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The Policy Study Group on China-Japan-US Cooperation in Asia-Pacific Regional Trade and Investment Liberalization (Trilateral Forum) -- Interim Report: An American Interpretation

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### Author

BRIE

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**The Policy Study Group on China-Japan-US  
Cooperation in Asia-Pacific Regional Trade  
and Investment Liberalization  
(Trilateral Forum)**

**Interim Report:  
An American Interpretation**

Prepared by  
The Berkeley Roundtable on the International Economy  
(BRIE), University of California, Berkeley<sup>1</sup>

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<sup>1</sup> This report was prepared by BRIE Co-Directors Michael Borrus, Stephen S. Cohen, and John Zysman, with research and editorial assistance from BRIE graduate fellows Daniel Buck and Lily Tsai. Additional assistance was provided by Cyndie Berg, Pei-Hsuing Chin, Yvonne Chiu, Noriko Katagiri, and Ann Mine. Support for the project was provided by the United States-Japan Foundation.

**The Policy Study Group on  
China-Japan-US Cooperation in Asia-Pacific Regional  
Trade and Investment Liberalization  
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**Interim Report:  
An American Interpretation**

*prepared by  
The Berkeley Roundtable on the International Economy (BRIE),  
University of California, Berkeley<sup>2</sup>  
October, 1998*

***Preface***

*The Policy Study Group on China-Japan-US Cooperation in Asia-Pacific Regional Trade and Investment Liberalization (Trilateral Forum) was created in early 1996 and held its first formal meeting in Tokyo that December. The project, made possible by a grant from the United States-Japan Foundation, is organized by the University of California's Berkeley Roundtable on the International Economy (BRIE) in collaboration with the Council of Policy and Strategy (CPS), Shanghai, China, and the Dentsu Institute for Human Studies (DIHS), Tokyo, Japan. The project's design calls for two meetings each year over a three-year period, with the site for each rotating among the three countries. Each two-day gathering is built around a briefing document, background papers, and discussion questions. Participants include a core group of senior policy experts from government, the private sector, and academia; specialists join these discussions as needed.*

*This volume presents findings from the Forum's first three meetings. Each of the volume's sections includes a synthesis and excerpted presentations. For the English-language versions of contributors' biographical information, the complete text of most briefing papers, information on collaborating institutions, and summaries of proceedings, see <http://socrates.berkeley.edu/BRIE> (click the "Forum" button).*

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### **Summary Introduction**

The Trilateral Forum project began in a different era, one in which the Asian Miracle provided a very significant element of context. But the world has changed during the course of this work, and moving from Miracle to crisis has posed a whole new set of questions—and opportunities—not only for this project, but for US, Japanese, and Chinese policy toward Asia. The pre-crisis insights elaborated below remain valid; post-crisis, they are gaining new currency and creating opportunities to reframe the terms of the debate and break the deadlock over China's WTO accession.

### **The Pre-Crisis Debate**

The old terms of debate largely concerned the United States and Japan thinking about and discussing, as two albeit differing capitalist systems, the issues raised by integrating China—a transitional economy—into the global trading system. The Forum's first meetings developed an innovative approach to these issues and, by rephrasing the debate in terms of "systems frictions," engaged the three groups as equals in a genuine "trialogue." The initial rounds of the Forum established an ongoing process of mutual learning, discussion, and relationship building. In our view, some of the more salient understandings to emerge from this process include:

- The United States, Japan, and China all speak of the need for liberalization, but their definitions of liberalization differ considerably, in part because their conceptions of what constitutes a market economy differ so considerably. Both Japan and China are liberalizing, in the sense that their economies are in many ways more open than they were a decade ago. But there is little commonality in how each is liberalizing, and the differences have a significant impact on the prospects for further liberalization in the region as a whole. For example, each country holds a key to the region's economic recovery—China by not devaluing, a choice which is enabled by slow capital account liberalization, and Japan by increasing imports from the region, a choice which is frustrated by slow financial liberalization.
- The regional trading system is triangular in nature; it relies on Japanese supply, Asian-based assembly and production, and American demand. Flows of *intra*regional and *intra*sectoral trade and investment create an intense level of economic integration that aggregate data fails to fully capture. This has important implications for how rapidly the region can recover from the current crisis—and recovery is the *sine qua non* of continued regional liberalization. Export-based recovery, for example, assumes the

US as spender of last resort, but how long can the US maintain that position politically to support China, Japan, and all the crisis economies together?

- It is not simply, as commonly supposed, the scale of the Chinese economy that makes its entrance into the WTO and the Pacific trading system a systemic problem. It is, rather, the *form* that scale takes. For example, were China to be organized along American political and economic lines, its entrance would alter the position of others in the system. The system could, however, adjust. But, as the Chinese participants stress, many of China's evolving market institutions are "distinctive" from existing models and China itself is composed of vastly different inland and coastal economies, as several of the Japanese participants note. In its present form, China's entrance could stress the system to its breaking point.
- In China, debate has shifted in the last few years from a debate between pro- and anti-reformers to one between reformers and liberalizers. The former want marketization without significant foreign participation; the latter want marketization with increased openness to foreign trade and investment. Thus, within China, there are conflicting priorities vis-a-vis WTO accession. WTO accession is, however, essential if liberalization (not just reform) momentum is to be maintained.

### **The Debate since the Crisis**

According to the new point of view coalescing in the Project, the Asian crisis is *permanently* altering both China's and Japan's respective roles in the region and their attendant self-conceptions. China has begun to realize that it is playing a significant role in the international system and that such a role comes with the responsibility to manage domestic adjustments in ways that enhance rather than undermine regional economic stability. Japan is beginning to see the regional consequences of not addressing more rapidly its domestic economic problems. Political awareness in the US has not yet begun to catch up with this significant change. The change, however, offers the possibility of recasting the terms of debate in ways that create new opportunities for Trilateral cooperation and might even break the deadlock over China's WTO accession.

- China appears to be and is in fact accepting significant responsibility for regional economic stability by maintaining RMB stability during the crisis. It has even attempted to work with the US and Japan to stabilize the yen. One unexpected outcome is that increased US-Japan-China coordination suddenly seems beneficial to all three, and to the rest of Asia as well. This creates a new opportunity for increased coordination that must be systematically reinforced by US and Japanese policy in order for it to become permanent.
- China's emergence as a participant in international institutions was projected, pre-crisis, to progress from WTO accession to OECD membership and then to G-7 participation. Perhaps the most exciting post-crisis prospect for increased cooperation

is to reverse this implicit set of priorities in each country's policy. Including China in the G7 *now* would accomplish many of the same legitimization benefits that Chinese liberalizers are seeking through early WTO admission. In turn, responsible Chinese behavior in the context of the G7 would significantly depoliticize the WTO accession process and turn it into a series of technical problems that can be resolved over time. The reversal of progression would bring China into the global economic system sooner than into the WTO, but in such a way that it could better play its essential role in helping to manage the Asian crisis.

- A second opportunity is to define a new coincidence of American-Japanese-Chinese trading interests. Structural reform of financial systems and other heavily regulated sectors is essential for both Japan and China. Increased domestic consumption in Japan and China must substitute to some extent for US demand, if all are to play a positive role in resolving the Asia crisis. In a few of the sectors that need reform, increased openness to US goods, services, and investment will stimulate the necessary domestic structural adjustments faster than would otherwise occur. In sectors such as telecommunications and parts of financial services, further liberalizing reforms can perhaps now be agreed upon which will benefit both local industrial adjustment and foreign entrants.

## **I. BUILDING THE CONTEXT FOR A “TRIALOGUE”**

### **Main Issues:**

- Re-conceptualizing debate as “systems frictions”
- Resolving different views of liberalization and different definitions of “market economy”
- The meaning of WTO membership
- Resolving systems frictions

### **Selected excerpts:**

- A. “The American Perspective on the Liberalization of Trade and Investment, by Michael Borrus, Stephen S. Cohen, and John Zysman
- B. “A US Vision of Liberalization of Trade and Investment,” by Alan Wm. Wolff
- C. “An Assessment of Chinese Thinking on Trade Liberalization,” by Jialin Zhang
- D. “China Plays a Constructive Role in the Dynamic Growth of the Asian and Pacific Economies,” by Li Zhongzhou

### **Summary: Building the context for a “trialogue”**

Understanding the conceptual foundations of the different paradigms guiding the making of trade and investment policy is the first step toward easing the frictions over international trade and competition among the world’s three largest economies.

The authors in this section explore the different conceptualizations of key terms in the debate over China’s accession to the WTO.

Although, as Zhang and Wolff note, all the actors have come to realize that “liberalization, like virtue, is its own reward,” (Wolff 1), the various authors continue to interpret liberalization in different, though not necessarily mutually exclusive, ways.

Many authors focus on liberalization as a primarily economic process. For Wolff, the process of liberalization culminates in an open trading system, which has two characteristics: freely permeable borders, and domestic markets which operate fully on

free market principles, in which all actors are motivated by solely commercial considerations. Liberalization, moreover, necessarily entails reciprocity, for “no good , service, or investment can cross America’s border (in either direction) unimpeded without there being another market sufficiently open to allow that transaction to take place” (5).

Others moderate this view by suggesting that liberalization be evaluated in terms of the particular economy and not on “sectoral reciprocity” (Li 1). Zhang and Hara argue that there is no universal form or strategy for liberalization. (Zhang 25, Hara 1). Li emphasizes that Japan, China, and the US still have much to gain from mutually expanded trade (4). Zhang develops the concept in a different direction, claiming that liberalization can, and perhaps should, be unilateral. He focuses on the principle of “concerted unilateralism,” which is nonbinding but created through discussion among different countries (15). Zhang suggests that the rate of liberalization should be considered in addition to any indicator of an absolute level of liberalization. By this criterion, China has liberalized quite a lot over the last ten years; observers cannot, however, always expect the rate to be so high. Zhang points out that liberalization should be tailored to the needs of particular industries or sectors (13), thereby shaping the process so that it is gradual and incremental.

Zhang also views liberalization as a goal which requires teamwork to achieve, rather than just a state of existence. In order to achieve this goal, he argues, developed countries must provide advanced technology and sufficient funding in order for industries in developing economies to become more competitive. Only when their industries are more competitive can developing countries afford to liberalize (14).

Another view, advanced in the first piece by BRIE, conceptualizes liberalization as having both political and economic elements, which are mutually reinforcing. In addition to open borders, antitrust principles, and a free market, BRIE highlights the integration of rule of law and liberal democracy into the concept.

Concepts of market economy also differ in their incorporation of politics. Wolff, for example, assumes minimal government intervention in a free market economy, and therefore opposes the use of Japanese industrial policy (7). Domestic industrial policy is, therefore, fair game for international trade negotiations because it impinges on one of his two key elements of liberalization, a free domestic market. Zhang represents an alternative approach to the concept of free market. He points out that government intervention can correct market imperfections in developing countries which suffer from uneven credit, labor, and technology markets (7). Protection in the short term can increase economic health and the rate of liberalization over the long term. Short-term protection can generate spillovers and increase productivity and competitiveness quickly, thereby facilitating liberalization. Industrial policies can be less costly and more temporary than trade barriers (8).

Another concept which is central to the debate is the concept of WTO membership itself. Li and Wolff offer different perspectives on the significance of membership which could

potentially be synthesized into one concept. Wolff's discussion of WTO membership reflects his concerns with reciprocity and equality of status and responsibility among all members. Each member should reciprocate benefits received with meaningful trade concessions (5). The terms of WTO accession should provide the WTO with continued leverage to assure continued liberalization of a potential member (7). Li, on the other hand, sees WTO membership as an opportunity to resolve systems frictions. In his view, the WTO can act as a common denominator to regulate trade relations among economies which follow different models of liberalization.

**The American Perspective on the Liberalization of Trade and Investment**  
**Michael Borrus, Stephen S. Cohen, and John Zysman<sup>3</sup>**  
**December 1996, Tokyo**

***Introduction***

Frictions over international trade and competition among the world's three largest economies are caused as much by conflicting public philosophies, or visions, as by conflicting interests. By explicitly addressing differences in these visions, the conference hopes to improve mutual understanding among the three countries and thus their economic relationships.

**I. Vision of Liberalization of Trade and Investment: More Like US**

***Understanding the American Vision and Politics of Liberalization***

The American vision and the American politics of liberalization are the twin driving forces behind US foreign economic policies, which, in turn, strongly influence the trade and investment flows that have brought prosperity to the Pacific Rim. America's leading role is, at the same time, both an indispensable asset and a problematic liability for economies cooperating in the region. For instance, the US lead in keeping its market open has fueled the economic integration of the region. On the other hand, waves of US demands to open others' markets have also been the major source of frictions across the Pacific. To address such frictions and to reconcile competing visions, such as so-called "concerted unilateralism," it is crucial to understand the American vision and the American politics of liberalization.

The American vision of liberalization is a product of the Great Depression and America's leading role in the post-WWII world. Concluding that the protectionist 1930 Smoot-Hawley tariff was a major culprit behind the international Great Depression and the ensuing war, postwar American leaders of all political stripes developed an unusually strong consensus regarding the need for a liberal world economic order. This elite consensus not only informed their efforts at shaping the Bretton Woods institutions, but also led to the gradual establishment of a liberal-leaning trade policy system within the US.

Several structural features of the postwar trade policy system permit the elite vision of liberalization to dominate US trade politics. First, by delegating its constitutional authority to set trade policy to the executive branch, the Congress distances itself from trade demands and the business of making product-specific trade law. Second, by striving to open foreign markets on the basis of reciprocity, the executive branch increases the stake and influence of exporters, thus fostering a political counterweight to balance the intense interests of import-competing producers. Third, the quasi-judicial process of granting

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<sup>3</sup> Michael Borrus, Stephen S. Cohen, and John Zysman are Professors and Co-Directors of BRIE (The Berkeley Roundtable on the International Economy) at the University of California, Berkeley.

trade remedies provides a safety valve for interests seriously hurt by imports or “unfair” foreign practices.

These structural features that safeguard the liberal ideology from the manipulation of interest group politics can be maintained only with the tacit support of the general American public. The prosperity and economic pre-eminence of the early postwar period lent credence to the elite vision of liberalization and kept the public happily indifferent to the issue of trade. The Cold War provided the critical purpose for both relegating trade questions to second order priority and for sustaining bipartisan support of executive-led foreign policy. It also provided powerful reasons for America to see commonalities—instead of differences—among the economic systems of the nations on “our” side of the iron curtain. But when inflation rose and growth stagnated after the 1970’s, foreign competition and trade deficits became issues of widespread concern. This shift in public perceptions and attitudes underlay the subsequent slow erosion of the postwar trade policy system since then.

In this briefing, we will articulate in sequence the three major parts of the American vision and the American politics of liberalization: the elite consensus that defines “What is US,” the producer interests at the center of American trade politics, and the public perceptions and attitudes regarding issues like the seemingly permanent and compounding trade deficits with Asia.

### **A. Dominant US Vision of Liberalization: “More Like US”**

#### *What Is US?*

As the oldest modern nation, the Americans are naturally prone to regard their own system as the normalcy that other countries will in time converge to. In this vein, we may characterize the dominant U.S. vision of liberalization as simply “More Like US.” This then begs the question of “What is US?” For our present purposes, the liberal ideology has five successive levels: open border, free market, antitrust, rule of law, and liberal democracy.

At the most basic level, the government should not put barriers to trade and investment at its borders, or intervene to shape outcomes. Trade should be conducted privately, between independent entities. In addition, the government generally should not interfere with the operation of a free market economy. The exception is when there are “market failures,” in which firms form monopolistic cartels or other restrictive business practices. When the government intervenes in this and other situations, it should follow and uphold the rule of law. Bureaucratic intervention should be limited. Ultimately, the rule of law is under the will of the people through the process of liberal democracy.

Although all countries depart from these principles, the US’ practices are as close to them as any other country. Because the American elite and to a lesser extent the American public believe that these five liberal principles form the basis of peace and prosperity not

just in the US but for the whole world, they generally feel that it is justified for the US government to push other countries in that direction. The basic principles are directly related to trade and investment, while the higher principles, like what should be considered basic human rights in a liberal democracy, may justify the use of trade sanctions. Before we address them as whole in the next section, some examples of the five principles are in order:

#### 1. Open Border

Lowering tariff and other border measures restricting trade and investment remains a high priority item on the American trade agenda in Asia and Europe. The recent US initiative in APEC, and then in WTO, over the Information Technology Agreement represents an interesting case. The US proposals of zero tariffs on computers and related products by the year 2000 are largely consistent with the interests of many Asian countries, who are themselves competitive producers. But China's desire to protect its fledgling industry may compromise the Agreement.

#### 2. Free Market

The American advocacy of *laissez-faire* economics does not always find sympathetic ears in many Asian governments who are used to intervention in the name of economic development. The car industry is a case in point. With successful precedents like South Korea, many countries including Malaysia, Indonesia, and China have developed policies that aim at establishing national car industries.

#### 3. Antitrust

The history of supporting national champions to compete on the world market in many Asian countries has created domestic industrial organizations and competition policies which foster restrictive business practices in the eyes of American firms and antitrust lawyers. A large part of US contentions with Japan nowadays relate to such non-tariff, non-policy issues as market access problems.

#### 4. Rule of Law

The protection and enforcement of intellectual property rights has become a key US trade policy concern in Asia. The proposed trade sanctions against China in the last few years over poor IPR enforcement and market access for American intellectual-property-based products highlight US insistence that foreign laws and trade agreements be followed.

#### 5. Liberal Democracy

Although the renewal of China's MFN status has been delinked from issues like human rights, there is still much potential for conflicts over high-level principles to affect the US-China economic relationship. Cases like China's display of military might this year before the presidential election that made Taiwan a true liberal democracy might still cause the US to consider economic sanctions in the future.

## **B. Underlying Domestic Politics: Balancing the "Bicycle"**

### *What Is Special About US?*

Trading partners at different levels of development and with different competitive sectors are bound to have different interests regarding the first three issues listed above: open border, free market, and antitrust. And with the passage of time, even rule of law and liberal democracy are likely to become less controversial as countries converge, though far from completely. What is really problematic for the Pacific economic relationships is not so much sharing the American vision but dealing with the American politics of liberalization as generated by the country's particular brand of rule of law and liberal democracy.

The openness of the US market and the extent to which Americans accept economic and social displacements by imports often amaze Asians who thrived in the past three decades by penetrating the world's largest national market. However, US postwar openness might equally surprise an American living in the century before the War. The informal postwar division of powers in the American democracy put the authority to regulate foreign trade in the Congress. As a decentralized, undisciplined institution, the US Congress is more readily influenced by organized interests with concentrated concerns than by diffuse public interests. Historically, this meant that import-competing producers who faced clear and present losses could often secure protection from Congress, typically at the expense of consumers and exporters. Controlling trade policy at the executive branch also permitted the use of trade policy to bolster Cold War alliances and allies. The executive, with the Pentagon and the State Department in the lead, would readily subordinate questions of commercial asymmetry and reciprocity to larger concerns and objectives of strategic US Cold War policy.

