerals is limited.

Even though China has not been as aggressive as the EU and the US in attempting to use PTAs to open the markets of its negotiating partners, the potential that such agreements may have to enhance exports at a time when China faces growing protectionist pressures in North America and Western Europe is clearly an attraction to domestic economic interests. But with the exception of the agreement with Hong Kong (which accounts for over 15% of China's total exports), China's PTA negotiations are taking place with relatively minor trading partners. Although Beijing has frequently emphasized the potential significance of the combined CAFTA market (the "world's largest FTA"), ASEAN countries together account for only 7% of China's total exports. And, given the zero tariffs of Singapore, ASEAN's single most important market for China, which accounts for 2% of China's global exports, it is not immediately obvious how much its market access will be improved when CAFTA is fully implemented (not least because of the vagueness of the trade liberalization provisions—their being defined in customary ASEAN

fashion as tariffs between zero and five percent—and because of the historic reluctance of ASEAN economies to reduce protection of politically sensitive industries despite PTA obligations).

Liberalization of trade in services has not been high on China's initial negotiating priorities in its PTAs—indeed, in several of the agreements, negotiations on services have not begun until several years after the treaty on goods trade was concluded. China's reluctance to negotiate on services has been a contentious issue in the negotiations with New Zealand and particularly Australia, where domestic service industries have lobbied to ensure that talks on services occur simultaneously with those on goods. Beijing is clearly reluctant to expose weak domestic service industries, especially the financial sector, to international competition beyond that to which it has already committed in the WTO. China prefers a safety-first approach to liberalization, in particular in finance, not least because of its memories of the detrimental impact of crises on its neighbours. Beijing also argues that the liberalization of telecommunications and cultural services sector may endanger its national security if liberalization is not done carefully. One of China's objectives in service negotiations with industrialized economies has been to improve the opportunities for Chinese professionals to work in partner economies—in the Australian case the focus has been particularly on nurses. Apparently Beijing sees PTAs providing a partial solution to lack of domestic employment opportunities.

Beyond these general principles in its PTAs, individual agreements have served particular economic purposes. For instance, CAFTA has

provided a foundation for infrastructure strengthening and for micro-regional development in the Greater Mekong River sub-region in Western China. The closer economic partnerships with Hong Kong and Macau, on the other hand, are clearly intended to give Chinese networks in these countries an advantage over those involving Taiwanese capital that operate across the Straits.

### **Case Studies**

#### **Case I: China-Hong Kong Closer Economic Partnership Agreement (CEPA)**

On the sidelines of the 14<sup>th</sup> General Meeting of PECC on 28 November 2001 (immediately after China and ASEAN had agreed to set up a PTA), Chinese Vice Minister of MOFTEC Long Yongtu disclosed that Tung Chee Hwa, Hong Kong Chief Executive, had proposed to form a special trade area comprising the mainland, Hong Kong and Macau. Then Chinese President Jiang Zemin and Premier Zhu Rongji reportedly immediately gave a positive response to Tung's proposal (CASS, 2003; Dong, 2003). Long Yongtu held that the establishment of such an area was totally in line with the WTO regulations, and this view was supported by Mike Moore, then Director General of the WTO, who cited the examples of the EU and NAFTA.<sup>8</sup> In December 2001, during his annual job report in Beijing, Tung formally submitted proposals to the central government to establish a 'Sino-HK Free Trade Area'. Beijing welcomed the proposal but re-named the proposed arrangement a Closer Economic Partnership Agreement (CEPA), on the grounds that FTAs were usually concluded between sovereign countries (CASS, 2003; Peng, 2003).



### ***Beijing's Motivations***

The CEPA was widely considered a 'big present' from the mainland to Hong Kong, presented upon Premier Wen Jiabao's first visit in June 2003 (Hu, 2003). Because Hong Kong had historically positioned itself as a free port, the CEPA was largely a one-way opening of trade by the mainland. China Customs Administration predicted that HK's services exports to the mainland would increase but the mainland would not gain many economic benefits. Trade in goods would not increase by much because the labour-intensive products of the mainland already dominated the HK market and most of HK's manufacturing had already moved to the mainland to utilize cheap labour and land (Guan, 2005).