The old trade-restricting system that centered on Congress was gradually replaced after the Depression by a trade-expanding policy system led by the executive branch. The executive branch assumes the authority through the linking of trade policy with international negotiations, its constitutional prerogative. But Congress can always pull it back by withholding "fast track" authorization. The coupling of foreign and domestic markets opening through international bargaining on the basis of reciprocity transformed US domestic trade politics. Acting as the agent of American commercial interests abroad, the executive branch effectively organizes and gives more influence to US exporters and US multinationals in trade policymaking. They could be mobilized to prevent the general openness of the US economy from being overwhelmed by the protectionist demands from import-competing producers.

### *American Openness and Assertiveness*

This modern US capacity to accommodate economic and social displacements by imports makes possible the difficult but mutually very beneficial extension of the international division of labor across the Pacific. Vertical division of labor allows countries to benefit

from their comparative advantage. Horizontal division of labor allows trading partners to benefit from scale economies through competitive differentiation. While all countries, including the US, gain from the international specialization created by access to foreign markets, it has been particularly critical to the phenomenal growth of East Asian economies who have limited domestic markets and originally lagging technologies.

Keeping the American market open, however, to waves of Asian industries in the postwar period requires a constant balancing act by the US executive branch. As countries in East Asia develop one export industry after another with the open US market as their main target, the displaced American firms and workers these industries naturally seek protection from the US government. Those in disinvesting industries in which Americans have lost their comparative advantage need time and assistance to shift into other industries. Those reinvesting may need help coping with foreign competition as they transform their businesses. To keep these trade-restricting pressures at bay and the Congress passive, the executive branch has to keep advancing US interests abroad and opening up foreign markets, otherwise it will lose credibility at home and Congress' delegation of trade policy authority. After all, to continue accommodating displacements by imports, the US government must ensure that there are adequate new opportunities generated by American economic growth, which now depends increasingly on exports to Asia. The end of Cold War exacerbates this problem for the executive, as does heightened awareness of "system friction" or the differences in the economic systems of our trading partners.

Continued US efforts at opening up Asian markets may seem assertive, particularly through the use of Section 301 and Super 301 of the 1974 and 1988 Trade Act. But without these efforts delivering results, the American politics of liberalization cannot work. The executive branch will not be able to manage the pressures of import-competing producers coming through Congress to reduce access to the US market, particularly by Asian producers. In light of the discussion above, the assertiveness of US trade policy and the openness of US market are two sides of the same coin. The American policy has been the most assertive because the American market has been the most open and America does not rely on bureaucratic discretion in these matters. Proponents of "concerted unilateralism" must not lose sight of this basic linkage.

American trade diplomacy, however, can often become abrasive rather than just assertive. A major source of this aggressiveness is the legalistic orientation of the American rule of law. Trade policy-making and the actions of interested parties are funneled into narrow procedural channels, while trade issues are cast into the limited categories like dumping or subsidy permitted under existing trade remedy laws. Within this American framework, trade problems with foreign competitors are defined as unfair trade practices rather than as strategically different competitive behaviors with their own logic.

Because American trade diplomacy and remedies place moral claims on foreign practices on the ground of internal US rules and procedures and because they sometimes challenge the sovereignty of foreign countries over domestic economic policy, they often appeared unduly aggressive to America's trading partners. This can be most problematic in the case

of Japan and China. As the two largest sources of US trade deficits, they inevitably become the foremost targets of unfair trade allegations, while their fundamentally different administrative and economic systems provide ample room for misunderstanding and misinterpretations. Whether and how America's politics of liberalization can adjust to its deepening relationships with the world's two next largest sovereign economies is a challenge confronting the future prosperity of the region.

Concerning China and Japan, there are significant differences between them in the balance of producer interests in US trade politics, as a result of their levels of development, among other things. A trading partner is both a market and a competitor. While American producers typically view China as the biggest "future market," they often see Japan as the biggest "current competitor." When American firms press for the opening of the Japanese market, such as in the case of semiconductors, their concern was not only Japan as a market per se, but as a competitive threat elsewhere. In general, the intensity of producer interests concerning foreign competitors decreases with domestic growth, and heats up substantially with recession.

By contrast, the intensity of exporting interests usually increases with foreign growth. China's sustained high rate of economic growth over the past one and a half decade and the sheer size of its population has created in the early 1990's the so-called "new China lobby" among US exporters. It is perhaps the most influential pro-trade coalition ever organized by American firms on their own initiative, including major firms like Boeing, General Electric and producers' groups such as the National Association of Manufacturers. This represents a major change in the American politics of liberalization because, as mentioned above, past exporters alliances for trade expansion were generally organized by the executive branch of the US government.

The reason why American exporters and multinationals rallied on their own was the fact that the US government might put human right performance above the annual extension of Most Favored Nation status to China, as President Clinton pursued his campaign pledge during the early years of his Presidency. The Business Coalition for US-China Trade mobilized widespread supports among exporters to delink the MFN renewal and human right issues. Their powerful campaign moved the political center to the delinking position so that, when Clinton backed down from his own executive order in June 1994, there was only limited reaction from liberal Democrats.

While the new China lobby went a long way against official US policy on human rights in order to keep open the normal Sino-American economic exchange, it lent full support to US trade representatives assertively negotiating intellectual property rights protection and enforcement with China. Unlike the MFN issue, the largely unified American position conveyed credibility when USTR proposed Special 301 sanctions against Chinese exports. Real concessions and efforts by the Chinese government have so far prevented the sanction from going into effect, but the complexity and difficulty of the subject will keep the IPR on the agenda of Sino-American trade talks in the foreseeable future.

Not all American allegations made against its trading partners are as justified as the one against Chinese piracy of US software and CDs. Top among those dubious claims is the widespread notion that American trade deficit is caused mainly by foreign unfair practices that close out US exports. While most economists attribute America's global deficit to domestic macroeconomic forces, most non-economist Americans believe otherwise. In the future, as in the past, such perception has the potential to make a trading partner the target of popular economic discontent and to undermine the postwar American politics of liberalization, which, to repeat, has lost its Cold War non-economic rationale.

## **II. Asian Economic Region and the Global Free Trade System**

### ***A. Formal Institutions and Their Roles***

#### *WTO and China's Accession*

The World Trade Organization (WTO) and its predecessor, the General Agreement on Tariffs and Trade (GATT), have been the major institutional frameworks underlying the global free trade system. In its efforts to build closer relationships with the Asian economies, the US remains fully committed to the primary role of the WTO as a forum for achieving multilateral non-discriminatory liberalization policies among its member nations. The US played the major role in setting up the GATT system, and Washington maintains a dominant role in the new WTO.

China's accession into the WTO represents the biggest challenge to the role of WTO as a truly global organization for trade matters. To date, much of the discussion about China's entry into the WTO has focused on whether it should be considered a developing economy (therefore eligible for Generalized System of Preference treatment) or an industrialized economy (therefore to be treated like the US, Japan and other industrialized countries). But China may, in fact, fit neither category comfortably. The incorporation of state-led, transitional economies like China, and in the future Russia, raises a new set of issues for the multilateral system. For example, should the WTO provide for accelerated GSP treatment rather than deem China an industrialized economy, or should a wholly new category of WTO membership be created for transitional economies? How are China, Japan and the US likely to react under alternative accession scenarios?

Indeed, the China's into the newly-created WTO creates both opportunities and challenges for the multilateral trading system. On the one hand, the huge size of the Chinese economy creates a potential for WTO countries to capture new benefits of trade. On the other hand, the WTO system rests on the assumption that international trade among its members is conducted primarily between private firms in capitalist economies. WTO agreements, including the GATT itself, are largely based on that assumption. Yet China remains committed to maintaining a major role for its state-owned enterprises and a major role for the state in shaping its economic development. Although forces for privatization are strong, the process is difficult. Even as a significant private sector emerges in China, state intervention is likely to continue in substantial ways, both indirectly through industrial and macroeconomic policies, and directly through state enterprises. Given the unique characteristics of China's economy, such as the preponderant role of the state, it is in everyone's interest to absorb China into the international trading system without creating new trade frictions.

#### *APEC and Open Regionalism*

The Asia-Pacific Economic Cooperation (APEC) forum is the most important regional organization formed to promote economic cooperation in the Pacific Rim. By elevating its

annual meeting from the ministerial to the summit level in Seattle 1993, the US contributed to the prominence of APEC in the Asian economic region.

The Asian APEC members constitute the US' most important economic partner. Between 1990 and 1993, American two-way trade with Asian APEC members increased by nearly 23 percent, compared with less than 18 percent for its trade worldwide. However, Asian trade growth has been lopsided for the US. Asian APEC accounted for 88 percent of the US trade deficit in 1993, suggesting that there is considerable scope (and political pressure) for growth of US exports to these key markets.

In November 1994, APEC leaders met in Bogor, Indonesia and agreed to "adopt the long-term goal of free and open trade and investment" in the region by the year 2010 for industrialized economies and by 2020 for developing economies. In pursuing that goal, APEC would be committed to the reduction of trade barriers with nonmembers, and would thereby avoid becoming an inward-looking trading bloc.

According to the 1994 Bogor vision, APEC should become neither an integrated entity like the European Union nor a free trade area like NAFTA. Rather, APEC accords would be open to other countries, probably the entire WTO membership. APEC is, in essence, considering a wholly new model of regional economic cooperation, one which would steadily ratchet up trade liberalization between the regional and global levels. This approach reflects APEC's dedication to "open regionalism," which stresses that existing global arrangements must not be undermined and that APEC will attempt to address regional issues in their global context.

The most recent example of the ratchet-up approach is Washington's proposed Information Technology Agreement. In the November 1996 Manila summit, the US sought APEC's support on the zero-tariff pact for computers and related products before putting it on the table at the inaugural meeting of the WTO in Singapore a month later.

It is one thing to embrace a vision; it is quite another to transform that vision into reality. There are huge hurdles that must be overcome before further substantial economic and trade liberalization can occur. APEC member-country economies differ dramatically, creating different liberalization priorities and implementation difficulties. Nor is it clear that all members view the "Bogor Vision" in the same way. In the 1994 Osaka summit, the members adopted the principle that in moving toward the long-term goal of free trade and investment in the region, the APEC will employ voluntary efforts by individual economies and collective actions.

The loose structure of the APEC organization, its non-binding "consensus" approach, implies that without active supports from its dominant members, no APEC initiative is likely to be successful. APEC provides a valuable structure for US engagement in Asia and allows it to practice the joint leadership of the future that involves mainly US, China, and Japan. As economic interdependence among the three countries deepens, the US and Japan will increasingly engage China in their coordination of economic policy. How a

fully developed and thus powerful China will choose to play its role in the world economy is one of the biggest unknowns of the next generation. But in all likelihood, China will learn about its new role by sharing responsibilities with the US and Japan to safeguard growing common interests of all three. The continued development of a trans-Pacific economic community will dispel the Huntingtonian notion of East-West civilization confrontation.

## ***B. Current Status of National Policies and Economic Activities***

### *Country-Oriented Trade Policies and Region-Wide Production Networks*

The rapid expansion of trade, investment, and technology flows among Asia-Pacific countries over the past four decades is most remarkable. On the one hand, it has generated national economic growth rates unseen in the past and innovative regional production networks destined to lead in the future. On the other, this close and enduring economic cooperation has been achieved without the benefit of a formal regional organization, such as the European Union. Instead, economic integration of the Pacific Rim developed under the driving forces and organizing influences of private competition and public coordination between its two dominant economies, the US and Japan. For example, early American investments in Asia, mainly in electronics, were motivated by both Japanese imports and US policy. Accelerated Asian investment and trade flows over the past decade were likewise launched by US-Japan trade imbalances and consequent coordinated currency realignments.

Although the rapid integration of the Asian economic region has blurred the issues of nationality, the basic approach to trans-Pacific trade politics remains highly country-oriented rather than region-oriented. This is not just because of the non-binding structure of APEC. The practice of the Section 301 and Super 301 of the US trade laws, in particular, reinforces the traditional country-to-country emphasis. The designation of “priority foreign countries” that “unfairly” restrict American exports focuses public attentions and trade negotiation efforts on individual countries. Looking through the lens of past frustrations, US legislators and the American public see in Asia only “smaller Japans” or “another Japan,” rather than recognizing the Asian economic region as a group of countries increasingly integrated into a production system.

The mismatch between a country-oriented approach to dealing with trade tensions and a regional supply base that transcends national borders is both ironic and problematic. It is ironic because US pressures on Japan and the four East Asian newly industrializing economies to appreciate their currencies were the driving forces behind the rapid development of cross-border production networks in Asia. Figure 2a and 2b illustrates the link between dollar policy and Asian economic integration.

The top of Figure 2a shows the increasing shares of the US in total East Asian exports as the dollar appreciated in the early 1980’s. When the dollar depreciated after 1985,

Japanese and NIEs firms held on to their US market shares partly by relocating their production to southeast Asia and China, whose open-door policies greatly facilitated overall Asian trade adjustments. These relocations drove up the intra-Asia direct investment flows. By 1993, Asia, not including Japan, accounted for an astounding two-thirds of its own inward direct investments, while Japanese FDI accounted for another 17 percent. Consequently, East Asia (excluding Japan) also became its own foremost destination of exports and foremost source of imports, as shown in Figure 2. Japan has become a more important source of imports, particularly components, as firms from other Asian countries upgrade their products. But its shares of Asian exports remain largely unchanged.

### *Shifting Surplus and Business Networks*

The mismatch between country-oriented trade policy and region-wide supply base is also problematic because together they frustrate efforts to reduce trade tensions. Table 1 and 2 and Figure 1 show the differential effects of dollar policy in reducing America's trade deficits with Asia and the rest of the world. On the one hand, the trade deficits with Asia were never significantly reduced by the cheaper dollar. Japanese surpluses, in particular, remain high. On the other hand, the exchange rate adjustments shifted Asia's surplus with America to concentrate increasingly in China.

Without addressing the saving-investment gaps in the American economy, the efforts of the US government to push down the dollar vis-a-vis the currencies of individual countries merely shifted America's trade deficits with Asia among countries. As total trade deficits remain high, the protectionist pressures on US officials and legislators are not reduced. Moreover, unfair trade allegations against China, fueled by growing bilateral trade imbalances, may prove more difficult to deal with than the protectionist demands against Japan. The Japanese government has the capacity and the channels to orchestrate Japanese businesses in response to US pressures. The overseas Chinese networks that generate a large part of Chinese exports, by contrast, excel at neutralizing the official policies of their host governments.

Chinese business networks have been developing rapidly from a complex fusion of firms with very diverse origins and ownership. Although their business patterns are still evolving, it is already clear that some elements of the emerging business community can destabilize the broader relationship, as exemplified by the network of overseas and mainland Chinese pirating firms that looms large in recent US-China trade confrontation. Better knowledge about the developing Chinese business network is thus crucial in promoting China-US-Japan economic cooperation.

The key to understanding the seemingly elusive international Chinese business network is to view it as the product of a triangulation process. Chinese businesses first entered Asian Pacific trade and investment as subordinates of the Japanese and the American networks. They linked up and Chinese business evolved into a network in its own right only in the 1990's. Although its operation is very different from its Japanese and American

counterparts—less formal in structure and more flexible in conduct—its development has been constantly shaped by its interactions with the two older networks. In the foreseeable future, economic integration in the Asia-Pacific will still be the outgrowth of such a triangulating process—an inchoate group realizing its potential through collaborating and competing with the established and known networks of Japanese and American businesses.

### **C. Real Impact of Industrialization and Development Policy**

The increasing concentration into China of East Asia's trade surplus with the US is pushing the two countries onto a course of system frictions. Although US dollar diplomacy was at least partly responsible for the relocation of final goods production, destined mainly toward America from the four EANIEs and Japan into China, the surging bilateral trade imbalance is not any less troublesome in American trade politics. Sure to follow are more American demands for reciprocity, for opening up the Chinese markets in industries traditionally reserved for China's state enterprises. Such requests may at times be difficult to reconcile with the East Asian view of "trade and investment liberalization as a real tool for economic development." Particularly important is the message of the 1996 Manila APEC address by China's President Jiang, that technology transfer and cooperation must proceed in conjunction with trade and investment liberalization.

The development policy for building richer and stronger China implies that China must attract technology and know-how from abroad—and not just from overseas Chinese. It needs the big multinational corporations from Europe, Japan, and the US in aerospace, autos, electronics, etc.—a full range of advanced technologies for which the multinationals have become the principal instrument of geographical diffusion. These multinationals are likely to play two key parts in China's modernization strategy: trading critical technology for market access and defending China's growing trade surplus with the US.

Scale defines China's development policy. Market size, and tightly controlled access to it, is China's principal trade and industrial development instrument. It will not be discarded despite WTO accession. On the inbound foreign investment side, the combination of the lure of the giant market, the controlled access, and the existence of competing MNCs, from different national bases for almost every key technology, will enable China to continue to swap market access for technology.

The combination of large trade surplus and controlled market access in China inevitably generates unfair trade allegations in the American politics of liberalization. Although US firms in the "new China lobby" provide substantial counterweight to protectionist pressures from import-competing producers, the ranks of the latter will also expand as China moves up the ladder of value added from goods Americans no longer make to goods directly competitive with US output. In the long run, the bilateral US-China trade imbalance has to be kept within manageable proportions. The balance of interests in American trade politics will not allow the US to be the market of last resort, especially not for an exporting country of the size of China.

The current rate of growth in the US-China trade imbalance will not be politically sustainable. Adjustments have to take place either through an expansion of Chinese imports from the US and/or the absorption of more Chinese exports elsewhere. Japan has been running a small trade deficit with China in the 1990s, while maintaining big surpluses with both the US and the Asian NIEs. It is interesting to see whether Japan, as she further deregulates, can absorb substantially more exports from China. The Japanese and the

Chinese are rightly proud of their own development histories and growth records. They need not, and probably should not, be "more like US." However, if American openness to foreign trade and investment is what East Asians "like about US," it is definitely in their own interests to help the US in keeping the balance of interests in American trade politics.

## **“A U.S. Vision of Liberalization of Trade and Investment”**

**Alan Wm. Wolff,<sup>4</sup>**

**December 1996, Tokyo**

The primary objective of American trade policy has been to create a single world market, free of barriers, discrimination, and subsidies. To this end, the US government has devoted over sixty years of unrelenting effort, from the passage of the Reciprocal Trade Agreements Act on June 12, 1934 to the present. During this time, US policy has been the antithesis of mercantilism. As a general policy matter, it has eschewed government intervention in trade, either at the border or at the source of trade, the point of manufacture.

America's trade philosophy is, of necessity, evangelical. It is not enough that America's borders remain open for both its exports and imports, but also that the international trading system provides a global regime which is equally open, for no good, service or investment can cross America's border (in either direction) unimpeded without there being another market sufficiently open to allow that transaction to take place. America has generally been the principal champion of the GATT. Its negotiators were instrumental in designing the new World Trade Organization (WTO). The WTO and GATT systems were painstakingly constructed to assure that borders are open. But this is not sufficient. The heart of what America seeks is that foreign economies be at least as open as our own, i.e. market-driven. We want others to be just like us. Borders must not only be freely permeable but markets must also be contestable—that is, they must operate fully on free market principles. For this to occur, all actors (buyers, sellers, investors) must be motivated solely by commercial considerations, thus America's support for privatization of foreign government-owned and operated enterprises. Market factors—not bribes, cartels, or group loyalties—must determine competitive outcomes.

Few, if any, of America's trading partners would concede to America a moral superiority in trade matters. But for the purpose of this analysis, it is not necessary to debate this point, nor to defend past American policies or actions or to determine its morality in matters of international trade.