The first objective of the CEPA was to lift Hong Kong's economy out of depression. In 2001, Hong Kong was in one of the worst economic depressions in its history after being hit by the Asian Financial Crisis and the subsequent global economic slowdown. An economist at the Hong Kong-Macau Office of China's State Council pointed out that CEPA could help HK maintain production and exports, and expand services trade to deal with the adverse external economic environment.

Secondly, CEPA was intended to give Hong Kong a time advantage that would allow its products and companies duty-free access to the mainland market earlier than other countries would achieve under China's WTO commitments (Kong, March 2003) (Zhang and Wei, 2004) (Jia, 2005). When it became certain in 2001 that China would become a member of the WTO, Hong Kong businessmen were worried they would lose their traditional role of

being an economic bridge between the mainland and other countries. Some Hong Kong companies (in particular small-and medium-sized enterprises), academics and professionals in Hong Kong put pressure on the HK government to request the mainland central government to grant them preferential treatment. According to officials at the China Customs Administration and the National Development and Reforms Commission (NDRC), Beijing supported the proposal because it considered it an obligation to help maintain the prosperity and stability of HK after 1997 (Guan, 2005; Kong, March 2003; Peng, 2003).

Third, Beijing hoped CEPA would help the integration of the mainland, HK, Macau and Taiwan. In July 2003, then Chinese Vice Minister of Commerce An Min stated that CEPA was “an operationalization of the ‘one country, two systems’ strategy.” The advantage of being ‘one country’ is shown in opening “earlier than under the WTO, more preferential than for the ASEAN”, and “exemplifies the mainland’s support and help to HK’s economy” (n.a., 2003). CEPA was regarded as an important step in China’s economic integration strategy and the starting point for constructing a ‘Greater China Economic Circle’, which would have a greater influence on neighbouring countries than the mainland alone does. Beijing hoped CEPA would push Taiwan to join the three others through both by providing an example and through the increased competition Taiwanese exports would face (CASS, 2003; Guan, 2005).

Finally, CEPA might help mainland businesses to enhance their productivity. In the speech mentioned above, An Min expected that the

agreement would have some negative impact on the mainland economy but hoped that mainland sectors would grow through competition and dynamic integration with HK businesses, a similar kind of 'platform' as the grand 'reform and opening' strategy of Deng Xiaoping after 1978 (CASS, 2003).

### ***Negotiations and Impact***

Negotiations started in early 2002 but were reportedly not easy because of the wide sectoral coverage. Beijing wanted to promote Hong Kong's interests, while keeping the agreement WTO-compliant and keeping in mind the possible impacts on the mainland economy as well as other countries' reactions (2003). Addressing some doubts expressed in Hong Kong on the prospect of the realization of CEPA, the MOFTEC Minister Shi Guangsheng stated on 13 November 2002 that the negotiations were going smoothly without major obstacles, and set a target for finalizing the agreement in 2003. Later during the SARs epidemic in 2003, the central government decided to accelerate the negotiations to alleviate the impact of the crisis on Hong Kong's economy. On 29 June 2003, the CEPA was signed in Hong Kong by the new Chinese Premier Wen Jiabao, and implemented at the start of 2004. CEPA is a 'living' document to which new content can be added if both Parties agree. In subsequent iterations, CEPA II and III, the mainland granted duty-free entry to more HK products and preferential treatment to additional services.

In manufacturing, because most of HK's labour-intensive production had already moved to the mainland (mostly in the Pearl River Delta), CEPA has helped HK keep its 'niche' manufacturing sectors. The exports of

traditional Chinese medicine, jewellery and watches, chemicals and information technology products from HK to the mainland have increased since the signing of the CEPA (Zhang and Wei, 2004). Moreover, according to the Hong Kong Trade Development Council, the agreement has encouraged the further development of production networks in which Hong Kong produces intermediate goods with competitive technologies and exports them to the mainland for further labour-intensive processing (Zhang and Wei, 2004).

In services, the agreement opened many service sectors earlier or more widely to HK companies and individuals than was available to other countries under China's WTO commitments. This concession was intended to reaffirm HK's position as a gateway for foreign businesses to enter the mainland market (Woon, 2003). It led to a mushrooming of Hong Kong businesses on the mainland in 2004. A researcher of the NDRC has observed that the increasing entrance of HK services expanded the services available in the mainland, and brought in business experience to mainland companies (Guan, 2005).

In particular, policymakers and academics in China and HK hold the view that the major and long-term benefit of CEPA would mainly be the integration of mainland manufacturing and HK's manufacturing services including consultancy, logistics and banking. On the one hand, it helps integrate HK's service sectors closer with its manufacturing bases in Guangdong. On the other hand, HK services companies are now allowed to work on projects of China's state-owned companies as well as the mainland's

small and medium enterprises, rather than only on foreign companies and joint ventures as before the agreement. HK's services for manufacturing have catered to the needs of manufacturers in the mainland (whether owned by HK or the mainland), reduced the cost in services and helped them enhance specialization and scale of production. The agreement has facilitated the formation of production chains networks between HK and the mainland, so far mainly in the Pearl River Delta (Guan, 2006; Guan, 2005; Qu and Li, 2004; Zhang, 2006a; Zhang and Wei, 2004; Zhang, 2006b).

## **Case II: China-ASEAN Free Trade Agreement (CAFTA)**

### ***Initiation and progress***

In the late 1990s, fear of the 'China threat' was rampant among ASEAN countries. In particular, ASEAN governments worried that when China joined the WTO it would out-compete ASEAN's industries in domestic and export markets, and draw away foreign direct investment. At the 2000 ASEAN-China Summit in Singapore, ASEAN leaders raised their concerns with the then Chinese Premier Zhu Rongji and asked China to pay special attention to their economic interests. Zhu responded that China and ASEAN could explore the possibility of a free trade relationship, to the surprise of other countries as well as his Chinese delegation. (Interviews, Beijing, March 2006)

Although Chinese officials were surprised by Premier Zhu's proposal, they took swift action to realize this initiative because they understood significance of the leadership's commitment. A year later, a report on Economic Cooperation by the China-ASEAN Experts Group was submitted to the leaders, and their recommendation of establishing a CAFTA was

endorsed. At the next ASEAN-China Summit in November 2002, the leaders signed the Framework Agreement on the Comprehensive Economic Cooperation. Because some ASEAN countries doubted the CAFTA would bring real benefits to them as China claimed, China proposed an 'Early Harvest Program' (EHP)—a fast-track trade liberalization of agricultural products—to 'let ASEAN pick the peaches and taste the sweetness first'.<sup>9</sup> A Sino-Thai FTA on trade in vegetables and fruits, as part of the EHP, was signed in 2003 and came into effect on 1 October 2003, earlier than for other ASEAN countries. The intention was to accelerate bilateral trade liberalization and show other ASEAN countries the potential benefits of the partnership. In November 2004, the Agreement on Trade in Goods, which came into force on 20 July 2005, and the Agreement on Dispute Settlement Mechanisms were concluded. In January 2007, the Agreement on Services of CAFTA was signed at the 10<sup>th</sup> ASEAN Summit; negotiation on investments is underway.

### ***Motivations***

It is widely acknowledged among Chinese officials and scholars that the motivation of Beijing in proposing a PTA to ASEAN was more political than economic. First, China wanted to allay ASEAN's worries about the repercussions of China's accession to the WTO.<sup>10</sup> As part of '*mulin youhao*' [peaceful and friendly neighbourhood] policy, Chinese policymakers hoped the CAFTA would stabilise Sino-ASEAN political and economic relations, which Beijing saw as crucial in creating a peaceful strategic environment.<sup>11</sup> Second, the CAFTA initiative was regarded as a diplomatic landmark for China in taking the leading position in propelling the progress of East Asian

cooperation by forging institutional arrangements and making economic concessions first. It gave China a diplomatic advantage over Japan. Third, China and ASEAN hoped CAFTA would strengthen their voice as a group in global trade and economic issues (Xu, Li and Li, 2003).