### **US Policy Towards Japan**

Japan and the US may have the most troubled bilateral trading relationship in the world. Japan has historically resisted all calls for trade liberalization for any specific product or service which has benefited from a scheme of Japanese government-supported protection. A Japanese policy of industrial targeting was practiced for decades in a large number of sectors, with sophisticated protectionism included as a central element. Japan's negotiating style was to deny reality and yield ground only very slowly. Wherever possible, it first denied the existence of a problem. The Japanese approach, until recently,

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<sup>4</sup> Alan Wolff is Attorney at Law with the firm of Dewey Ballantine, Washington, DC.

was at the same time relatively pragmatic, agreeing to painstaking negotiations initiated by its trading partners which were allowed to result in very slow, but discernable, progress in bringing about some liberalization.

Most of the attention to the Japanese market access problem has come from the US. There was until recently something of a state of equilibrium reached in US-Japanese trade relations. America would make its claim and Japan would resist. Then, with the generation of more heat than light, a compromise would be reached that resulted in greater, not lesser, two-way trade. The trade relationship might have continued for some time along this uncomfortable but not very dangerous path had the Cold War not unexpectedly come to an end. This event coincided with a natural renewal of Japanese nationalism. Pragmatic bilateral trade negotiations, conducted with grimaces and grudging liberalization, have in some cases recently been supplanted by Japan's rejection of further foreign pressure (*gaiatsu*.) In other cases, such as insurance, the prior cyclical pattern of resistance, *gaiatsu* and compromise have been maintained.

The policy of rejection was first popularized by Shintaro Ishihara in his call for "The Japan That Can Say 'No!'" Its realization may be attempted by Prime Minister Hashimoto and a school of "hard-line" MITI bureaucrats. Some of them believe that it is both inappropriate and unnecessary to respond positively to American requests, demands or threats regarding further access to the Japanese market for foreign goods and services. For American trade policy and the fledgling WTO, this poses a major challenge. Japanese thinking appears to be compartmentalized on trade in a way reminiscent of the irrational incompatibility of Soviet pronouncements favoring peace and its concurrent belligerent actions during the height of the Cold War. In trade matters, Japan holds itself out to America and Europe as a model of complete openness. Japanese industrial policy and protectionism, although well-documented in official Japanese sources, are not so much denied as treated by Japan (its government, press, and scholars) as non-existent, although this stance is at odds with Japanese leaders' own calls for liberalization of the Japanese economy as a means of assuring the future competitiveness of Japanese industry. Bilateral requests for consultations or negotiation on trade barriers are treated as affronts to Japanese sovereignty.

The WTO system is based implicitly but most definitely on each member (most particularly large members) reciprocating benefits received with meaningful trade concessions. This requires having a functioning domestic market. If there is a basis for believing that a large member is not meeting this threshold requirement, and there is no ready means to rectify the deficiency, not only are the seeds of a major conflict sown, but the basis for the WTO compact itself is called into question.

**An Assessment of Chinese Thinking on Trade Liberalization**  
**Jialin Zhang<sup>5</sup>**  
**December 1996, Tokyo**

Tariff rates (nominal) in China remain high, and non-tariff barriers exist. Nevertheless, one should not ignore the fact that only ten years ago, China turned away from a completely closed society relying on a centrally planned economic system. The transition from that old system to a market economy could not be done overnight. Trade and investment liberalization can only be achieved in a gradual, incremental way. What is most important is that the Chinese elite have increasingly realized the urgency of trade and investment liberalization because of its positive effects upon the domestic economy. The leadership has become committed to reforming its trade regime on a unilateral basis. Economic reform and growth, rather than foreign pressure, have necessitated further liberalization. So far, bold trade liberalization programs have been launched, and significant progress has been made, especially in the 1990's.

This paper discusses how the Chinese elite's conceptions of liberalization<sup>1</sup> and their learning curve have evolved, outlines the Chinese attitude toward regional liberalization—the APEC and finally, describes the liberalization steps China has so far taken and their constraints.

*Evolution of Economic Thinking*

Under a centrally planned economy, China closed its market for nearly 30 years. During this period, China considered it acceptable and desirable to use high tariffs and quotas to restrain imports, maintain fixed exchange rates, and use foreign exchange rationing as a further trade-restricting device.

The dominant economic thinking in China at that time was the "self-reliance" theory. That argument held that using the country's limited foreign exchange to import selected technologies and to build domestic industries would achieve rapid industrialization.

As the economic reforms continued and a market economy was proclaimed, however, the merits of import substitution-driven protection were not so unquestioningly accepted as in earlier years. A policy of attracting FDI and expanding exports and imports itself, the key element of economic reforms, calls for trade liberalization. The market economy, in essence, is an open system, incompatible with trade protection. Although some protection was inevitable at the initial stage, the full implementation of the market mechanism necessitates not only free competition in the domestic market, but also a free international trade policy and the integration of China into the world economy.

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<sup>5</sup> Jialin Zhang is Senior Fellow, Shanghai Institute for International Studies, and Director of the Board of CPS (Council of Policy and Strategy), Shanghai.

A central element in intellectual and policy developments in mid-and-late 1980's was the reevaluation of trade policy and the trading system. "The economic loss incurred by protection had been underestimated," recalled a scholar, "while its positive effects were overstated." (Chen Feixian 1996) A perception was growing amongst academicians and state planners that import controls helped maintain inefficient and high cost intermediate and capital goods sectors of the state-owned enterprise. Depressed prices for raw materials and production inputs, when combined with the high tariffs for most intermediate and capital goods, have produced high effective rates of protection for these industries and penalized downstream activities. The desire to limit the imports of nonessential consumer goods only reinforced incentives to expand the domestic production of these commodities, thus contributing to excess capacity and irrational investments designed to meet the needs of a regionally segmented market. In the absence of a flexible exchange rate policy, the trade regime has also been used to control the demand for imports for balance of payments purposes. Ultimately, this kind of an economy is prevented from obtaining the benefits derived from access to more efficient foreign products.

The high rate of protection, some scholars argue, also inhibited the import of capital goods and new technologies, which are necessary for modernization. Some new theories of international trade had been introduced into China at that time. According to the "spillover" theory, technology spillovers take place when advancements in knowledge made by one economic unit are adopted by another economic unit. Liberalization increased the prevalence of technology spillover as trade barriers were reduced. (Gunter and Meldrum, 1993) Spillovers could decrease the cost of innovations and increase an industry's competitiveness. Del Melo and Robinson (1992) suggested that these externality effects are an important factor behind the superior performance of export-led countries relative to those committed to import substitution. Chinese scholars believe that import restrictions eliminate externality effects, limit competition, generate inefficient administered protection, and ultimately harm export performance. (Hai Wen, 1995 and Zhao Guosheng, 1996)

Other side effects of protection include the following: high tariff rates cause rampant smuggling, while imposing import quotas and licensing lead to widespread corruption. Nevertheless, there has been an ongoing debate over the issue of whether infant industries should immediately represent a kind of intervention into the allocation of resources that led to price distortion and low efficiency.

This should not mean, however, that China needs no protection at all. The "infant industry" concept is not a Chinese invention. It was Friedrich List, the German economist, who stressed the protection of infant industry during industrialization a century ago. (Warren Hunsberger, 1964) In earlier phases of their development, several East Asian economies combined export development with import protection. Japan, Korea, and Taiwan, for instance, provided substantial import protection to their infant industries through trade barriers and financial incentives. Development theories in the 1950's and 1960's endorsed this approach. (World Bank, 1994)

Nor should government intervention be abandoned regardless of the concrete conditions in specific country. Given the imperfections in the markets of credit, labor and technology in many developing countries, it is wishful thinking to assume that the markets in these countries would provide correct price signals. In fact, state intervention is precisely called for, if only to overcome the distortions imposed by market imperfections. (Chakravarty, 1988) Even now, the new international trade theory embraces the "strategic trade protection" concept. Governments can select a number of long-term and strategy-oriented industries, according to this notion, for protection by enacting policy incentives. Japan and other developed countries followed this policy during the post-war period, although such protection was short-term, and always moved from one industry to another, referred to by Givens as "the narrow moving band." (Krugman, 1990) The objectives of protection were to generate spillovers and increase productivity and competitiveness within a short time.

Government role in supporting export development and sustaining outstanding economic performance in East Asian nations was also highlighted. "Looking ahead, both liberalization and government efforts to ensure adequate regulatory frameworks will be important." (World Bank, 1994)

The challenge that the Chinese government faces, scholars propose, is to pick the right products, not necessarily industries, to protect in the context of a strategic development policy. Using industrial or consumer policies instead of trade barriers might be less costly in the short term. (Hai Wen, 1995)

Since the early 1990's, consensus among Chinese development theorists was moving toward further trade liberalization. (Chen Feixian, 1994, 1996; Hai Wen, 1995; Wang Qinfang, 1996; Zhao Guosheng, 1996) This thinking was reinforced by the positive role played by FDI. The experience of most East Asian countries showed that they are unlikely to give up protection without a credible alternative for acquiring technology. That alternative exists. Industry now can be promoted more effectively through FDI than through import substitution. China is using FDI for development of competitive industries such as textiles and electronics.

The trade-FDI link in East Asia is often illustrated by the "flying geese" hypothesis, according to which the dispersion of technology that influences trade patterns is transmitted through FDI from the lead country to follower countries. (Akamatsu, 1960) Lead-country firms combine their technological advantage with the lower factor costs in follower countries and move their production of "second tier" products offshore. The combination of foreign capital and cheaper production costs makes the follower country's products more competitive in world markets. So their exports rise. Japan is usually regarded as such a lead country, followed by the early NIES, which in turn have been followed by Malaysia, Thailand and, more recently, China. The distribution of production is determined by comparative advantage and the ability of the host countries to absorb the technology embodied in the FDI flows within an increasingly open trading system. Foreign investors pressure the host country governments to relax import restrictions, often contributing to a more open trade regime. FDI promotion, therefore, is attracted by liberal trade regimes,

contributes to export growth, and in turn creates pressure for further trade liberalization. The World Bank called these processes a "virtuous circle."

In sum, trade liberalization is not a result of foreign pressure, but an intrinsic necessity of economic reforms. There is a general consensus among the Chinese elite that the initial stage of trade liberalization in China might be painstaking. But this is the transaction cost the country has to pay during its transition to a market economy. In the long run, greater openness should help the country reduce the current inflationary pressures and increase the market discipline of state-owned enterprises. An important objective of trade reform, then, is to rationalize the allocation of resources by placing enterprise decisions in the context of international price signals, and to boost national welfare.

### **An Approach to Regional and Global liberalization**

During the first ten years of the Chinese economic reforms, their emphasis focused upon domestic problems. There was insufficient attention paid to policy and the issues of international economic cooperation. Some scholars maintained the dogmatic view that economic integration constituted the exploitation of underdeveloped countries by the major economic powers.

As China's economy opens to the outside world, there is a growing awareness that economic interdependence and free trade are irreversible trends. Eliminating protection and opening the market are just a matter of time. As the world economy grows healthily and interdependence increases, China's interests clearly are linked with an open and multilateral trading system. Hence, China is well advised to participate fully in all initiatives to promote multilateral trade liberalization. Actions in the regional context will be of interest if such initiatives are non-discriminatory. For China, the benefit of a regional approach to liberalization would be a potential increase in its exports to East Asia and sustained FDI inflows with substantial technology transfers to China. Both developments would serve to provide opportunities for export market diversification and dampen the adverse impact of liberalization on the current account in the short term.

As the largest developing country in the region and the world, China's salient features of economic development should be taken into account when participating in such regional integration. Although the economy grows extremely fast, its productivity is very low; the newly-born market system is immature and imperfect; agriculture is particularly backward, and its suppliers of products can not endure foreign competition; and many sectors like automobile, electronics, finance, insurance, and communications are still in their infant stage. But the domestic market potential is enormous, and demand for technology and management skills is huge.

It is desirable that developed countries obligate themselves to extend some assistance to developing countries in technology transfer, building infrastructure, environment protection, human resources development, improved management, etc. Japan's promise of

10 billion yen contributions, made at the Osaka meeting for these purposes, was widely praised.

In China's view, in the final analysis, liberalization is a matter of opening markets. *Only* with advanced technology and sufficient funding, provided by the developed countries, can industries of developing countries become more competitive, and their markets open up. Unfortunately, the US has opposed making APEC a vehicle for development projects and "pooling" its development aid with other APEC donors. (Ortblad, 1996)

Concerted Unilateralism: Since the Seattle meeting, there has been a trend that APEC could turn into a regional trading arrangement with binding rules. Most Asian member countries, however, oppose this, as they believe this organization should be open to nonmember countries. Many scholars admitted that institution-building in APEC is a protracting, painstaking process. Too hasty an effort to erect the superstructure risks toppling the whole framework.

Unlike traditional trade areas that enforce their agreements through binding mechanism, APEC relies on consultation and unilateral commitment of individual countries. The Osaka meeting reasserted the "Asian way" of reaching decisions through consensus. As for the best way to achieve trade and investment liberalization, there were two different approaches: "collective action" as advocated by the US involves collectively-agreed action plans of liberalization for all members, while "concerted unilateralism" allows each member to move forward independently. China, Japan and other Asian members were inclined to support the latter. In recent years, unilateral initiatives are favored in many countries of East Asia, where they have been responsible for more market opening than concessions produced through tough bargaining. New Zealand, Indonesia and China are notable examples. (Wain, 1995)

In China's opinion, each country should set out its own plan of liberalization according to its domestic situation, then decides the priority, scope, sequence, and pace to implement the plan. Concerted unilateralism should have three dimensions. 1) Collective action formulated on the basis of unilateral action plans, i.e. unilateral action as the mainstay and collective action as a supplement. 2) Unilateralism does not mean doing as one pleases. Individual action plans should abide by common principles which are agreed upon by other member countries. Where possible, they will be "concerted" through a process of consultation and review. Hence, the action agenda will include a section setting out objectives and guidelines for both individual and collective actions across a wide range of issues. 3) Establishing an appraisal and assessment mechanism. All individual plans must be comparable. During consultation, member countries can compare each other's action plan, revise and coordinate them. So, each country moves in roughly the same direction in an even way.

Nondiscrimination. In China's view, the fruits of APEC's liberalization should be enjoyed by all member countries without discrimination. In other words, MFN treatment among APEC members should be unconditional. Otherwise, "open regionalism" is nothing but

empty talk. Linking human rights to China's trading status and annual review of MFN is another absurd tactic. The MFN treatment has become a global standard for normal trade. It does not render a favor, but assumes reciprocal obligations. More than 120 countries now have lower tariff rates than those under MFN by enjoying the Generalized System of Preferences (GSP). This tactic will only inhibit the liberalization process of APEC.

### *Is the China Market Closed?*

Does China have the highest tariff rate in the world? Yes, its nominal average tariff was 43 percent in 1992. No, its effective tariff was only 4.6 percent in the same year. This paradox reflects the distorted tariff structure that originates from the old system and the new measures taken by the authorities trying to open China's economy.

In a closed, central planning economy, the tariff was regarded as the embodiment of sovereignty. Its functions were assigned to ensure government revenue and to protect domestic industries. Liberalization can cost the government much on revenue grounds. Acting on this principle, China implemented a high tariff policy during 1949-1979. In the process of the economic reforms, however, the thinking on the functions of tariffs in policy and academic circles has changed. Tariffs are no longer regarded merely as a source of government revenue, but as a tool for regulating imports and exports, expanding foreign economic relations, and rationalizing the domestic industrial structure. The consensus reached is that high tariffs will not generate increased government revenue. Judging by the composition of imports, the major imported goods were not those subsistence ones that China cannot produce and supply. Given a large elasticity of supply, high tariffs on these goods will restrict imports and thus decrease tax revenue. As a result of this thinking change, the country consistently cut tariffs after 1991.

In November 1995, President Jiang Zemin announced at the APEC meeting in Osaka that China had decided to cut tariffs by at least 30 percent, at the same time revoking various tax exemptions. These tariff reductions that came into force on April 1, 1996 covered approximately 4,000 commodity lines that bring China's average tariff rate down from 36 percent in 1995 to 23 percent. The new duties on average represented a 40 percent decrease from the 1994 rates. This was a major step for unilateral liberalization in compliance with the agreements reached at previous APEC meetings.

In addition to tariff reduction, China's entire trade system has also undergone major changes. Since the start of the economic reforms, China's trade system has moved from planning and carrying out all trade through a handful of foreign trade corporations (FTCs) to one in which the role of planning is much diminished. Since 1985, export planning has been eroded by the decentralization of FTCs. Foreign trade can be conducted by local government and local FTCs on a contract basis. All FTCs are responsible for their own profits and losses, and they no longer monopolize foreign trade.

Over 5,000 domestic enterprises and hundreds of foreign-funded firms now have the right to engage in foreign trade. On the import side, the coverage of the plan fell from 40

percent of all imports in 1988 to 20 percent in 1992. Later, the government announced its decision to eliminate mandatory import plans, reduce the scope of *import* controls on machinery and electronics equipment, eliminate licensing and quota requirements for some products, and simplify import procedures. On December 31, 1995, 176 non-tariff measures, totalling 30 percent of total import quotas and licensing, were phased out.

In addition, reforms of exchange rate management, including the unification of the rates and the abolition of retention quotas, have resulted in currency convertibility for current account. This has eliminated an important source of economic rents and the need for government intervention in the allocation of foreign exchange.

These developments demonstrate that over the last few years China has made a big stride toward unilateral liberalization. Nevertheless, China's trade restrictions, both tariff and quantitative, remain relatively high. The recent cut of the average rate to 23 percent is still short of the simple average rate of 17 percent maintained by most developing countries. As many government officials have stated, the next step might come in a few years. Foreign countries also point to some 300 non-tariff measures, including licensing requirements, import quotas, and certification requirements.

In fact, China's market is far more open than that of Japan, Korea, or Taiwan at comparable stages of their development. Although China has a trade surplus with the US, it incurred a \$12.2 billion global trade deficit in 1993 and has done so in two of every three years since the late 1970s (Chart 1). It makes little sense to argue that the Chinese market had been closed when China was running a large current account deficit. (Lardy, 1994)

It is unrealistic and unfair, however, to demand that China abolish all barriers at once. For trying to understand China's growth and development objectives in the global trading system, it is important to emphasize how different the circumstances are for China and the developed countries. China has a huge population and a very low per capita income. Its industry, agriculture, and service sectors are still underdeveloped. Social dislocations and disturbance could worsen if the protections for certain industries were lifted, perhaps destabilizing the region if not the whole world.

History has shown that economic liberalization in most countries has been an incremental and progressive process. China accepts that different rules should apply for different countries at various stages of development. Take the case of Japan. It took 17 years to reduce Japanese tariffs to the levels required by GATT. When Japan acceded to the GATT in 1955, the one-third tariff cut was its first cut in this century and still, there remained many high tariffs. Despite its 40 percent cut in the Kennedy Round, Japan's tariffs remained higher than that of other developed countries until 1972 when it promulgated a unilateral 20 percent reduction that made its tariff level similar to other OECD countries. South Korea and other developing countries also acceded to the GATT under exceedingly generous terms. The harsh conditions set and double standards used by Western powers to regulate China's accession to the GATT only violate the principle of nondiscrimination.