As for economic interests, Beijing wished first to guarantee the supply of energy and raw materials from ASEAN and, second, to help achieve the foreign trade policy objective of diversifying export markets. Chinese trade officials thought that CAFTA would be useful to deal with trade protectionism in American and Europe, and to reduce the dependence of both parties on those markets (Xu, Li and Li, 2003; Zhang, 2004; Zhang and Jianglin, 2003). As it did with New Zealand and Australia, China obtained acknowledgment of its market economy status (MES) from ASEAN in September 2004, before the agreement on goods was signed. Moreover, Chinese policymakers view FTAs as an important policy option to create more space for economic development. They hoped the enlargement of market size and the establishment of market coordination mechanisms in China and ASEAN would improve the investment environment and attract more investments from outside the region.

### ***Domestic Coordination***

After the Chinese government announced it would negotiate a PTA with ASEAN, not many Chinese sectors other than agriculture were worried. The Ministry of Agriculture (MOA) organised its own study on the potential impact of the CAFTA on China's agriculture. The report was not optimistic for producers of tropical produce or raw materials in South China. MOFCOM

responded that they should 'look at the big picture' and consider the national interest; as Premier Zhu directed, 'we should calculate the political balance sheet.'<sup>12</sup> As a result of the EHP, the sudden increase of imported agricultural products from ASEAN in the markets bordering ASEAN, in particular in Guangxi and Yunnan provinces, caused adverse impacts on local Chinese agricultural producers. The MOA and the local government of Guangxi Province submitted internal reports to MOFCOM regarding the negative effects.<sup>13</sup> MOFCOM argued that liberalizing the agricultural industry would be beneficial for improving its productivity and competitiveness, and cited the positive impacts of liberalization under the WTO on some sectors as a precedent. The central government tried to divert attention from costs to opportunities by letting Guangxi hold an annual China-ASEAN Expo and funding Yunnan's infrastructure development as part of the Greater Mekong River Sub-regional cooperation.

During the negotiations, a conflict among domestic interests sometimes occurred between different parts of a production chain. For instance, the reduction of industrial input prices would be detrimental to raw material producers but beneficial to processors further down the production chain. The trade negotiators would often attend more to the interests of the former than to the latter because they thought the negative effects would be more severe and more concentrated than the reduction of potential profits for processors.<sup>14</sup> Moreover, some raw material producers are big state-owned enterprises, generally acknowledged to be the companies with the most influence on the central government in China.



As noted by the China-ASEAN Business Association and economists, intra-industry trade has increased significantly between China and ASEAN, changing the economic structure of the region.<sup>15</sup> China and ASEAN had previously largely been competitors in third country markets, but with the implementation of the CAFTA, ASEAN increasingly exports raw materials, manufactured parts and industrial inputs to China, where they are processed and assembled before being exported to third countries (mainly the US and the Europe). There is a risk to both ASEAN and China that the products are too concentrated in electronics, and the final market is over-dependent on the US.<sup>16</sup> However, MOFCOM is glad to see that ASEAN's economic dependence on the US, Europe and Japan is gradually being shifted to China so that they are 'bound' with China.<sup>17</sup>

During the process of negotiating and implementing the CAFTA, Beijing has learned that FTAs are a useful implement for achieving foreign policy goals, and that PTAs are most effective as an instrument when they provide substantial benefits so that the other party will increase its economic dependency on China.<sup>18</sup> Moreover, because CAFTA caused other countries to be eager to enter FTAs with China, Chinese policymakers feel that championing this agreement has helped increase China's leverage in FTA negotiations with others.