As indicated above, China has been committed to cut tariffs to those levels maintained by most developing countries. To be sure, there are still non-tariff barriers, but they persist everywhere. Neither Europe, nor North America can claim to have open markets in terms of non-tariff barriers. Moreover, it appears that such barriers are hard to define and measure. Neither World Trade Organization (WTO) nor GATT, its predecessor, was incapable of reducing these barriers. While the US is most critical of non-tariff barriers in other countries, one only sees the increased use of US protective measures—quotas, anti-dumping and countervailing duties, safeguards, trade sanctions, and linking trade retaliation to non-economic issues—against its trading partners.

Even the US has admitted that the scope of trade openness must hinge on prevailing economic conditions. As US Trade Representative Kantor once stated, in the 1950's and 1960's the US could afford to open its market because it controlled 40 percent of the world economy, but in the 1990's its share of the world market has declined to 20 percent and it cannot afford to do so any more. If so, why can other countries not decide the extent and pace of their market opening according to their own economic conditions?

It would not make sense to argue which country is protectionist and which is a free-trader. Any country moving towards unilateral liberalization or liberalization within multilateral arrangements should be actively encouraged. We do not see a universal form of liberalization as the US defines it. We do believe, however, that the broad trends across the world are towards greater economic openness.

## **China Plays a Constructive Role in the Dynamic Growth of the Asian and Pacific Economies**

**Li Zhongzhou<sup>6</sup>**

**November 1997, Berkeley**

Certainly, China shares common interests with Japan and the US in maintaining dynamic growth of the APEC region. China's potentials for growth as a developing economy are far from being exhausted. China will continue to make efforts to contribute to the dynamic growth of the APEC economies. In the coming four years till the end of this century, China envisages to achieve an average 8 percent annual GDP growth. As the economy grows in magnitude, growth rates will fall hopefully to around 7 percent for the first decade of the next century. In other words, China will continue to be an important growth factor for the APEC region. The external sector has already played a very significant role in the national economy. Import and export trade together is equivalent to some 40 percent of GDP. Although the method of comparison has been questioned, it doesn't change the basic fact that foreign trade has strong bearing on the national economy. Import and export trade is envisaged to reach US\$400 billion by the year 2000. In other words, for the coming four years, China will create a total demand of some US\$700 billion for imports.

Encouraging foreign investment is one cornerstone of China's open policy. By the end of 1996, China had absorbed a cumulative foreign direct investment of US\$177 billion. Foreign investment accounts for 17 percent of total domestic investment. The Chinese government has undertaken to further improve the investment environment by guaranteeing profit repatriation (already significantly facilitated by convertibility of RMB), accelerate law-making, and enhance policy transparency and administrative efficiency. In keeping with the national focus on infrastructure construction, the government will continue to use foreign loans and credits as well as encourage foreign investment on infrastructure projects.

The service sector assumes rapidly increasing importance as the economy grows in size. Great efforts are being made to build a regulatory system to prepare for further multilateral negotiations on trade in services.

China, Japan and the United States will substantially benefit from dynamic growth of the APEC economies. Previous paragraphs described the constructive role China could play in promoting APEC economic growth. Appropriate policies by Japan and the US could interact with each other to create the momentum of growth.

Japan is China's most important trading partner, with the exception of Hong Kong. For the period of 1991-1995, China's import and export trade with Japan was US\$190 billion,

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<sup>6</sup> Zhongzhou Li is Minister Counselor (Economics & Trade) in the Permanent Mission of China to the United Nations at Geneva.

accounting for 18.74% of China's global trade during the same period. China's export to Japan was US\$87.76 billion accounting for 16.93%. In the import scene, Japan took 20.62%, amounting to US\$102.29 billion. Given the complementarity of the two economies and the geographical vicinity, there is still large potential for further trade growth. Japan can take on more goods from China and can also create greater demand by investing more in China. Japan's share in China's foreign investment has actually dropped sharply from 32.69% for 1986-1990 to 11.27% for the period of 1991-1995. Protectionist pressure in Japanese domestic industries such as textiles and clothing may create problems for bilateral trade relations. The two governments need to work together to find appropriate solutions to promote both trade and investment.

Economic and trade relations between the US and China have the largest untapped potentials. Given the high degree of Complementarity between the US as a highly developed industrialized country and China as a fast growing developing country, there are no conflicts of interest. China's major exports to the US are labor-intensive products such as textiles and clothing, footwear, and other light industrial products which the US no longer produces. China imports a wide range of products from the US. Large items includes wheat, chemical fertilizer, civil aircrafts, industrial equipment, etc. At present, China is the top buyer of American wheat as well as a major buyer of American civil aircrafts. Up to date, China has purchased 308 crafts amounting to US\$8.72 billion.

The US is also one of the major sources of foreign investment. About 100 of the 500 top American enterprises are investing in China. Five American banks have established eight branches in China. Out of the six foreign insurance companies approved by the Chinese government to open business, three are American firms.

China-US trade relations started from scratch in 1976 by signing the first bilateral trade agreement in which both parties mutually granted most-favored-nation treatment. That agreement ushered in a period of expansion of bilateral trade with an average 18% growth rate. The US quickly become China's third largest trading partner after Hong Kong and Japan. Obviously, constructive bilateral relation is the basis for expansion of bilateral trade. Unfortunately, recent political debates in the United States have distorted the actual constructive bilateral economic and trade relations and dramatized the so-called "threat" of Chinese economic growth. The fundamental MFN principle prevailing in international trade is labeled a "privilege" granted to China. Extremist groups advocated trade sanctions. Trade will occur only when both sides benefit from it. The withdrawal of MFN is likely to inflict a destructive impact on the dynamic growth of the whole APEC region. Processing trade is a major component of China's trade accounting for 55.8% of total trade. The withdrawal of MFN will seriously hurt suppliers of intermediate goods and foreign investment enterprises engaged in processing in China including many American enterprises such as Nike. The Chinese government and the US administration are working together to defuse the explosive issue. It is important for the academics and the administration to explore the true story of the most touching issue of trade deficit that caused so much emotion in the US. A joint expert group consisting of Chinese and

American statistical experts was established to investigate the issue. The group discovered three aspects that divide the two parties.

First, US imports statistics overstated imports from China by omitting value-added in further processing by third parties. The added value ranged from 40% to 100%, but still counted as Chinese goods without discounting the added value. According to US data, only 20% of Chinese goods imported into the US is directly delivered by China.

Second, US exports statistics omitted transshipment through Hong Kong to China, which valued around US\$2.3 billion (1993).

Third, problems also arise from rules of origin, which need to be further investigated. Analysis based on the first two factors revealed that the US trade deficit has been exaggerated by at least 60%. Confrontation touched off by emotion based on inaccurate information could mislead us to overlook the real mutual interests of constructive relations. Both parties should discourage emotional debates and carefully look into the areas where common interests lie. The US should not lose sight of the fact that China is the fastest growing market for the US; American investment and direct export to China alone create at least 300,000 jobs for the US. China should bear in mind that the US is the most important market for Chinese goods, a major source of foreign investment, and a supplier of high technology badly needed for economic development. The trade balance issue could be resolved constructively through friendly consultations.

China has already undertaken liberalization of market access on three fronts, namely WTO concession, APEC individual action plan, and unilateral measures taken as part of the overall economic reform program. The Chinese government took other major steps in market access liberalization and made autonomous tariff reductions covering 4,874 tariff items. This represents an average 26% reduction. As a result, the average tariff level has dropped from 23% to 17%, a level very close to our committed target of 15% by the year 2000. China has done its utmost within its ability and will continue to do so. The US may need to make its own efforts to increase exports to China. The most important thing to do is to resolve the uncertainty of US-China trade relations, lift export restrictions on non-military technology and equipment, enhance competitiveness in competition with Japan and European enterprises, permit American enterprises to participate in public tenders for infrastructure projects and provide export financing generally available for other countries.

#### *China's approach to the liberalization of trade and investment*

As explained in Section I, China adopted a progressive approach to economic reform in the light of China's special conditions. It is a practical and pragmatic approach which is also applicable in the liberalization of trade and investment.

#### *Development strategy*

The objective of development strategy is to achieve high, sustainable, low-inflationary economic growth by full utilization of internal and external financial resources as well as the internal and external markets. The open policy adopted in 1978 has resulted in rapid development of the external sector. By any standard, the external sector is already very large in proportion to the national economy. Total value of imports and exports is equal to around 40% of the GDP. Foreign investment accounts for 17% of total national investment. Foreign investment enterprises take 47% of import and export trade. This suggests that the Chinese economy is already highly integrated with the world economy and will continue to move toward an even greater degree of integration. Depression of the world economy will have immediate impacts on the Chinese economy and the sharp decline of China's dynamic growth will in turn inflict heavy loss on its partners particularly in the APEC region. China shares common interests with APEC economies in maintaining dynamic growth in the region.

#### *International division of labor and Complementarity*

As demonstrated in the above section, China's main exports are low value-added labor-intensive products, over half of which are simply processed products with 10-20% value-added. Our industrialized partners no longer produce such products or maintain production at high cost through protection. China's main imports are high value-added industrial equipment, technology and food grains. This complementary pattern of trade is a win-win game based on comparative advantage.

This pattern of trade, however, now faces a danger of being short-circuited by protectionist measures such as unilateral restrictions, discriminatory anti-dumping actions, and biased rules of origin taken by China's industrial partners. In textiles and clothing for example, China has been downgraded from first to third biggest supplier in the US market. At the insistence of the US, a new agreement expanding quota restriction coverage and reducing growth rate of existing quotas was signed. The US side insisted on putting pure silk products on quota restrictions even though the US has no domestic silk production to be injured. The only result is increased cost for consumers. Such protectionist measures always cause chain reactions. The European Union wanted similar agreement by claiming MFN treatment. Japan threatened to impose unilateral quotas for the first time for fear of trade diversion as a result of US and European restrictions. This had been done when the Uruguay Round Agreement on textiles and clothing to phase out all quota restrictions within ten years came into effect. If this tendency continues, China's liberalization efforts may be bounced back as its comparative advantage is dented by protectionist measures. It should also be recognized that the globalization of production has blurred the traditional country-to-country division of labor. Restrictions on a product produced in one country may affect one or several other countries. For example, US footwear manufacturers are hurt by EU quota restrictions on Chinese footwear.

#### *Correlation between protection of infant industry and upgrading industry*

China has no intentions of providing permanent protection for sunset industries. The basic objective of protection is to give infant industries adequate time to achieve a scale of production which allows them to enter into international competition. The ultimate goal is to upgrade the industries rather than insulate them forever from international competition. Questions have been raised about China's protection of the auto industry. Three factors have to be borne in mind. First, the world auto market has been carved up by intra-firm transaction and governmental market sharing arrangements. China could emerge as a new competitive market. Auto producers are teaming up for manufacturing in China. There is likely to be healthy competition. Secondly, auto production is globalized. The Chinese auto industry to emerge will consist of multinational ventures with benefit-sharing. Thirdly, the auto industry is regarded as a pillar industry which has broad linkage effects proliferating into steel, glass, paints, motors, road constructions and auto services. It is not a question of protection, but a question of development.

### *Regionalism vs. multilateralism*

China favors multilateralism and supports regional cooperation, which is consistent with multilateral rules. China does not wish to see regional cooperation arrangements drifting into exclusive trading blocs, because that would be detrimental to China's full-fledged open policy and her efforts to diversify her trade relations. China has actively participated in the APEC liberalization of trade and investment, and reiterated her emphasis on unconditional MFN. This has been the fundamental principle of international trade for half a century. The US still has reservations about this principle. APEC liberalization will not be smooth-going short of strict observation of this principle.

### *Integration of China's economy into world economy*

China views WTO membership as an effective instrument to promote integration with the world economy. WTO provides a comprehensive framework of rights and obligations for all members. China is ready to take this framework as the basis for economic reform. China has already accepted the Uruguay Round package by signing the final document in Marrakech. The remaining issue is to reach agreement on market access concessions. The major trading partners took advantage of the negotiations to demand that China pay a high price which China considers to be beyond the level of her economic development. There is also the outstanding controversy over the major trading partners' insistence on having provisions permitting WTO members to apply trade remedy measures beyond what is provided for in the existing legal instruments of the WTO. China does not accept such discriminatory protectionist provisions.

### *System Friction and Level Playing Fields*

The world economy consists of diversified economic systems and divergent levels of economic development. There is no single model which is universally applicable for all countries. If each of our countries carries out trade only in accordance with its own systems, then there is a real system friction. We need a common denominator to regulate our trade

relations. The WTO, notwithstanding all its inequality and imperfection, has been accepted as the common denominator for countries to observe in the conduct of international trade. While recognizing the marked improvement of the dispute settlement procedures, one should not take for granted that the WTO can in all cases guarantee fair play and provide for level playing fields in international competition. To a large extent, economic power is still the force in rule-making. Small economies can in no way prevent things from happening which may cause harms to their economic interests. Latecomers are normally asked to undertake more obligations and pay a higher entrance fee than existing members. China has taken the position that it will do its utmost to make greater market access concessions to the maximum extent possible, but it will not accept discriminatory rules inconsistent with existing WTO legal instruments. All major trading partners of China including the US and Japan have in one way or another maintained discriminatory trade measures against China. Accession to the WTO will of course require China to make radical trade policy and system adjustments. It also requires China's trading partners to eliminate discriminatory measures against China. We are aware that vested interests strongly resist such policy adjustment. That is the background behind the demand for trade remedy clauses to be included in the future Protocol of Accession. China's accession is actually left at the mercy of its major trading partners. Top Chinese leaders have made it clear that China wants to be part of the multilateral trading system but will not sacrifice its fundamental economic interests in order to accede to the WTO. Within the WTO, China has an important role to play in maintaining sustainable, dynamic economic growth in the Asian and Pacific region, as well as strengthening the multilateral trading system. China has come to terms with Japan on the accession but has yet to reach a common understanding with the US.

The US administration's position on China's accession to the WTO has been heavily influenced by the emotional reaction to the exaggerated trade deficit in goods, overlooking the substantial benefits the US has gained in the overall positive economic and trade relations. This relation is a dynamic one in nature. It has served to accelerate the process of structural reform in both countries. It is inappropriate to focus only on the imbalance of trade in goods. There are many more positive elements to talk about in our bilateral trade and economic relations. The balance in China's favor only temporary and only in goods. The US has surplus in services. The US began to have deficits in trade in goods in 1972 and never regained a surplus. But the deficits in goods are compensated by surplus in services. In 1996, the United States had a record high trade surplus of US\$72.6 billion in services, offsetting 40% of the trade deficits in goods. (CSI Reports-The Service Economy by Joseph P. Quinlan) It is a dynamic structural adjustment in US interests. It reflects the continuous upgrading of the US economy. It means more white collar jobs, less blue collar jobs. The US economy is in extremely good shapes with a strong dollar, comfortable growth rate, low inflation and low unemployment.

For China, the expansion of the external sector and the reform and open policy are interacting with each other. Without rapid growth of exports, there would have been no rapid expansion of imports (five folds between 19 and 1996). Without a substantial increase in foreign exchange reserves, we would have not been able to abolish the foreign

exchange certificate, multiple exchange rate and foreign exchange retention scheme. And we would have not been able to achieve the goal of RMB convertibility on current accounts so soon. Also, there probably would not have been so many American banks established in China.

China-US bilateral relations should be assessed from a long term perspective and a broader framework. The two governments should work closely to avert disruption of this constructive relationship by emotional debate on particular issue such as trade deficits in goods. We do not underestimate the problems, but assert that it should be examined on a economy-wide basis, not on sectoral reciprocity.

With the rapid advance of modern technology and profound structural changes in the world economy, many of the traditional concepts such as “national treatment,” “reciprocity,” “asymmetry,” and “fair trade” have to change. All these concepts were developed on the basis of international movement of goods with relative static state factors of production. Now all factors of production have become active actors of the world economy by moving across border extensively. Indulgence in sectoral balance by argument of reciprocity, asymmetry or fair trade only delay the dynamic process of structural adjustment of the world economy. It does not make sense to talk about asymmetry in the labor-intensive sector when the major industrialized countries have actually monopolized the high technology and service sectors.

The two countries should work together to narrow the gap by way of positive balance, in other words by expanding trade to grow out of the imbalance on an overall basis. China on its part has been undergoing drastic economic reform and has taken incessant measures to facilitate the transition toward a market economy system. In spite of high unemployment of more than ten million, China has made four rounds of autonomous tariff reductions which effectively brought down the simple average tariff rate by more than 60%. Most of the non-tariff measures have been eliminated and the remaining will be phased out in the framework of WTO negotiations. China has also substantially liberalized its foreign exchange regime by abolishing the exchange allocation system and multiple exchange rate, and has achieved the goal of current account convertibility, completing the transition from IMF Article XIV to Article VIII within an unprecedented short period. However, US trade officials continue to assert that the widening trade gap is attributable to protectionist measures by China. Such an assertion gives the business community a wrong message to scare them away from the Chinese market. China is in a process of dynamic, liberal reform, moving rapidly towards globalization. As mentioned in previous paragraphs, foreign investment enterprises account for 47% of China’s imports and exports trade and 17% of China’s domestic investment. Sustainable, dynamic economic growth is no longer a mere national pride of China, but a major contribution to regional economic growth for which all three of our countries share a common responsibility. Many in the US fail to observe this fast evolving trend. They are obsessed with trade sanctions. Sanctions do hurt China, but they hurt the US as well. It never solves problems, but create problems. The US has missed many of the opportunities through its own faults: bans on exports of high technology and nuclear power equipment, withholding

export financing, discouraging American enterprises from participating in international tenders for the Three Gorges projects, etc. High technology and huge projects provide effective solutions to narrow the trade gap. The US wishes to maintain its existence in Asia. Active participation in Asia's dynamic economic growth is the most effective means of achieving that objective.

Accession to the WTO will lock in China economic and trade regime with WTO rules and accelerate the integration with the world economy. If the issue is to be resolved, the misconception that China has not made commercially significant offers has to be corrected. How can one argue that China's offer is not commercially significant when negotiators privately admitted that China's package offer outweighs the total concessions of the whole Tokyo Round? How can such negotiating rhetoric be convincing, when China as an agricultural countries gives up the right to provide export subsidies for agricultural products (when all major agricultural exporting countries continue to provide large amount of agricultural export subsidies well into the next century), commits to phase out all non-tariff measures inconsistent with WTO, and further reduce tariff level along with its economic growth?

China is aware of the need to make necessary legal and administrative adjustment to meet WTO obligations. But the ultimate goal is to build a system that will ensure sustainable, dynamic growth, increasing purchasing power and progressively expanding market access for foreign goods and services. The adjustment will include adapting to a tariff-only system by making commitment to phase out non-tariff measures which are inconsistent with WTO and making sharp tariff cuts in response to WTO members' requests. China has committed to bring down its tariff to an average level of 15%, making major structural change in the foreign trade regime and gradually replacing the foreign trading right system with a registration system, phasing out trade-related investment measures (particularly local content requirement), adjusting towards current account convertibility (this has already been accomplished), and accelerating preparation for further liberalization of trade in services. The General Agreement on Trade in Services only sets the framework for negotiations. Bargaining for concessions will follow in the years to come.

This is an illustrative list of broad areas requiring China to make substantial adjustment. Many more detailed, specific adjustment requirements are contained in the Uruguay Round package agreements. We are confident that we can manage to meet those obligations within the framework of WTO. Imposition of additional obligations beyond the WTO will distort competition and sow discord in future trade relations between China and WTO members.