### **Case III: Australia-China FTA (AUCFTA)**

#### ***Beijing's motivations for accepting Australia's proposal***

When China started to embark on free trade agreements (FTAs) in international economic cooperation, the Australian government became

worried that it would lose out to ASEAN and other countries in the Chinese market. The AUCFTA was said to be proposed by Australia during one of the high-level visits by Australian leaders to China. (Interviews, Beijing, 2006) Political analyses were conducted by China as a preliminary assessment by the Ministry of Foreign Affairs (MFA) and the China Institute of Contemporary International Relations (CICIR), a quasi-governmental think tank mainly concerned with state security issues.

Both institutions gave positive reports on the state of bilateral political relations and on the potential economic and political benefits for China from strengthening cooperation with Australia.<sup>19</sup> First, the political conditions were considered 'mature' enough for a PTA. In other words, there was enough political trust between the two countries and they did not have "fundamental differences".<sup>20</sup> Beijing appreciated Australia as offering First World goods and services without "the political baggage that comes with the Americans and the Europeans" (Callick, 2004). Second, Australia was an important country in the Southern Pacific as well as the Southern hemisphere. In Beijing's strategic map, Australia belonged to the "big neighbourhood" so the 'friendly neighbourhood' policy should apply.<sup>21</sup> And finally, Beijing felt Sino-Australia political relations were not close enough, and hoped the FTA could promote political trust, like the China-ASEAN FTA had done.

There were two major economic motivations for China in negotiating a PTA with Australia. First, Beijing hoped the PTA would secure a 'stable' supply of resources from Australia, since energy security had become a priority in China's foreign economic policy objectives. Beijing believed the

Canberra government could constrain company behaviours contrary to its interests like raising prices or even switching between contracting partners. Besides, the prospective enhanced investment conditions for Chinese companies were expected to bring China to a more equal position as American investors in resource exploration enjoyed in Australia (because of the Australia-US Free Trade Agreement). During the negotiations, Beijing demanded that Canberra allow Chinese workers to staff China's resource production chain in Australia, but Canberra has considered this proposal to be too intrusive. (Interview, Canberra, 2006) Second, since Australia was the *demandeur* in proposing the PTA, Beijing could ask Canberra to grant China market economic status, thereby setting a precedent that it could request the EU and the US to follow.<sup>22</sup>

Upon Chinese President Hu Jintao's visit to Australia in October 2003, the two governments signed the Australia-China Trade and Economic Framework (the Framework Agreement), in which they agreed to look into the feasibility of a bilateral free trade agreement. The Joint Feasibility Study was finished in March 2005, and formal negotiations commenced in April. Although the Feasibility Study was accomplished earlier than the October target and the leaders of both countries have repeatedly expressed their support for the initiative, the progress of Sino-Australian free trade talks has been far slower than that between China and ASEAN, Pakistan or Chile. As discussed below, domestic resistance, not least in China, and different approaches between Beijing and Canberra to the design of PTAs are the two main obstacles. The bureaucratic capacity of China for FTA negotiations is

another constraint. MOFCOM negotiators have lamented that domestic industrial sectors could not provide enough support to the negotiation.<sup>23</sup>

### ***Domestic resistance***

Major resistance in China to AUCFTA has come from the agricultural and services sectors. In agriculture, the Ministry of Agriculture has been the most stubborn opponent to the prospective liberalization of Chinese agriculture to Australia.<sup>24</sup> First, they argued that China's trade negotiators had already made too many concessions under the WTO, which had caused major damage to Chinese agriculture. Besides, they argued, unlike what they were told to believe by the MOFTEC, the competitiveness of Chinese agriculture had not increased significantly because of liberalization under the WTO. The MOA noted that intra-industry trade in wool textiles had already been happening; further tariff reduction through a PTA with Australia would not bring much more profit to textile producers but would damage raw material producers in China. Moreover, compared with China's FTA with ASEAN, the volume of agricultural trade between China and Australia was much bigger, and the geographical area to be affected by the potential FTA was much wider—including Heilongjiang, Liaoning, Shandong, Hebei, Shaanxi, Gansu and Inner Mongolia, instead of only Guangxi, Yunnan and Hainan in the ASEAN case. Importantly, agricultural issues have become more sensitive in China in recent years, marked by rising peasant protests, and therefore the government had placed solving 'three agricultural' problems—peasant, rural area, and agriculture—on the top of the government policies at the 16<sup>th</sup> National People's Congress in 2004.<sup>25</sup> Chinese Vice Minister of Commerce,