#### *National Treatment*

Finally, a few words about national treatment. National treatment is a broad term. It has different ramifications in different contexts. National treatment in GATT relates only to non-discriminatory treatment for imported products in respect of internal taxes and regulation of marketing and distribution. It has nothing to do with treatment of foreign

enterprises and foreign natural persons. National treatment in GATS (General Agreement on Trade in Services) does relate to legal natural persons. But such treatment is negotiated case by case; it is not automatic. Negotiated national treatment may be qualified, modified or limited, depending on the writing of the schedules. China recognizes national treatment for imported products and are negotiating qualified national treatment for selected sub-sectors of services.

National treatment in respect to foreign investment has to be dealt with differently in different contexts. What has been frequently referred to by foreign investment enterprises reflects their interests in gaining equal access to foreign exchange, access to public services at the same prices available to Chinese citizens and Chinese enterprises, and access to bank loans and credits. The achievement of convertibility on current account has already solved the problem of access to foreign exchange. As market-oriented reform is being intensified, state pricing for production inputs is disappearing. The government has decided to unify prices for public services. The reform of the banking system requires that commercial banks operate on market principles. Domestic enterprises are going to have advantages over foreign enterprises.

Another side of the matter is how to deal with preferential tax exemption for foreign investment enterprises. The government has to respond to domestic enterprises' demand for the right to compete with foreign investment enterprises on level playing fields.

## II. WHY A TRIALOGUE MAKES SENSE

### **Main Issues:**

- The triangular regional production system
- Economic integration through investment and trade

### **Selected excerpts:**

- A. “Views on Trade and Investment: Perspectives of Japan,” by Akira Kojima
- B. “Asian FDI Inflows and Outflows: Patterns and Trends,” by Dennis J. Encarnation
- C. “Scenario for Asian Pacific Economic Growth,” by Heizo Takenaka

### **Summary: Why a Trialogue Makes Sense**

Holding a trialogue between the US, China, and Japan is an effective way of discussing the issues at large because the triangular regional trading system between the three nations yields a high level of economic integration, through mutual trade and investment, and will play integral roles in the continued development of the region.

The authors in this section discuss the structure of Asian regional production and its future implications in light of the recent changes and developments in regional trade and investment patterns.

The increased importance of investment over trade, as Kojima notes, has profound implications for Asian economic development. The astounding increase in direct investments and mutual economic interdependence since the late 1980's was caused by several simultaneous conditions, including the Asian nations' economic systems renovations, which opened them to other countries and led them to develop direct investment strategies. (Kojima 2) Direct investment has since become vital component of bilateral and multi-lateral trade adjustments, which helps solidify the relationship between trade and investment, to the point where the emphasis of the world economy has shifted from trade to investment, says Kojima, to the point where trade has become an “index” of investment. (Peter Dragger, from Kojima 2)

Several trends have marked the elevated importance of capital shifts over trade of assets and services, including the creation of the WTO in 1995. While GATT expanded free trade opportunities and supported the development of a world economy, the post-Cold War WTO is involved with direct investments as well as trade. In addition, notes Kojima, there have been accelerated internationalization of enterprises in both advanced and developing nations, dramatic increases in overseas direct investments by advanced

countries in developing countries, and lower national barriers allowing for greater flexibility in choosing among global production sites.

Intra-Asian FDI is now more important than intra-Asian trade in determining the magnitude and pace of regional integration, according to Encarnation.

During the 1990's, East Asia has become not only a major site but also a significant source for foreign direct investment (FDI). FDI in Asia, concentrated largely in the manufacturing and service sectors and natural resource-based industries, have altered the nature of Asian trade and has increased regional integration beyond what trade alone accounts for. (Encarnation 1)

The Asian Pacific economic triangle—Japan as technology supplier, developing Asian nations as producers, and the US as consumer—could not, however, be sustained in the long run; when US trade balances reached heavy deficits in the mid-1980's, the political decision to devalue the dollar was made with the expectation that Japan would absorb much of the US' consumption role. (Takenaka 2)

Japan's structural economic reform allowing for increased consumption never developed and by the end of the decade, the NIEs took over that role, surpassing Japan's total import volume. The "revised Pacific triangle," as Takenaka calls it, sees the NIEs operating as absorbers and suppliers of technology and capital to some extent. Rising income levels in the NIEs allow them to expand their imports from ASEAN countries and their FDI has become the largest source of capital for ASEAN and China, surpassing that of Japan and the US. (Takenaka 6)

While the largest contributors to FDI in Asia remain Japan, the US, and the EU, the relative share of industrialized countries has declined over the last twenty years. FDI outflows from other Asian countries, excluding Japan, have outpaced that from their European counterparts and from most industrialized sources. Growth has been further stimulated by relaxed capital controls on FDI outflows from and liberalized capital controls on FDI inflows to several of the Asian countries. (Encarnation)

The developing Asian nations' dependence on the US and Japan has declined in this period and will continue to follow this trend, predicts Takenaka. They are beginning to focus within the regional economic zone for export markets and investment funds sources, thus creating what Watanabe calls the "Asian Self-Generating Structure."

Of the myriad possibilities for the future of Asian Pacific economic development, Takenaka claims that the region's economic development in the 1980's was not some fluke but instead has a solid foundation, and predicts that it will continue at relatively high levels in spite of a slowdown. In addition, China's purchasing power will increase significantly, US trade dependency on the Asian Pacific region will rise, and Japan's influence on the Asian countries will fall.

Despite the economic boom of sorts in Asia, several shortcomings must be addressed. The host governments are not entirely equipped to deal with the recent trends, warns Encarnation. They have too few offices to handle the rapid inflow of investment from the NIEs partly because, while they have designed incentives to attract FDI from industrialized countries, they still debate over their fellow Asian investors from developing countries. These governments also have not had enough time to adjust to the recent, rapid outflow of investment from their own economies.

Within this scenario, APEC will play a large role in determining the region's economic paths. Within APEC, the seeming conflicts of interest between the US' push for rapid liberalization and the Pacific nations' desire for Asian-style development while not losing the opportunity to liberalize contribute to the complex "web" of relationships between the member states, for which Japan, who has attained an income level comparable to the US through Asian-style growth mechanisms, can serve as the "glue." (Takenaka)

On the global scale, APEC itself will be the "glue" in the world trade system, says Takenaka. Western trade with the APEC nations will grow and in order to liberalize world trade through the WTO, APEC will become the glue connecting the three regional associations of the EU, NAFTA, and APEC.

**Views on Trade and Investment: Perspectives of Japan**  
**Akira Kojima<sup>7</sup>**  
**December 1996, Tokyo**

One of the megatrends in the world economy since the late 1980's has been the changing character of the economic game, which resulted from the overwhelming increase in direct investments unrestricted by national boundaries, as well as the mutual economic interdependence among countries and regions.

The conditions evolved due to the simultaneous occurrence of the following: 1) The consolidation movement that developed in Europe under the EU system; 2) The renovation by each country, especially the Asian nations, of their economic systems from the opening up of such countries to other countries and from the adoption of direct investment strategies for their economic development; 3) The dramatic end of the cold War which completely demolished the former Soviet "control and order-type" economic system, thereby creating a "domino effect in favor of a market economy even among former Eastern countries and China as well; and 4) Direct investment, a decisively important means in corporate management strategy, which arose from the dynamic reevaluation of the exchange rate following the 1985 Plaza Accord among the five major advanced nations.

As a result, direct investment came to be incorporated as a crucial aspect of bilateral and multi-lateral trade adjustments, consequently significantly strengthening the relationship between trade and investment. It was in 1989 that Mr. Peter Dragger, the elderly management specialist of the US, described the "era of investment" as follows in *The New Reality*, his novel that predicted the collapse of the USSR:

"The world economy has changed from an international economy to a trans-national economy. The global economy has come to greatly influence the domestic economy. This is not moved by the trade of assets and service but through the shift of capital. In the future, trade will come to follow investment more and more. Actually, trade will become the index of investment. The main role of the world economy has shifted from trade to investment, in contrast to the conventional pattern where investment followed trade."

As shown in Diagrams I and II, direct investment has expanded drastically since the latter half of the 1980's. In 1995, the WTO was born, taking over the GATT regime that expanded free trade opportunities and supported the development of the world economy after World War II.

The fundamental characteristics of the WTO are: 1) It is the first full-fledged, international organization established since the end of the Cold War; 2) In terms of its

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<sup>7</sup> Akira Kojima is Chief Editorial Writer, *Nihon Keizai Shinbun*.

important areas of coverage, it is involved with direct investments as well as trade; and 3) It is a global institution that assumes the entrance of new nations that are starting to adopt the market economy, such as China (in contrast to GATT which played an important role during the era of Cold War when the “Eastern” and “Western” economies were completely separated.)

Movement toward liberalization in the area of trade during the days of GATT focused on lowering non-tariff barriers such as duties on trade assets, restrictions on import quantities, and conventional transaction customs. As a result, tax rates were lowered greatly, while non-tariff barriers were dropped. In particular, import and export duties, the border adjustment factors of price, came to be limited in terms of their practical economic effects due to the fluctuating bond market system adopted in 1973.

Under the WTO regime in the post-Cold War and post-GATT days during which time direct investments have rapidly expanded, the newly evolving, important themes were how direct investment should be positioned in the international arena and what is relationship with trade and its influence over the domestic economy of each nation was.

The UN “World Investment Report 1996,” released in September, proved the correctness of Dragger’s prediction from seven *years* ago by noting the following points:

- a. The speed of internationalization among enterprises has accelerated dramatically. Together with technological progress and intensified competition, more and more corporations from developing countries are promoting internationalization in the same pattern as companies in advanced nations. The annual billing among the many overseas subsidiaries and related companies of such multi-national enterprises well exceed the six trillion-dollar mark.
- b. The total amount of overseas direct investments made by advanced countries in developing countries increased by 40% in 1995 on a flow basis to 315 billion dollars. Of this amount, 100 billion dollars was spent on developing countries, including investments totaling over 38 billion dollars to China.
- c. The relationship between trade and investment is starting to be transformed. Historically speaking, manufacturers conducted trade before investing. Today, however, the relationship between trade and investment has become more complex and is creating new opportunities. During the 25 years until 1993, the number of multi-national corporations with their headquarters in the 15 most advanced nations tripled to 23,000. What is more important is that the creation of a new economic environment (decreased physical, technological and political obstacles for the flow of goods, services, capital and corporate activities, greatly improved the transfer of production elements due to technological progress, and so on) have expanded the freedom of choice for corporations as to whether to produce products domestically for export, to produce products locally for local sales, or to produce products in a third country for export to a second country.

- d. The main concern among corporations today is already shifting to what kind of corporate activities that offer additional value should be conducted in which country. This means that the moment a destination is chosen, the flow of capital investment and trade is determined.
- e. Corporations are starting to think of investment and trade on a global scale. The amount of intra-firm trade against the total trade volume of multinational corporations is increasing. As a result, the transfer of goods, services, intellectual property, and so on of corporations unrestricted by national boundaries is increasing, while competition in international business is progressing, thereby creating a new economic-structure on a global scale.

**Asian FDI Inflows and Outflows: Patterns and Trends**  
**Dennis Encarnation<sup>8</sup>**  
**May 1997, Shanghai**

During the 1990's, East Asia finally joined North America and Western Europe as both a major destination and a principal source of foreign direct investment (FDI). Not only has Asia attracted such investment from more traditional FDI sources—Japan and the US, followed by Europe—but the region has also become its own source, given the strong intra-Asian bias of its sizable and growing FDI outflows. Hong Kong is the largest of these Asian sources, followed by the region's other newly-industrializing economies (NIEs). While a few such economies are both sources and destinations for FDI, most are not, serving more often as host than as home. The largest such host in recent years is China, at least in terms of annual FDI inflows. But Singapore and the rest of Southeast Asia remain sizable hosts for FDI stocks accumulated over several decades.

Those multinational corporations (MNCs) supplying Asia with FDI vary widely in size, from small-to-medium sized enterprises (SMEs) to the world's largest companies, many of which are increasingly based elsewhere in the region. Most of Asia's largest MNCs started either as family-owned businesses or as state-owned enterprises (SOEs); but today, many have evolved, as elsewhere, into widely-held, publicly-trade companies. Most of these Asian MNCs, plus their American and Japanese counterparts, have constructed complex production and distribution networks, either through their own diversification and integration, or through external linkages with unrelated buyers and suppliers. Such networks are especially common in the manufacturing sector, which has attracted the largest share of FDI in Asia, led by electronics and electrical goods, then textiles and garments. The next largest share is concentrated in the service sector, especially in physical and financial infrastructure, as well as trade and distribution. What remains of FDI in Asia is largely invested in natural resource-based industries, from agri- and aqua-business, to forestry and derivative products, to mining and petroleum. Taken together, this FDI in Asian manufacturing, services, and natural resources serves to alter the value, composition, and direction of the region's trade, bounded by larger macro-economic forces. Yet at the same time that FDI helps establish the prevailing structure of Asian trade, it has also worked to increase the magnitude and pace of regional integration in Asia beyond that evidenced by trade alone.

These several patterns, all common to FDI in Asia, are analyzed in five sections below: geographic sources and destinations, firm and industry characteristics, and regional operations. While the general findings presented in each section are consistent with data from a variety of sources, many of which are identified at the end of the paper (see "Note on Sources"), any such findings are nonetheless constrained by the general lack of available, comparable data on FDI in Asia. Moreover, the rapid pace of change

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<sup>8</sup> Dennis Encarnation is Director of the Pacific Basin Research Program, Harvard University. Please note: Tables referred to in this excerpt can be found at <http://brie.berkeley.edu/BRIE/>.

affecting this FDI means that any conclusions reached today are best viewed as hypotheses to be tested tomorrow. Given these data constraints, moreover, our findings are largely limited to a highly specific cluster of Asian countries: the 4-NIEs, the ASEAN-4, and China. Here, the paper consistently employs several geographic terms with very specific meanings. The 4-NIEs include the newly-industrialized economies of Hong Kong, Korea (Republic of Korea), Singapore, and Taiwan; while the ASEAN-4 include Thailand, Malaysia, Indonesia, and the Philippines, all four members of the Association of Southeast Asian Nations (ASEAN). Moreover, unless otherwise noted, Asia as used in this paper excludes Japan to produce a short-hand term that aggregates the 4-NIEs, the ASEAN-4, and China. Outside of these few Asian economies, sizable FDI outflows are largely nonexistent, and FDI inflows also appear to be relatively minuscule.

Finally, this paper will conclude with a brief analysis of the broader implications of our findings for both host and home governments in Asia.

### **Geographic Sources**

Analyzing the geographic sources of FDI flows into Asia, at least four significant patterns have important implications for both host and home governments:

1. Japan and the US remain the two largest national sources of FDI in Asia, both well ahead of the 15-member European Union.
2. The most rapidly growing sources of FDI in Asia are economies lying elsewhere in the region.
3. Of these other Asian sources, Hong Kong is the largest, followed by the regions' other newly-industrializing economies (NIEs).
4. While a few of these economies are both major sources and principal destinations of FDI, most are not, serving more often as host than as home.

### *Industrialized Economies*

Worldwide, Japan and the US—plus the fifteen members of the European Union—are the largest national sources of FDI. Asia is no exception. Through 1992 (the most recent year for which comparable data are available), these industrialized countries together accounted for 55 percent of cumulative FDI stocks invested in the region [see Table 1]. Japan was the largest contributor at 23 percent, followed by the US' nearly 18 percent and the then-twelve members of the European Union with just over 14 percent. While large, these percentages do fall below comparable shares elsewhere in the world, where the five largest national sources of FDI—US, Japan, UK, Germany, and France—generally account for roughly 70 percent of all flows [UNCTAD].

Moreover, the relative contribution of these industrialized countries to FDI in Asia has actually declined over the past two decades [APEC]. For example, through 1980, the

EU, Japan, and the US together accounted for 66 percent of cumulative FDI stocks invested in the region. While Japan's relative contribution remained roughly constant over the following decade (roughly 24 percent in 1980 and again in 1992), the relative contribution from both the US and the 12-member European Union declined significantly. Indeed, in 1980, the relative contribution of the US and Japan was roughly comparable (between 23 and 24 percent); by 1992, even as Japan's relative contribution remained constant, that from the United States declined over the decade from 23 percent to 18 percent. Similarly, the relative contribution of EU members fell from 19 percent in 1980 to 14 percent in 1992. Such a decline is less a function of the numerator than of the denominator in the calculation: Even though EU and US FDI flows to Asia have grown considerably over the decade (see below), their growth has failed to keep pace with FDI from elsewhere—namely, from Japan and especially from other Asian economies.

### *Asian Economies*

The fastest rising sources of FDI in Asia are economies lying elsewhere in the region, outside of Japan. Together, these other Asian sources contributed over 25 percent of cumulative FDI stocks invested in the region through 1992 [see Table 1], up from 20 percent in 1980 [APEC]. Back then, over a decade ago, these other Asian sources collectively ranked behind Japan and the US as sources of FDI stocks, just alongside the 12-member European Union. But over the next decade, fresh FDI outflows from these other Asian sources grew dramatically, so that by the mid-1990's, they had even grown to exceed FDI outflows from most industrialized sources, including recession-hobbled Japan [see Table 2]. No other cluster of newly-industrializing economies could boast such a record. Latin America and East Asia, for example, recorded roughly comparable FDI outflows in the early 1980's, but a decade later, by the early 1990's, the value of these Asian FDI outflows was already ten-times larger. During that decade, and especially after 1985, several factors combined to greatly accelerate Asian FDI. In Asia's 4-NIEs (Korea, Taiwan-China, Hong Kong, and Singapore), the rapid appreciation of exchange rates and the rapid rise of relative factor prices (especially labor) combined with the growing loss of key export markets (most notably, the US) to push investment out in search of new production sites.

Growth received a further stimulus with the relaxation of capital controls on FDI outflows in several home economies (notably Korea and Taiwan), and with the liberalization of capital controls on FDI inflows in several host economies elsewhere in Asia (notably China). Indeed, at least after 1992, some of the surge of FDI from other Asian sources can be explained by the preferential treatment afforded foreign firms in China, prompting erstwhile domestic enterprises to seek foreign status by moving capital abroad and then back home again, in a process known as “round-tripping.” To remove the distorting effects associated with China “round-tripping,” assumed by the World Bank to be somewhere between one-quarter and one-third of China's FDI inflows, recorded levels of outward FDI from Asia need to be adjusted downwards. On the other hand, recorded levels of outward FDI from Asia also need to be adjusted upwards to include unreported (and perhaps illegal, until the recent relaxation of capital controls) FDI from Taiwan.

None of these adjustments, however, alters the fact that Asian FDI outflows today have reached unprecedented levels.

### *Hong Kong*

Among other Asian sources of FDI, Hong Kong has emerged the largest [see Tables 1 and 2]. As long ago as 1980, Hong Kong contributed by far the largest share among Asian sources outside Japan—roughly 10 percent—of cumulative FDI stocks invested across the region [APEC]. Subsequently, at least during the late 1980's, Hong Kong was joined by Taiwan in accounting for most of the region's new FDI outflows [see Table 2]. By the 1990's, however, Hong Kong emerged preeminent among Asian sources, including Japan, even after correcting for the circular flow ("round-tripping") of FDI from, and then back to, China—nearly all via Hong Kong. Of course, remaining estimates of Hong Kong's FDI outflows are undoubtedly boosted by Hong Kong's intermediation of capital ultimately destined for China, but originating either from outside the region or in other Asian economies. But even after making these corrections, by 1992, Hong Kong contributed roughly 14 percent of cumulative FDI stocks invested in Asia [see Table 1].

In addition to Hong Kong, the number of Asian economies reporting FDI outflows has begun to proliferate. Indeed, each of the other 4-NIEs (Korea, Singapore, and Taiwan-China) has also recorded rapid and rather comparable increases in new FDI outflows during the 1990s [see Table 2]. And in addition to official statistics, unrecorded increases—at least in the case of Taiwan and Korea—may be even larger. Moreover, outside of the 4-NIEs, China has begun to emerge as a new Asian source of outward FDI, even after again correcting for the distorting effects of "round-tripping." Finally, among the ASEAN-4, Malaysia had also emerged as a new FDI source, followed by Thailand. Elsewhere in Asia, from India to Indonesia, FDI outflows remained negligible. Even so, the diversity of Asian FDI sources continues to be quite pronounced.

**Scenario for Asian Pacific Economic Growth**  
**Heizo Takenaka<sup>9</sup>**  
**December 1996, Tokyo**

**Pacific Triangle**

Table I shows economic growth rates for the various Asian Pacific countries since 1980. All developing Asian countries show a continuing high growth rate, and the entire region is strengthening its position as a global growth center.

Clearly, the distinctive feature of Asian countries is that each has achieved high economic growth through expanding exports. Consequently, the share of global exports held by seven countries—the Asian NIES plus Thailand, Malaysia, and Singapore—grew from 3.0% in 1965 to 6.0% in 1980 and 9.1% in 1990. Without a doubt, increased industrial competitiveness has driven this growth. Presently the total exports of these seven countries exceed Japan's total exports. Remarkably, the Asian NIEs now account for 6.7% of all exports, indicating clearly that this region is supported by export-led growth.

However, the Asian Pacific economic growth mechanism has hardly been uniform, and I have probed the differing patterns at different times. During the high-dollar period (the early 1980's), an economic triangle formed among Japan, developing Asian countries, and the USA. This stage (Period 1) displayed a dynamic development mechanism.

During this period, Japan exported capital and intermediate goods to developing Asian countries. Japanese exports included machines and parts and, incidentally, the export of “technology.” By combining this technology with their own ample domestic labor resources, developing countries such as the Asian NIEs and ASEAN established themselves as a global production bases. Success stories abound pertaining to the industrial development of various Asian countries during this period.

However, the fulfillment of the economic mechanism requires that products produced in this manner be purchased by some other country. The country that contributed the most as consumers (absorbers) of these export products was, quite simply, the US. Therefore, a division of labor arose placing Japan in the role of technology supplier, developing Asian countries as producers, and the US as consumers. This was the birth of the Pacific triangle. This triangle made the region's energetic economic development possible.

This mechanism could not, however, be sustained over the long run. Around the middle of the 1980's, US trade balances sank heavily into the red. The high dollar and the deficits in the current account balance of payments had to be reconsidered. The result was the Plaza Accord (1985), a political agreement to revalue the dollar.

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<sup>9</sup> Heizo Takenaka is Professor, Faculty of Policy Management, Keio University.

After the relative value of the dollar was reduced, Japan was expected to play a major role in continuing regional development as a consumer (absorber). The Maekawa Report in 1986 intensified expectations that Japan would increasingly deregulate and open its markets. In fact, for two years immediately after the Plaza Accord, exports from the Asian NIEs to Japan shot up, and Japan appeared for a time to be fulfilling the absorber function. However, economic structural reform was soon stymied by domestic political scandals and other problems. Japan was unable to adequately play the role laid out for it.

Instead, it was the Asian NIEs that stepped in to make a significant contribution to the economic development of the Pacific Region. Their rising income levels enabled them to expand imports from ASEAN countries. By the end of the 1980's, the total import volume of the Asian NIEs had already surpassed that of Japan. In addition, economic growth generated upward pressure on wages in the small labor markets of many countries. In response, factories shifted overseas to ASEAN countries; direct overseas investment by the NIEs expanded. In some ASEAN countries, NIEs investment now exceeds Japanese investment.

In other words, with the NIEs functioning to some extent as absorbers and suppliers of technology and capital, they formed a "revised Pacific triangle." This period in the recent development of the Pacific economy is known as Period II.

All over the world, the end of the Cold War structure is plainly visible, but the typical wars that took place during the Cold War (the Korean and Vietnam Wars) were fought in Asia. Significantly, the regional economic zones that will ultimately dissolve Asian socialism are forming and flourishing on sites that were previously enemy territory. The areas where regional economic zones are forming—Hong Kong and China, Taiwan and China, and Thailand and the three countries of Indochina—were areas of military tension and conflict during the Cold War. The expression "My neighbor is my greatest enemy," is particularly apt here. For regional economic zones to emerge from among. These same neighbors are a symbol of current economic development in the Asian Pacific.

Another characteristic of Period III is a weakening of the pattern of excessive dependence on the US and Japan. This dependence is being replaced by a turning within the economic zone for export markets and supplies of 'investment funds.' Table 2 compares the Asian Pacific Region Trade Matrix in the last half of the 1980's (1984-1988) to recent years (1988-1992). As I stated earlier, during Period II, (the last half of the 1980's), regional growth was supported to some extent by the absorber functions of some Asian NIEs. According to the table, while the NIEs did not increase their imports as much as the US did, they more than doubled Japan's increase in imports. The import increases of the Asian Pacific NIEs are even more conspicuous in recent years, growing at more than triple the rate of the US. (During the same period, the US was concentrating on increasing its trade within NAFTA.)

The NIEs have also become the largest source of capital for ASEAN and China. Of investments in ASEAN from 1990 to the first half of 1994, NIEs accounted for \$23

billion, which exceeded Japan (\$19.1 billion,) and the US (\$7.1 billion). Investment in China (as of 1993) displays the same trend drawing from a powerful network of overseas Chinese—65% comes from Hong Kong and 11% from Taiwan, while the US and Japan together are a distant third, comprising a collective 13%.

Watanabe (1995) refers to these recent trends as the "Asian Self-Generating Structure." By strengthening their absorber and capital supplier functions, Asian NIEs are reducing their dependency on advanced countries outside the region and marshaling the conditions necessary for even greater growth. Expecting Japan to act as driving force in both supply and demand, Asian countries spoke regularly of "the Japan effect" and "the Japan opportunity." Now, however, it is suggested that the "NIEs effect" holds far more meaning for regional development.

The Asian Pacific economy has flourished because no political framework has been forced upon it. As regional economic zones demonstrate, practical economic development across political boundaries unencumbered by theoretical or ideological structure is precisely what has given the Asian Pacific economy its special flavor. The approach differs markedly from the EU and NAFTA, which bind countries on the basis of political proclamations and treaties. Period III however, will require a new type of framework, one based on firmer commitment to regional cooperation. We need a peace to debate regional security for the purpose of facilitating disarmament. To eliminate regionalism, we need a reliable forum for multinational discussion. The role of APEC in this effort is vital.

## **The Asian Pacific and APEC in the 21st Century**

### **Scenario for the Asian Pacific**

In creating a scenario for the Asian Pacific economy in the 21st century based on the points described above, many aspects are obscured by unknowns. However, the following can be predicted with confidence.

First, economic growth in Asian countries will slacken but will continue at relatively high levels. In the preceding section, I showed that Krugman's hypothesis questioning Asia's ability to grow is not necessarily applicable. Based on this premise, WEFA (1994) projected growth rates for each country. As shown in Table 7, their projections show the developing countries of Asia continuing to grow, expanding their relative economic base by the year 2000. The economic base of the nine selected developing Asian countries (except India) is expected to grow, with respect to the US, from 23.3% in 1992 to 34.2% in 2000.

A second definite element in our scenario is, against a background of overall growth in Asia, that China will acquire the status of the world's second highest level of purchasing power. This point is confirmed by the notes column in Table 7. However, according to Noland (1994), who analyzed the implications of Asian economic growth, the Chinese economy, which already rivals Japan in earnings, only from the perspective of international

average price, will continue to increase its share of world earnings from the present 9% to 13-16% in 2003. Furthermore, the share of other Asian countries will grow to 10-11%, roughly equal to that of Japan (8-9%). Naturally, future risks associated with China are considerable, but we can be certain that, at least in terms of size, the Asian economy of the future will cease to be as centered on the US and Japan as it has been to this point. Stability will require balanced management among the US, Japan, China, and other Asian countries.

The third point of the scenario is that US trade will continue to increase its dependency on the Asian Pacific region. Following the growth scenario above, US trade with Asia will be twice its trade with Europe in the year 2003. Asian countries, on the other hand, will trade more with other Asian nations and less, in terms of share, with the US. Despite intensifying US trade friction with Asian countries, the traditional strategy of threatening to close the market (unilateral bans on imports) will lose its effectiveness. As a result, the importance of conflict mediation between US and Asia at the level of multinational bodies such as the WTO and APEC will increase. APEC in particular will assume extremely critical adjustment and coordination functions.

Fourth, Japan's influence on Asian countries will decrease significantly. Japan will continue to be the primary source of economic aid in the region, but the development of Asian countries will reduce the need for such assistance. The Asian "self-circulation structure" mentioned earlier will largely supplant the former "Japan effect" with the "NIEs effect," and the influence of both the US and Japan will decline.

Given the above scenario for the 21st century, APEC, the primary multinational organization providing balanced management of the crowing Asian Pacific region, will clearly assume far greater importance. At the same time, the direction in which APEC's basic functions and character evolves will largely determine the economic future of the region.

### **Conclusion: Japan as Glue**

Asian Pacific economic development, which went into full swing in the 1980's, stands without question on a firm foundation; that trend is not likely to change. At the same time, it must be recognized that problems have appeared in the region's economy, another reason to strengthen the APEC framework.

However, within APEC, a wide chasm divides the US and the developing countries of Asia. The US, wanting rapid liberalization in order to realize the fruits of expanding trade with the new frontier of Asia, will tend to push for a stronger framework. While opposing American-led liberalization and pushing for Asian-style economic development, Asian countries are trying not to lose the opportunity to liberalize. The interests represented by APEC, which comprises countries with vastly different levels of economic development and historical and social backgrounds, are tangled in a web of complexity. Within that

web, Japan, which has achieved an income level rivaling that of the US based on Asian-style growth mechanisms, will play a critical role as “glue” in these relationships.

As regional economic unions such as the EU and NAFTA develop, APEC itself will have to play a key role as glue in the world trade system. As pointed out above, reflecting the rich growth potential of the Asian Pacific, Western trade with APEC countries will grow steadily. Therefore, in the interest of liberalizing world trade through the WTO, APEC will become the glue connecting the three regional bodies. Actually, the GATT Uruguay Round at the end of 1993 managed to reach an agreement because the strong movement toward liberalized trade and investment evident at APEC's Seattle Conference several months earlier had fostered a sense of crisis related to GATT's very existence.

Today, when we cannot expect any country to wield the overwhelming political power required to lead the world as the US did previously, a triple track approach dependent on global, regional, and bilateral agreements will become essential to managing the international economy. Any new mechanism will be required to utilize the creative tension among the three tracks. The first condition for a global organization will be a strong core; at the same time, it will need sufficient glue to bind the three regional economic bodies. Standing firmly on the principle of multinational diplomacy, Japan must become the glue of APEC. APEC, in turn, must become the glue of the world trade system.

### **III. THE IMPACT OF DIFFERENT LIBERALIZATION PROCESSES ON THE “ASIAN MIRACLE” AND ECONOMIC RECOVERY**

#### **Main Issues:**

- Each vertex of the triangle holds a key to the economic recovery of the region.
- Different processes of liberalization impact prospects for further liberalization in the region as a whole.
- The need for structural reforms in Japan and China to support their initiatives for regional economic recovery.

#### **Selected Excerpts:**

- A. “Roles Played by the Yen in the Global and Asian Financial and Capital Markets,” by Teruhiko Mano
- B. “Evaluating Japan’s ‘Big Bang’ Financial Deregulation,” by Edward J. Lincoln
- C. “Multilateral Economic Cooperation and China’s Macroeconomic and Financial Problems,” by Lin Zhiyuan
- D. “China’s Financial Reform: Achievements and Challenges,” by Barry Naughton

#### **Summary: The impact of different liberalization processes on the "Asian Miracle" and on economic recovery from the Asian financial crisis**

The diverse methods of liberalization in Asia affect the prospects for further liberalization in the region as a whole. Each country has a vital role, complementary to that of the others, in recovering from the Asian financial crisis. The authors in this section advocate various changes and reforms for the region’s recovery from the crisis and continuance on the path of liberalization. In particular, they believe that Japan and China must absorb more imports, and these countries will have to undertake structural reforms in order to fulfill their roles.

According to Mano, three problems have aggravated the currency disturbances in recent years: (1) the fall of the US—possessor of the most powerful international currency—into a large and growing net debt; (2) the appreciation of the US dollar and the Japanese yen due to capital transfers; and (3) increasing competition among the developing Asian nations.

The US cannot remain spender of last resort while running increasing deficits and yet continue to absorb exports from Japan and Europe. This is the time, say Mano and

Lincoln, for Japan as the largest net creditor nation to step in and absorb exports from its surrounding countries. Though Japan has its own structural deficiencies, its account surplus makes it more stable option than the US' account deficit.

Mano advocates that Japan do the following: 1. Make financial contributions toward stabilizing the currency crisis in Asia through cooperation with the IMF; 2. Expand its imports and absorb exports from other Asian countries; 3. Further internationalize the yen, thus allowing yen users to utilize the lowest interests rates in the world and eliminating rate fluctuation risks from yen-dominated debts. The last item would make the yen a key international currency, thus reducing the instability of the US dollar, and would require Big Bang-type financial and capital reform.

Mano notes that he does not advocate that all Asian currencies be linked with the yen, nor that the US dollar's role be eliminated. Despite the weakness of relying on multiple international currencies, he says, given the US' reduced share in the global economy from nearly one half in 1955 to approximately one quarter in 1990, the US can no longer support the entire world economy and thus nations cannot rely on a single key currency.

The proposed "Big Bang" deregulation of Japanese financial markets by 2001 will ostensibly create the structural changes necessary for Japan to open its economy and absorb more exports, but reforms are being implemented more slowly than the rhetoric claims, warns Lincoln, and there are few answers to the many questions this plan raises.

It is unclear whether the reforms can induce international financial stability by correcting the problems of market price distortion and incorrect signaling (attracting too much capital to some investments and too little to others), difficulties which Japanese financial institutions had in the 1980's. Underlying management and personnel problems which contributed to previous lapses and losses have not been changed. Japanese institutions must improve risk analysis, says Lincoln, or chance continued interjection of inappropriate financial asset pricing into the international market.

This can be achieved if more of Japan's international capital flow moved through foreign financial institutions with stronger analytic capabilities, which is a part of the Big Bang reforms, but the Ministry of Finance does not seem particularly eager to use deregulation to enhance the role of foreign financial institutions, says Lincoln. Also, *keiretsu* structures causing reliance on long-term relationship only increase the possibilities of adequate project appraisal. (Lincoln 58) These enduring structural problems leave the financial system inefficient and vulnerable to moral hazard problems, and it is unclear how open the system will actually become after the reforms.

But Japanese financial reform can provide some noteworthy lessons for China, as the latter tackles privatization and financial sector reform. The former's heavy government control over its financial sector has proven less than optimal and, Lincoln warns, China should carefully consider the problems inherent in such systems when determining the rules for its own.

The Chinese economic and financial system possesses many problems and contradictions which hinder its ability to maintain stability, to aid in resolving the financial crisis, and to liberalize. Problems with the monetary and banking system and with financial supervision have inflicted heavy costs on foreign exchange reform and led to high inflation and massive lay-offs.

The main obstacle lies within the central bank system, according to Lin. The centrally planned economic system had only one bank and did not distinguish between central and commercial banks. Under bank reform, the PBC expanded its privileges even in the commercial realm, but did not change its internal organization accordingly. Personnel management, function accountability and supervision, credit planning, and income distribution still follow the old model, which does not respond to the market environment. Monetary policy remains dependent upon traditional administration, which has a single target of inflation or money supply and lacks comprehensive and macroeconomic considerations; this hinders its performance and retards policy reactions. New regulations on investment funds and investment banks have also not yet been developed. Efficient banking supervision is required for maintaining stability of the banking system and before developing and opening the domestic financial market. (Lin) Naughton notes that the role of enterprise restructuring in resolving bank debt problems remains unclear; current laws can be loosely interpreted.

While China reforms, it is particularly vulnerable to financial crises. But it cannot protect its financial sector with regulatory protection forever if it is to open its market, so China must undertake comprehensive rather than piecemeal reform, says Lin. China's cautious financial reform has succeeded in establishing important new institutions and channeling large national savings flows to end-users, says Naughton. Its financial system has begun to diverge from that of the standard command economy model to resemble that of most market economies. China is also putting in place basic administrative structures to govern the banking system, but development of capital markets has been much slower. Consequently, most of the financial deepening has been channeled into the banking system, which means that the growth of competition to state-owned banking has been too slow. (Naughton)

Economic management—in the areas of business accounting, cost-output valuation, exact accountability, supervision, and fair competition—is crucial in reforming enterprises, government organizations, and banking institutions. Lin advocates applying economic management methods to governmental organizations responsible for macroeconomic control. The continued lack of progress in creating more efficient institutions and coping with poor previous lending decisions create significant risks for a major financial crisis.

The dangers which threaten China are significantly different from those threatening the southeast Asian countries, says Naughton. Because it has relatively little private debt denominated in foreign currency and limited interaction between volatile domestic financial markets and foreign currency markets, China does not run a high risk of contagion from the southeast Asian economies' financial problems. Its own risks stem from uncertainty which would cause short-term financial problems reducing growth rates and retarding fundamental financial reforms. (Naughton)

Economic stabilization in the reform and restructuring process has both favorable and stressful effects upon the system. Positive real interest rates and less policy intervention have been countered by sudden exposure of previously protected firms to tough market competition, thus increasing the risk for default and the concentration of "hot money" speculation in real estate development has led to the overbuilding of cities.

But Naughton sees some promising possibilities. Capital market development will

accelerate, he predicts, while bank expansion is likely to proceed slowly. The Chinese government appears willing to shift its financial structure away from the banking system toward capital markets, says Naughton. The government has approved the creation of mutual funds and is likely to approve pension funds and insurance companies in the near future. It may also reduce government ownership of banks and create opportunities for banks to monitor and discipline enterprise behavior.

**Roles Played by the Yen in the Global and Asian Financial and Capital Markets**  
**Teruhiko Mano<sup>10</sup>**  
**November 1997, Berkeley**

*Problems in the international currency system*

In addition to those internal reasons mentioned above, there are three other external factors that accelerated the currency disturbances related to the US-dollar dominated currency baskets. Let me discuss these external factors, while comparing post-war Japan to the current situations in other Asian countries.