Ms Ma Xiuhong, flagged in March 2005 that any negotiations with Australia over agriculture would be tough because if the government did not handle the issue of 740 million peasants properly, it would cause trouble or social unrest.<sup>26</sup>

In services, while Australian services industries have been keen to enter the Chinese market, Chinese domestic service providers and relevant government institutions have staunchly resisted liberalization beyond WTO commitments. Chinese officials at MOFCOM and ministries responsible for service industries (including the Banking, Insurance, Securities Regulation Commissions, the Ministry of Information and Transportation, the Ministry of Transportation, etc.) held that China would honour WTO commitments first, judge the impact, and then decide what to do next. This meant no special treatment would be granted to specific countries before the completion of the implementation of WTO commitments in December 2006. For instance, although the central government recognized the necessity of reforming the banking sector, it prefers to maintain control of the process and to ensure China's financial security because it believes domestic banks are still vulnerable to foreign competition. Beijing is also worried that if it gives preferential treatment to Australia, other countries like the US or the EU would demand the same treatment on the basis of WTO MFN principles.

### ***Different approaches to FTA negotiation***

First, China prefers a gradual approach to trade liberalization under the FTA while Australia seeks one comprehensive deal. Chinese regulators hold that many behind-the-border, or WTO-plus issues, such as IPR, transparency,

TBT and SPS, cannot be changed overnight. Australian industries, in contrast, believed progress on these issues to be crucial for their business with China. Beijing thinks Canberra should agree to a gradual approach.

Second, usually when China agrees to a proposal for international cooperation, the central government argues it will bring both opportunities and challenges but on the whole will be beneficial, without making specific assessments. In this way, the central decision makers try to dismiss the potential costs on both sides. However, the attempt to hide challenges does not always succeed. When Australian negotiators presented quantitative results of the potential losses to the domestic economy of a PTA, their Chinese counterparts were doubtful but could not provide an alternative calculation. Chinese negotiators are often in an embarrassing situation at the negotiating table when Chinese domestic industrial sectors provide inaccurate or inconsistent statistics and offers.

## **Conclusion**

China, like other countries, uses PTAs to pursue a variety of foreign policy interests. Unlike the PTAs of most other large economies, however, those involving China are diverse in their structure and coverage, reflecting the variety of diplomatic and economic objectives that Beijing is pursuing through its various partnerships. They vary substantially between the vague framework agreements signed with ASEAN and Pakistan to the comprehensive agreements being negotiated with Australia and New Zealand—their comprehensiveness not just a matter of Beijing's choosing but also reflecting the preferences of their trading partners. Many LDCs prefer the

lack of specificity and obligation of a vague framework rather than the legalistic approach that industrialized economies (including Japan) require of PTAs—not least because agreements involving the latter are subject to the more stringent requirements of the WTO's Article XXIV.

Of the PTAs that China has concluded or is negotiating, that with Hong Kong is the one that was most consciously aimed at the promotion of production networks. Moreover, it was designed to give Hong Kong-centred networks an advantage over those based in Taiwan. But its impact in promoting specifically “Chinese” networks is more questionable. The reason is that the CEPA with Hong Kong has a relatively liberal definition of what constitutes a Hong Kong company.<sup>27</sup> The agreement benefits Hong Kong subsidiaries of multinational corporations just as much as local Chinese capital.

More broadly, the impact of the CEPA with Hong Kong on manufacturing networks is likely to be limited—primarily because components from Hong Kong for assembly in the mainland already entered the market duty-free. In fact, components imported from Hong Kong for processing in the mainland and for ultimate export are not covered by the CEPA but by the mainland's “Regulation on Goods for Processing Trade”. This regulation provides for exemption from import duties provided the assembled product is exported. The division of labour in manufacturing between Hong Kong and the mainland had already been firmly cemented before the CEPA was put into place; most labour-intensive manufacturing had migrated North. As noted in the case study above, the main impact of the CEPA on production networks is

likely to be in facilitating the entry to the mainland market of Hong Kong providers of services, perhaps the most important of which are financial services to the manufacturing sector.

How much economic difference PTAs will make is a matter of ongoing debate. Low MFN tariff levels, reinforced by provisions such as duty-drawback schemes and the establishment of free trade zones that facilitate trade in components, restrictive rules of origin and the exclusion of politically-sensitive products from liberalization measures all have the effect of reducing the likely overall economic gains from preferential trading agreements. China's PTAs may well be as important for their diplomatic repercussions as for their economic effects.



**Table One: China's Preferential Trade Negotiations**

<b>Partner</b>	<b>Did China Initiate?</b>	<b>Current Status</b>
ASEAN	<b>Y</b>	Framework Agreement November 2002. Agreement on Goods began to be implemented July 2005; Agreement on Services Signed January 2007 to enter into force July 2007. PTA to be completed by 2010 (2015 for "new" ASEAN members).
Australia	<b>N</b>	Currently Negotiating (7 <sup>th</sup> Round Dec. 06)
Brazil	<b>Y</b>	
Chile	<b>Y</b>	Agreement on Goods Implemented Oct. 06; negotiating on services and investment commenced Jan. 07.
GCC	<b>Y</b>	Framework agreement on economic, trade, investment and technological cooperation signed July 2004. Negotiations on PTA continue. 3 <sup>rd</sup> round Jan. 2006.
Hong Kong	<b>N</b>	Agreement Concluded June 2003
Iceland	<b>N</b>	Feasibility Study Completed. Negotiating
India	<b>Y?</b>	Second Study Group Appointed Jan. 2007 (Indian government rejected 1 <sup>st</sup> group's recommendation for PTA).
Macau	<b>N</b>	Agreement Concluded October 2003
New Zealand	<b>N</b>	Currently Negotiating (10 <sup>th</sup> Round Jan. 07)
Pakistan		Early Harvest Program 2005. PTA signed Nov. 2006 for July 2007 implementation.
Peru	<b>N</b>	Study Group
Shanghai Cooperation Organization	<b>Y</b>	Proposed Sept. 2003.
Singapore	<b>N</b>	Currently Negotiating (previously suspended after Lee visit to Taiwan). 1 <sup>st</sup> round of talks Oct. 2006.
South African Customs Union	<b>Y</b>	Negotiations launched July 2004
South Korea		Under Study (to be accelerated Jan. 2007)
Japan & Korea	<b>Y</b>	Proposed.

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<sup>1</sup> Although the "Chinese" link figured prominently in some of these production networks, particularly those involving Hong Kong and Taiwan, the Chinese dimension can easily be overstated given the importance of US-based buyer-driven production networks. On China's role in production networks, see, for instance, Gaulier, Lemoine and Ünal-Kesenci (2004), Gaulier, Lemoine and Ünal-Kesenci (2006).

<sup>2</sup> We prefer the term "Preferential Trade Agreements" to either regional agreements or free trade agreements. Even though such agreements (when they involve industrialized economies) are referred to the WTO's Committee on Regional Trade Agreements for consideration (those involving developing economies exclusively go to the Committee on Trade and Development), their membership is often not "regional" in any conventional geographic sense of the word. And relatively few of the large number of preferential arrangements negotiated in the last decade come close to conventional criteria for "free" trade.

<sup>3</sup> See, for instance, the remarks of Ministry of Commerce spokesman, Chong Quan, in response to criticisms of China's activism in negotiating PTAs made by WTO Director-General, Pascal Lamy: Chong asserted that free trade agreements were "important supplements" to the WTO, and that the two mechanisms of freeing trade should be combined. "China to Advance Bilateral and Regional Free Trade Negotiation", *People's Daily* (16 September 2006).