The first factor is the quality change in the US dollar, which is still the de facto key currency. In other words, the country of the key currency has become a net debtor. After World War II, the US dollar functioned as a value standard, supported by the absolute economic power of the US. Also, an ounce of pure gold was pegged at US \$35, and foreign governments were given the right to change the dollar's balance to go at that rate. The IMF system was a gold-US dollar standard exchange rate system. The IMF's fixed rate played an important role in Japan's post-war recovery. The fixed rate worked as a stable system with which to obtain foreign currencies, allowing resource-poor Japan to restore its economy.

On the other hand, the convertibility with gold kept the US economy in order. Thanks to the sound economy of the US, Japan was able to use its current account balance as the criteria for its economic performance. When a deficit was recorded in the current account, Japan adopted a tighter financial and fiscal policy, and when a surplus was recorded, growth policies were employed.

However, along with the economic recovery of Japan and European countries, the role of the US started to change. At the time of the "Nixon Shock" in August 1971, accumulating overseas debt forced the US to lift the convertibility to gold, and it shifted to a floating system. At that time, the quality of the US dollar became equivalent to that of the Japanese yen and the German mark.

Nevertheless, the US dollar remained the most powerful international currency, due to the country's political leadership and military power during the Cold War, the lack of a replacement currency, the nation's relative advantages (such as the size of the US dollar market) and past inertia. This loosened the discipline of US economic policies, and the US turned into an international debtor in 1987. The main cause of the current exchange rate instability is that the currency of the largest debtor country is still used for international settlements. This is also one of the major causes of currency instability in Asia.

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<sup>10</sup> Teruhiko Mano is Adviser to the President, The Bank of Tokyo-Mitsubishi Ltd.

In 1995, the yen-dollar rate reached 80 yen/dollar, the opposite story from the current situation. I consider this to have been the result of a combination effect of the cheap dollar, which was caused by the fact that the strong yen resulted from a trade surplus, in addition to the clear revelation of the extent of US debt in the wake of Mexico's crisis.

The US' accumulated net debt is projected to reach \$1 trillion at the end of this year. The vast size of the US economy can still endure this enormous debt. However, it should be noted that the US also has a structure, just like those of Mexico and in Asia, where insufficient domestic savings are covered by international borrowing, and the nation's total debt is further growing.

Second, another factor which accelerated the currency disturbances was the appreciation of the US dollar and the cheap yen, which resulted from capital transfers. The exchange rate eventually settled at a rate to appropriately reflect relative comparisons of fundamentals, such as each country's growth rate, unemployment rate, inflation rate, and current external balance. However, the exchange rate often fluctuates temporarily due to capital transfers caused by the gap in interest rates.

Since the US economy is moving favorably at present, and because of the need to make up for insufficient domestic savings by utilizing non-residents' capital, US interest rates tend to be set higher than the inflation rate. Therefore, the actual interest rate in the US is high. Capital transfers encouraged by high interest rates caused the current appreciation of the US dollar and the cheap yen, despite the account balances of Japan and the US. Under these circumstances, ASEAN currencies, linked to US-dollar dominated baskets, were further overvalued against the US dollar, the Japanese yen and European currencies.

The third factor is competition among developing countries. Japan was able to concentrate on catching up with the US. It was after the Japanese income level increased substantially that Korea, Taiwan, and other NIEs countries emerged as competitors. The average annual per capita income in Thailand and Malaysia is about US \$3,000. With this income level, these countries must survive ever-intensifying competition with surrounding Asian countries, including China. Although the income level is yet fairly low, with much room for improvement compared with that of developed countries, these countries are also facing competition with even lower level countries. In this sense, the existence of highly populated countries such as China and India, the population of which would exceed China in the coming century, is significant.

Labor power is one production element but it involves people. Different from other production elements, transfer of labor across national borders has its limits even in this international era. In order to overcome this problem, other production elements that are relatively easy to transfer, such as capital or technologies, are moving across national borders and combining with labor and land in each local area. However, this results in discord between liberalization and the domestic economy, particularly unemployment problems. This issue clearly reminds us of the confrontation between the US and Europe in the summit meeting held this year.

Needless to say, the principle of capital activities is the expected return on investment. It is not easy to withdraw direct investments, while movement of financial and securities investments can be abrupt. Invested countries should be aware of this and prepare appropriate measures.

Measures should be prepared in accordance with the developmental stage of each relevant country, and should not always be the same as those for developed countries. Each country has its own history, traditional culture, and national interests. The recent currency disturbances reminded us of the risks involved in liberalizing capital account transactions more than the current account. Asian countries need to plan the liberalization of their capital accounts in accordance with each country's developmental stage and capacity.

### *Roles of Japan and the yen*

I have analyzed the internal and external factors in Asian countries with regard to currency and finance, and have also pointed out that the US has become a debtor country. In the post-war period, the US functioned as an absorber of exports from Japan and Europe. However, it is difficult to expect the US to function in the same way while the country runs current account deficits. Now it is time for Japan to make a contribution. Japan is the largest net creditor nation, although the amount of the surplus has shrunk somewhat, and it is the only country that can absorb exports of surrounding countries.

The amount of Japan's accumulated current account surplus matches that of the US' accumulated trade deficit. However, this balance is not necessarily favorable for both countries.

For Japan, where the aging of society is advancing, it is necessary to improve the infrastructure to secure a comfortable lifestyle while savings are still abundant. It is an urgent task for Japan to effectively utilize its savings to be used domestically. On the other hand, the debt-burdened US economy is unstable, as proven by the quick reaction of the stock market to Prime Minister Hashimoto's speech at Columbia University, just after the summit.

The three roles of Japan and the yen can be mainly classified as follows.

First, needless to say, Japan is required to make a financial contribution to the currency crisis in Asia in cooperation with the IMF. Cooperation of regional central banks has already made a start on preventing a currency crisis, mainly by procuring funds in US dollars. It is necessary to diversify the cooperation and add yen or other Asian currencies.

Second, and more importantly, Japan needs to expand its imports, in particular, absorb exports from other Asian countries. This will help exporting countries maintain their growth while Japan, just like post-war US, can import cheaper products to increase the domestic purchasing power of people whose income cannot be expected to rise further as

before. Due to the yen appreciation's affect on prices, the growth rate of imports exceeded that of exports, and the product import ratio exceeded 60%.

Another method is the income effect from a higher growth rate. It refers to investing Japanese savings in domestic projects, in particular the development of infrastructures. This does not mean expanding investments in public works, but rather utilizing private activities (including entries from overseas) and increasing capital efficiency.

Third, further internationalization of the Japanese yen is inevitable. Users of Japanese yen would then be able to utilize the lowest interest rates in the world, and could eliminate the exchange rate fluctuation risk from yen-denominated debts, such as ODA. Japan would also be able to avoid exchange rate fluctuation risk.

One purpose of implementing a single currency in Europe, the Euro, seems to be to minimize the fluctuation of US dollar exchange rates. Australia already keeps foreign currency reserves in US dollars, yen, and European currencies, evenly.

I am not suggesting that Asian currencies should all be linked with the yen. I consider it necessary to take trade and investment amounts into consideration when Asian countries set their yen weight or ratios for ASEAN currencies in their own currency baskets.

The purpose of my suggestion is not to eliminate the US dollar, but rather to reduce the instability of the US dollar by replacing the US' accumulated external debts. Since the US gross debt is nearly \$5 trillion, if it once started to flow out, it would have enormous destructive power, which could lead to a worldwide depression. Preventing such a scenario is the purpose of my suggestion.

Of course, there are some weak points in using multiple international currencies, when remembering the bimetallic experience of the past. However, it is difficult to produce one powerful key currency given the current state of the global economy. The country providing the international key currency must have sufficient centripetal force to support the centrifugal force of other countries that use the currency.

Since the end of World War II, the weight of the US economy in the world economy has shrunk year by year along with the growth of Japan, European countries, and developing countries. In 1955, the US had a 48.4% share, which is almost half of the global economy and is a sufficient centripetal force. This fact supported the IMF's US dollar-gold standard. The US' share had fallen to 27.3% by 1990, and is projected to fall to 23.6% in 2010. This is the long-term background under which the dollar-yen rate has moved from 360 yen to the 110 yen level. One-fourth of the global economy cannot support the entire world economy. Under current situations, we cannot expect to have a single key currency. Reducing the current instability to the extent possible is today's task.

In this sense, Japan's best contribution to the world economy would be to expand its function as a buffer to absorb exports from other Asian countries, for which there is little

or no time difference, as well as to increase the yen's international usage ratio. The currency disturbances in Asia can be considered an opportunity to do so.

Japan needs to reform its economy to further expand imports as well as undergo a Big Bang type reform in its financial and capital market, in order to make it easier to use the yen. The Hashimoto administration's goal of reform is in line with this purpose.

Japan's Big Bang is preparing substantial reformation plans towards 2001. Compared with the Big Bang in the UK, Japan's Big Bang will take place over a shorter period of time, and the areas for reform include not only the securities industry, but also finance and insurance concurrently. Therefore, the impact will be bigger than that of the original Big Bang in the UK, so we could call it the "Bigger Bang." The first step is complete liberalization of exchange controls; relevant laws have already been drawn up and will be implemented from April 1 next year. This liberalization promotes various reforms in Japan by exposing the Japanese market to overseas markets and by letting them compete according to the market principle. Some effects are already visible in various fields in advance of the liberalization. One example is the renewed entry increase of foreign financial institutions into Japan and related personnel transfers.

Finally, I would like to emphasize once again that current account deficits can be filled up temporarily by borrowings. However, it is a debt, and it needs to be repaid. Even in an era of internationalization and regionalization, each country must take responsibility for its own economic problems and resolve them with its own methods.

**Evaluating Japan's 'Big Bang' Financial Deregulation**  
**Edward J. Lincoln<sup>11</sup>**  
**November 1997, Berkeley**

In November 1996, Prime Minister Ryutaro Hashimoto called for a Japanese "Big Bang" deregulation of financial markets, borrowing his rhetoric from the deregulation of London financial markets in the 1980's. Deregulation of many aspects of the Japanese economy has been under discussion since 1993, with tepid results to date. But Prime Minister Hashimoto has given the impression that the financial sector changes will be pursued more vigorously and could be more significant than in other sectors by the announced completion date of 2001.

What should we make of the proposed agenda of changes? Japan's problems with its financial system have already had important implications for Japan's economic partners, including China and the United States. The proposed changes, should they occur as planned, raise new questions about the international impact of Japan's financial markets. Some of the lessons of Japan may be particularly important for China, now struggling with reform of state enterprises and the banking sector. Unfortunately, the conclusion of this paper is that Japan is not changing as much as the rhetoric suggests. The deregulation initiative is real, and a number of changes will occur, but some of the current weaknesses of the system may well continue despite these deregulation efforts. Thus, Japan's financial system may experience continued inefficiency and remain susceptible to moral hazard problems, with other nations facing the prospect of coping with the international ramifications of those problems.

### **The International Perspective**

What does the "big bang" imply for US, Chinese, and Japanese international financial activities? At this point in time, there are few answers, but plenty of questions.

Perhaps most the fundamental question is international financial stability. International systemic stability can be a highly technical issue. But at a simplistic level, one can argue that Japanese financial institutions affected international markets adversely in the 1980's. Because they failed to evaluate risk adequately, they damaged their own financial health and caused inappropriate pricing of international financial assets. As noted by one market participant of the 1980's, "No matter which [overseas] market the Japanese entered, they distorted realistic relationships and accepted low returns."<sup>12</sup> Eager Japanese banks ended up holding a huge 50 percent of short-term Mexican international debt in 1982 (and were thereby the ones capable of driving Mexico into default because of the short due dates). In the US, Japanese financial institutions lost as much as \$800 billion in the decade from

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<sup>11</sup> Edward Lincoln is Senior Fellow, Foreign Policy, The Brookings Institution.

<sup>12</sup> Eugene R. Dattel, *The Sun That Never Rose* (Probus Publishing Company, 1994) pg. 90.

1985 to 1995 from exchange losses, real estate losses and other mistakes. Now Japanese banks may be over-exposed in Southeast Asian markets.

Financial markets provide sophisticated and complex arrays of risk and return. To function properly, it is necessary that markets clear in a realistic manner. When one set of players, such as Japanese financial institutions, distort the pricing of these markets, then the signals provided by the market are incorrect and potentially damaging (attracting too much capital to some investments and too little to others). Japanese financial institutions appear to have done exactly this during the 1980's.

The question now is whether the "big bang" reforms will correct this problem. In some sense, the problem may be resolved even without the reforms. Japanese institutions were so badly damaged by their foray into international markets, that they have retrenched and are proceeding more cautiously. In the long run, however, problems may remain. Few executives have been punished for the serious lapses of the recent past. At Daiwa Bank, the individual trader responsible for losing \$2 billion has gone to jail, but the bank and the Ministry of Finance joined ranks to ensure that responsibility would be confined solely to him. The managers who should have known or did know what was happening have not been punished. Furthermore, as noted above, the underlying personnel practices yielding inadequate oversight are not changing.

This question matters because of the size of continuing net and gross capital flows from Japan to the rest of the world. In 1997, Japan's current account surplus is likely to be approximately \$100 billion, and even larger in 1998. In balance-of-payments accounts, net capital flow is equal in size to the current account, so that the net flow of capital from Japan to the rest of the world in 1997 will be roughly \$100 billion. Gross flows are even larger. In 1996, when Japan's current account surplus was ¥7.2 trillion (approximately \$64 billion at 1996 exchange rates), the gross outflow of private capital was ¥14.6 trillion (\$135 billion) and the gross inflow was ¥11.6 billion (\$105 billion).<sup>13</sup> Most of this investment is portfolio investment (bank loans, bond purchases, and portfolio equity investments) rather than direct investment. If Japanese financial institutions do not improve risk analysis, then they possess the potential of continuing to interject inappropriate financial asset pricing into international markets. Is the possibility of continued inefficient Japanese financial behavior sufficient to undermine international financial stability? No answer is offered here, but the question is worth asking.

Risk would be reduced if a higher proportion of Japanese international capital flow moved through foreign financial institutions with stronger analytic capabilities. Presumably some of the changes included in the "big bang" will provide foreign institutions with greater

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<sup>13</sup> Bank of Japan, Balance of Payments Monthly, April 1997, pg. 1, 33, 49. Note that beginning in 1996, the government of Japan eased publishing its balance of payments data in dollars and does not include a table of exchange rates in its balance of payments publication. The figures for capital flow presented here do not yield a net capital flow equal to the current account surplus. The difference comes from the movement in official foreign exchange reserves (which increased by ¥3.9 trillion— US\$35 billion, a very large amount) in 1996 and "errors and omissions" which showed an inflow to Japan of ¥131 billion (US\$1 billion.)

opportunities to handle portions of this flow. For example, changes resulting from the 1995 financial services agreement between the US and Japan permit foreign institutions to participate in the investment of social security funds. Currently, American investment banks are quickly developing financial products for individuals to enable them to invest overseas. How much of the international flow of Japanese money will move through foreign institutions remains entirely unclear, however, and the Ministry of Finance does not appear to be very eager to use deregulation as a means to enhance the role of foreign financial institutions. Therefore, the extent to which foreign financial institutions can penetrate Japanese financial markets and participate in the international flow of capital of Japan, remains a question with no clear answer.

Newly cautious Japanese banks could end up relying more heavily on servicing non-financial Japanese firms abroad. This phenomenon is common; firms providing corporate services (accounting, advertising, finance, logistical support) tend to follow manufacturing firms of their country abroad. One of the possible implications in the case of Japan, however, is the continued construction of strong keiretsu ties abroad. Finance has been one of the mechanisms for Japanese firms to enforce group loyalty or preference. Japanese banks following Japanese manufacturers to China and other Asian markets are likely to continue this practice. Stories already exist of Asian firms threatened with the loss of their Japanese financing if they shift to non-Japanese or non-keiretsu parts suppliers or sales outlets. In some ways, keiretsu structures enhance economic efficiency, but often the reliance of these long-term relationships becomes simply an excuse to avoid adequate project appraisal. Continued reliance of Japanese banks on their traditional domestic clients as they lend abroad would, in fact, suggest that they have not responded to deregulation by enhancing their risk analysis capabilities. But little information is available on Japanese lending to Southeast Asia, so bank lending patterns remain a question.

Finally, it is worth noting that Japan's efforts at financial reform provide some lessons for China, as that nation grapples with privatization of state enterprises and reform of the financial sector. In recent years, the "Japanese model" has been a popular concept for economic development. Among the primary elements of this model is the use of government guidance over the financial sector. As argued earlier in this paper, Japan appears to have managed a heavily controlled financial sector rather well from the 1950's through the 1970's. Nevertheless, the problems Japan has faced in the past decade and the difficulty in implementing reform of the earlier system provide sobering evidence of the problems endemic to such systems. In providing the institutional framework for nascent equity markets in China or reforming the banking sector, careful consideration of rules matters greatly. The consequence of poorly designed systems is speculative bubbling and collapse, a draining cycle that damages economic growth. Perhaps the lesson of Japan is one of financial policies to avoid.

## **Conclusion**

Japan's "big bang" financial deregulation is a real phenomenon. Some changes are already slated for implementation next year, and much of the rest of the proposed agenda should

be in place by 2001. These changes respond to an extraordinary decade in which Japanese financial institutions first created a heady and speculative asset bubble in the economy, and then wallowed in bad debt and scandalous revelations during the 1990's when the bubble collapsed. The US also experienced a series of financial scandals in the 1980's (the savings-and-loan bad loan problem, international bad loan problems, and insider trading scandals in the junk bond and other markets). However, the scale of the problems and scandalous revelations in Japan has been truly breathtaking.

Meanwhile, a quiet time bomb keeps ticking—the retirement financing for Japan's baby boom generation, due to begin retiring in another 15 years. With unusually low rates of return in post-bubble Japan, the future financial security of this generation is now in jeopardy, as rates of return on their pension funds are well below necessary levels to finance their retirement income. True deregulation of financial markets, coupled with shifts in behavior of both financial institutions and non-financial corporations ought to improve real rates of return by reducing inefficiency and misdirected allocation of capital. This would be beneficial for both future retirees and the overall efficiency and growth of the economy.

But the conclusion of this paper is that the present set of reforms in the financial sector may not be sufficient to remedy the problems in the system. The reforms are certainly a step in the right direction. Competition will be increased, some of the excessive fees and commissions will disappear, new financial instruments will appear, and foreign financial institutions will gain some additional business. Nevertheless, other problems are likely to remain or change only slowly. Internal personnel practices, reliance on personal contacts and long-standing relationships rather than dispassionate financial analysis, and corporate governance patterns will probably change only slowly.

Japanese investment funds matter to China, the US, and the rest of the world. We are all better off if Japanese savings are invested efficiently at home and abroad. The "big bang" includes a variety of steps that represent useful changes in the correct direction, even if some of them are far more minor than the government claims. But increased rationality and efficiency in Japanese financial behavior as a result of the "big bang" is by no means assured.

## **Multilateral Economic Cooperation and China's Macroeconomic and Financial Problems**

**Lin Zhiyuan<sup>14</sup>**

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In the past 18 years, China's reform of its banking and financial sector has made a great contribution to its phenomenal economic growth, about which a lot has been said. This paper will try to reveal the existing problems and contradictions in the Chinese economic and financial system, in order to find ways to solve them. The currency turmoil triggered by the sharp depreciation of Thai Baht since the early July and catching many other southeast Asian countries, has inevitably led the international community to scrutinize the soundness of China's banking system. And there is also hope that China can play an active role in helping such countries cope with their financial crises.