<sup>4</sup> On the potential for PTAs to accelerate trade liberalization in Japan see Ministry of Economy (2000), Munakata (2002). When Chinese officials have made reference to the potentially beneficial effects of international competition, this has occurred in response to complaints from domestic sectors fearful that their interests will be damaged by relatively inexpensive imports.

<sup>5</sup> See, for instance, "Commonwealth Offers Bright Future for E. Asia", *People's Daily Online* (15 January 2007) [[http://English.peopledaily.com.cn/200701/15/eng20070115\\_341324.html](http://English.peopledaily.com.cn/200701/15/eng20070115_341324.html)]

<sup>6</sup> Friedberg (2006) provides a concise summary of recent increases in China's import dependence.

<sup>7</sup> Before Australian Prime Minister John Howard's visit to Beijing in April 2005 to sign the MOU to start negotiations, He Yafei, Director of the Department for North America and Oceania at the Chinese Foreign Ministry told Australian media that Canberra "can certainly encourage companies to take a long-term point of view in setting prices." (*China Daily* April 19, 2005) During Hu's visit to Canberra in October 2003, on the sideline of the Framework agreement, the two countries signed a US\$30 billion deal to supply 3.3 million tonnes of Australian liquefied natural gas (LNG) over 25 years, after a similar AUD\$25 billion, 25-year contract of Australian LNG for Guangdong province.

<sup>8</sup> "China considering to set up special trade area: Long Yongtu", *People's Daily (English)*, 29 Nov. 2001.

<sup>9</sup> Interview with trade officials and academics in Beijing March-May 2006.

<sup>10</sup> Interviews with many academics and officials in Beijing February-June 2006. Also see Zhang and Jianglin (2003)

<sup>11</sup> Interview with a trade official in Beijing on 23 March 2006. Xu, Li and Li (2003) Zhang and Jianglin Zhang and Xiaobing (2003)

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- <sup>12</sup> Interview with an expert on ASEAN.
- <sup>13</sup> Interviews with officials at the MOA and the Bureau of Commerce of Guangxi.
- <sup>14</sup> Interview with a trade official.
- <sup>15</sup> Interview with the Director of the Business Association. Also see Ravenhill Ravenhill (2006).
- <sup>16</sup> Interview with the Director of the China-ASEAN Business Association.
- <sup>17</sup> Interview with trade officials.
- <sup>18</sup> Interview with a MOFCOM official in Beijing on 23 March 2006.
- <sup>19</sup> Interview with a researcher at the Department of Policy Research of MFA and a researcher at CICIR. Also see Yang Yang (2005)..
- <sup>20</sup> Interview with a researcher at CICIR, who participated in the preliminary evaluation, 18 April 2006, Beijing.
- <sup>21</sup> The small neighbourhood refers to countries adjacent to China including Southeast and Northeast Asia and countries bordering China.
- <sup>22</sup> A total of 57 countries have accepted China's status as a market economy since New Zealand stood out as the first acceptor in April 2004; this group includes Australia, Brazil, South Africa and Russia.
- <sup>23</sup> Interview with a MOFCOM official, April 2006, Beijing.
- <sup>24</sup> The information on MOA's views is based on the interviews with MOA officials, May 2006, Beijing.
- <sup>25</sup> See "Zhongyang guanyu zengjia nongmin shouru ruogan zhengce de yijian" [The central government's view on policies to increase peasants' income], *People's Daily*, 9 February 2004.
- <sup>26</sup> "China fears FTA's impact on farming", *ABC Australia*, 22 March 2005.
- <sup>27</sup> To qualify as a Hong Kong company for the purposes of the agreement, the company must be registered in Hong Kong, pay taxes on its profits there, and have 50% of its total employees from Hong Kong. A foreign company is regarded as a Hong Kong company one year after merger with or acquisition of a controlling share of a Hong Kong company.

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