In order to maintain the stability of its financial system in its economic reform and development and to play a bigger role in the Asia-Pacific economic cooperation, it is necessary for China to cooperate with the US and Japan on equal bases. For China, the participation in the international trade and investment liberalization is a process of integrating its economy into the world economy. China has made several rounds of tariff cuts and the next step must be the reform of its financial and banking system, which means that China will have to open its financial markets much more to foreign investors and face the fierce international competition.

China is a country in transition and at its early stage of economic development. It has institutional defects. In order to cooperate fairly with other countries, China must solve its own problems first, especially those existing in the macroeconomic management and banking system. China should be more realistic and serious about the existing problems, trying to find ways to overcome the obstacles and seeking cooperation and support in the international community.

### **Existing Problems in the Monetary and Banking System**

The great draining-out of the state financial resources in the banking system reflects the serious shortcomings in macroeconomic management. First, it is the monetary system and the central bank. Second, it is the financial supervision and banking system. Because of them, the macroeconomic adjustment has laid a heavy cost on the 1993-94 foreign exchange reform. According to the analysis of Table 8, since 1994, the channels of RMB issuance have dramatically changed. The RMB issuance by budget expenditure and bank's credit changed not only from positive to negative, but the number is also huge. In sharp contrast, RMB issuance by the increase of foreign exchange reserve changed from negative to positive, and the number is even larger. It has fully reflected the influence of

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<sup>14</sup> Zhiyuan Lin is Senior Fellow, Research Institute of Finance and Banking, People's Bank of China.

the huge capital inflow of the foreign exchange, which had a big impact on the RMB issuance and forced the rigid constriction of the state budget and bank's credit.

Table 8: Annual Change of RMB Issuance by Different Channels  
(in billion RMB)

| Year                        | 1992   | 1993   | 1994    | 1995    | 1996    |
|-----------------------------|--------|--------|---------|---------|---------|
| By state budget (net)       | 42.85  | 18.83  | -34.04  | -24.50  | -25.02  |
| By bank's credit (net)      | 86.42  | 134.27 | -110.48 | -123.32 | -173.83 |
| By foreign exchange reserve | -12.23 | -18.80 | 344.42  | 221.83  | 289.27  |

Based on Annual Report of the PBC 1994, Chinese Financial Outlook 1996.

The result of rigid constriction of budget expenditure and bank's credit is a serious disequilibrium of national economy which is reflected in, first, the high inflation in 1994-95 and second, the massive lay-offs. For the social and economic reform, there is a serious shortage of capital input in many less-developed areas, and both the housing reform and the social security system reform also lagged, which further affected the reform of state-owned enterprises.

The fundamental reason behind the weak monetary system and poor banking supervision lies in the central bank system. The lagged reform of the commercial banks, their large losses, and the large amount of non-performing credit assets are the outcome of the backward banking supervision, as well as the problems of the PBC. Under the centrally-planned economic system, there was only one bank and no distinction between central bank and commercial banks. All the operations and business of the bank are controlled by the State Planning Committee and the Treasury. The early reform (1979-84) established three banks—Bank of China, Construction Bank of China, and the Agricultural Bank of China—which started the initial competition in financial system of China. It was not until 1984-85 that a critical step of banking reform took place to organized the central bank by removing commercial business from the PBC to the newly established Industrial and Commercial Bank of China. Then the PBC began to play its role as a central bank with RMB issuance and the distribution of planned credit. After that, a few functions including state-owned capital distribution, which formerly belonged to the State Planning Committee and the Treasury, were gradually transferred to the PBC. So the authority and the privilege of the PBC have greatly expanded, but as an essential prerequisite condition, there is no systematic regulation built in to supervise the PBC's behavior. Even those formerly made by the State Planning Committee and the Treasury are not. With no restriction on its behavior, the PBC has, as a central bank, greatly expanded its privileges, even in commercial business. Its privileges have surpassed all the central banks in the world, but its internal control and function performance remain unchanged. The IMF and the World Bank have done much to help PBC with technical support in office-automation and systematic statistics, but its internal organization, function accountability and supervision, personnel management, income distribution and motives, which are the basic elements to determine the bank's behavior, still follow the old model of the government's bureaucratic organizations and cannot satisfy the demand for putting the central bank's

function into practice under the environment of a market economy. In recent years, because of the environmental change and the status-raising of the central bank in China, the problems in the internal control of the PBC have severely harmed its function performance as a central bank. Its monetary policy is still depends on the traditional administration, with only a single target of inflation or money supply, lack of comprehensive and macroeconomic consideration and a deep insight into the mechanics of monetary policy, which has caused bewilderment, retarded policy reaction, or even wrong policies of the PBC. As for the banking supervision, the practice is still at its primary stage because of the weak function of the PBC and the lack of highly experienced staffs and talented experts.

A considerable number of examples have showed that efficient banking supervision is the prerequisite for maintaining the stability of banking system, developing the financial market, and opening the domestic financial market. But in recent years, China has had to slow down the openness of domestic banking sector because the PBC has no adequate supervision of foreign banks. The reform of state-owned commercial banks is lagged behind because many regulations of the old credit planning system are still in practice in the banks and the development of some new financial institutions, such as the investment funds and investment banks, has halted because there are no adequate regulations to control them. Some newly approved regulations still cannot meet the demands of market economy, and some of which have even hindered the healthy development of the financial industry. All the facts tell us that the inefficiency of the banking supervision system has become the obstacle to openness of the financial market.

As to those state-owned commercial banks, not only does their reform lag behind, but they also face some serious problems. First, their capital resources from government budget and central bank's credit have been sharply cut since 1994 because a large amount of capital was transferred from the government's budget and bank's credit to foreign exchange reserve (Table 8), which forced the banks to raise their money from individual deposits at a much higher interest rate than they got from the government and central bank. Second, they began facing fierce competition with foreign banks in the market of best performing investments and credits, and some of their market share has been lost. Third, the reform of state-owned enterprises has a great impact on the bank's assets. Many enterprises even try to evade their bank loans through false bankruptcy or certain kinds of reorganization. Finally, the risk of investment and credit and financial crimes are still on the rise because of the loose control of banks. With such serious problems and considering that they hold as much as 70% of the total national asset, the SOC banks may impose an impact on the stability of China's financial system.

### **To Speed up the Reform of Macroeconomic Control System and Improve the Economic Management**

The experiences of many countries point to the fact that without a well-organized banking system, the country is vulnerable to financial crises when its financial sector is opened to the outside. China is a country in transition, and has had a history of rigid restriction on

the money-cashing of deposits. Most the residents and enterprises are accustomed to the postponement of their money cashing. So, even there is a liquidity crises of banks, a pervasive financial crisis is unlikely to happen. But such regulatory protection cannot last forever if China is to take more steps to open its market. Therefore, only comprehensive reform can solve all the problems. The basic idea of further reform is to do the following: first, fully adapt to the demand of the market economy and the integration with the world; and second, apply the economic management methods to the government's organizations who are responsible for the macroeconomic control. The early stages of economic reform in China have developed the market economy outside of the centrally planned economic system. Now that the pervasive basis of market economy has almost been established, and the old planning system has weakened under the impact of markets, the new economic system must be established under the new economic base. Economic management (including the practice of business accounting, cost-output valuation, exact accountability and its division, efficient supervision, fair competition and the mechanics of fittest survival) is the key to reforming enterprises as well as governmental organizations and banking institutions. They have no other way to go but to take such managerial reform if they are to change their inefficient performances and to adapt to the new environment of market economy. According to the actual situation of the Chinese financial system, the following concrete measures can be taken:

1. Reorganize the macroeconomic control system. One of the basic ideas is to stop up the draining-out of government's financial resources from the banking system in order to increase the budget income of the central government and leave most of the tax revenue to local governments and enterprises, which will help much to push the reform of enterprises and the social securities system, and thus create a healthy social environment for banks to improve their assets' performance. To stop the draining-out, it is necessary to readjust the division of accountability among the State Planning Committee, the Treasury, and the PBC; make the division clear; and set up systematic checking standards on them. There is also a need to rebuild the financial supervision on both the PBC and the Treasury according to the demand of market economy in order to make them quicken their steps in reforming and improving their functions as soon as possible.

2. Reform the monetary and central banking system by reorganizing the PBC with its internal organization and interest motives. As for many countries in the world, this has to be done in order for China to cut down the revenue and the profit of RMB issuance from the PBC and transfer them directly into the budget. At the same time, as a decent central bank, the PBC should have new and legal sources of income. By reorganization, cost-efficiency analysis and its mechanics of restriction can be set on the PBC, which will force the PBC to actively improve its functional performance and overcome its inefficiency.

3. Improve the current monetary and banking policies. First, cutting down the interest rate of reserve deposits with the PBC will lead the interest rate of monetary market to fall and thus reduce the inflows of hot money. Second, loosening regulations on private capital outflow can help balance the capital account of the international payments, reduce the impact on RMB issuance, and alleviate the constriction of government's budget and bank's credit. Third, one should fully cut the ratio of the required deposit reserve to the same level as that in many international finance market, reduce the restrictions on

commercial banks with their investment and market policy of raising money and at the same time push the reform of SOC banks with banking supervision, thus forcing them to actively reorganize, make internal control powerful, improve their economic management, face the international market, and enhance their competitiveness.

4. Make rigid regulations on the social banking activity outside banking system. The quick increase of social banking activity outside the government's control is a result of the contradiction between the rapid economic development and the retarded reform of banking system. Now, the simple prohibition on the activity cannot solve the problem. Only when a sound legal system is established to lead this activity into a rightful way and ensure its healthy development can the contradiction be thoroughly solved and the demand of economic development at same time be satisfied.

China is a country in transition and its early economic reform took place under conditions quite closed, when there were latent markets and the impulse of primary accumulation everywhere. Only with some anti-traditional spirit can one quickly realize his or her purpose of capital accumulation; there is little demand for specialized knowledge and managerial techniques. Such characteristics, reflected in the financial field, become the base for quick expansion of financial institutions and their employees in quantity, but not in quality. The business operation and economic management of many banking institutions still follow the old methods. Neither the central bank nor the commercial banks has any idea of cost efficiency, nor is there much demand for specialized know-how, service quality and internal control techniques. So, the internal control in many financial institutes are quite confused.

But the period of primary accumulation quickly finished. China has stepped into a new period of market system with fierce competition and the mechanics of survival of the fittest, but many government agencies and companies do not have enough knowledge about them. In the new period, the high level of economic management becomes the prerequisite for survival and development. By the end of 1980's, the number of financial institutions increased and their types were more diverse. A primary financial market began to emerge. In the middle of 1990's, the Chinese economic and financial system had undergone more profound changes. At the beginning, there was the deregulation on most of commodities and their prices, then the development of both interbank financing and inter-company financing, (both were not allowed in the centrally planned system.) After that, equity and bond markets emerged, and this was finally followed by the large inflow of foreign capital and the reform of many state-owned enterprises. All those have exerted great impact onto the present banking system and forced all the financial institutions, whether SOC banks or other financial institutions, to face the fierce market competition.

Though the PBC, as an authorized central bank, has no problem with survival, it is responsible for the effects of macroeconomic control, guaranteeing its function execution and the economic and finance stability, and pushing the healthy development of the entire financial industry. It has no other choice but to be actively improve its administration and overcome its internal shortcomings.

The basic element of market economy is the pervasive monetary exchange. The central bank, as a government's institution responsible for money supply and financial stability, is at the center stage of the macroeconomic control system and plays a very important role for the economy. In the history of world economy, as soon as a market economy developed to a certain stage, there would appear the necessity to reform monetary system and central banking system, in order to adapt to the economic development at a higher stage. For China, the historic course cannot go any other way. The reform in 1984-85 of the PBC conformed to the historic demand, thus creating a necessary condition for a decade of economic and banking development afterwards. But the reform at that time was only limited to the establishment of institutions and privilege authorities; the function performance of the central bank remained blank.

Today, China's market economy has gotten to a new stage. Not only has the social basis been established, but also the whole financial industry has begun an essential transition from the former government's subsidiaries responsible for the state capital distribution into an independent industry of the national economy with the purpose of pursuing profit. This will gradually form a financial market with competition and the mechanics of survival of the fittest. Facing such new economic situations, the central bank runs the risk of allowing the financial market to crash if it can not perform its functions well. So, the second stage of the reform of the central bank—setting the basic principles and functions of the PBC—has become an urgent requirement of our times.

In China, there is a special problem for the economic management of government and banks—who is suitable for choosing the personnel management for both government and banks and how to choose and promote them to take the important positions responsible for the economic administration. The personnel management system of government and banks certainly has some well written regulations, but most of their staffs are employed or promoted not because they have specialized and professional knowledge, but because they have certain relations. For them, well-written regulations become some blank papers. Those few people who are employed because of their talents and expertise, not because of relations, have to conform to the regulations and always become the sacrifices of such a personnel system. Now, the government and banks have a large number of staffs who are incompetent and lacking special knowledge for their jobs, but there is no regulation with which to dismiss or downgrade them, consequently causing all the government and bank employees to shut their mouths and idle with their antiquated knowledge. And this in turn makes it difficult to absorb competent people into the system.

In recent years, because of the development of a market economy and the massive brain-drain, it appears that the overall quality of the employees in the government and banks is declining but their bureaucracy is on the rise. If such problems could not be solved, any measure of macroeconomic reform will be distorted, and finally become a blank form without any crux of matter or even regress, such as the establishment of policy banks in 1993-94 and the State Taxation Administration. If the reform process is hindered, the economic management will not be able to improve quickly, and afterwards, the unstable elements of the social economy and the hidden peril in the banking system cannot be

removed by simply improving economic and administrative management. Some contradictions will even have deteriorated. So, we can conclude that the personnel management reform of the government and banks, at least in case of the PBC, is key to the success of pushing the macroeconomic reform and removing the hidden peril from the banking system.

Chinese economic reform has created great successes, but we should understand that every step of success is realized only by overcoming obstacles. Today, our reform is again facing some new obstacles. We believe that only by making determined resolution to overcome them can Chinese economic development stage on a new period of prosperity.

## **China's Financial Reform: Achievements and Challenges**

**Barry Naughton<sup>15</sup>**

**November 1997, Berkeley**

The southeast Asian currency crises of the fall of 1997 have inevitably led to heightened scrutiny of China's financial reform. The economy of China and the economies of southeast Asia share some important common features, both in terms of recent growth experience and potential fragility of the financial systems. Among all the regions of the world, only the ASEAN countries are remotely comparable to China in terms of the real development they have undergone in the past 20 years: production capacity has been built, human capabilities developed, and financial systems have become more sophisticated, more complex, and much larger. Yet despite those achievements, the southeast Asian countries have today stumbled into a serious financial crisis. It is natural to ask whether China, with similar achievements and equally similar financial shortcomings, is likely to suffer similar woes.

Particularly ominous is the plight of Indonesia. Indonesia has had economic growth approximately as rapid as China's. Moreover, Indonesia has had unrestricted capital account convertibility since 1970 and a balanced budget. Nonetheless, its currency has fallen by 35% since the beginning of the crisis, a serious credit crunch has stifled growth, and the increasing burden of dollar-denominated debt has thrown into question the financial viability of numerous Indonesian countries. More generally, Caprio and Klingebiel (1996) argue that financial crises in developing countries routinely exact costs up to or exceeding ten percent of GDP.

Conversely, the southeast Asian experience can also be interpreted as confirming the caution of China's reform process. Numerous observers have commented lately on China's emergence as a "bastion of stability" in the Pacific region. China's foreign reserves of over \$130 billion continue to grow, and the Chinese currency remains stable with a tendency toward appreciation. Most importantly, of course, China enjoys certain fundamental factors which differ from those of the ASEAN countries. Most of the massive capital inflow China has enjoyed has come in the form of foreign direct investment, and the currency is not convertible on the capital account. As a result, there is less danger of a downward spiral caused by capital flight in response to expectations of devaluation.

In light of contemporary problems in southeast Asia, this seems a particularly appropriate time to re-examine China's progress in financial reform. In this review, I argue that the cautious pace of financial reform has succeeded in important respects particularly in establishing important new institutions and channeling large national savings flows to end-users. However, progress in some areas is threatened by the lack of progress in creating more efficient institutions and in dealing with the legacy of poor previous lending decisions. As a result, there are significant risks of a major financial crisis.

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<sup>15</sup> Barry Naughton is Professor, IRPS, University of California, San Diego.

However, the nature of the dangers that threaten the Chinese financial system are quite different from those that affect the southeast Asian economies. Specifically, China has relatively little exposure to private debts denominated in foreign currency, and the interactions between volatility in domestic financial markets and foreign currency markets are quite limited. There is thus little danger for the present that China will catch the “Thai disease.” But China faces formidable problems of its own. These problems may prove especially difficult to manage in the next year or two. Successful macroeconomic stabilization and a renewed burst of enterprise restructuring create opportunities, but also substantial uncertainty and difficult new situations. These difficulties could easily lead to short-term financial problems that might reduce growth rates and set back hopes for fundamental reforms of the financial sector.

The first section examines the basic trends and main achievements of financial reform. The second and third sections look at the banking system and stock market respectively. The fourth and final section examines the current situation, with stress on the impact of current restructuring initiatives in concert with current macroeconomic conditions. The basic message is that while enormous progress is being made, there is a substantial danger of financial problems that could disrupt further progress.

### **Overall Trends and Achievements**

China is both a developing economy and a transitional market economy. Financial development in China reflects the influence of both these contexts. Economic development is generally accompanied by a gradual process of financial deepening. The ratio of various kinds of financial assets to GDP increases steadily with development. Some work indicates that increased financial deepening in turn accelerates the process of economic growth (King and Levine), but this is controversial. Transition to a market economy from a planned socialist economy is also expected to lead eventually to financial deepening, but for most European transitional economies, this process was not a gradual unidirectional change. Instead, in most of the European transitional economies, economic transition was preceded or accompanied by substantial inflation and economic decline. As a result, inflation wiped out accumulated financial balances. Many households lost their life savings. In those countries, transition took place in the context of a major disintermediation process: in Russia, broad money declined from 80% to only 20% of GDP between 1990 and 1993, and bank credit to enterprises and households declined from 40% to about 16%. (Dittus and Prowse) That is, the financial system became more “shallow.” At the same time, the disruption of transition caused a major decline in the flow of current saving. Households were not willing or able to increase saving quickly, and saving by government and enterprises collapsed. The financial system had to be rebuilt from the ground up.

The situation in China was quite different. National savings were high before, during and, presumably, after reform. However, the composition and institutions of saving changed dramatically. Most dramatically, household saving increased very rapidly during the early stage of transition, in response to the new opportunities created by transition. Total household saving—including both in-kind and financial saving—jumped rapidly from 7% of household income in 1978 to 17% in 1982, and have continued to

increase steadily since.<sup>16</sup> Even more crucially, financial savings tripled, increasing from 2.3% of household income in 1978 to an average of 6.8% in the years 1980-83. The household share of total national saving increased from 11% in 1978, surpassing 35% in 1981. (Cheng Xiaonong 1991, Macroeconomic 1987) Changes in the composition of savings are shown in Figure 1. Clearly, an important part of this smooth transition has been the fact that the real value of household assets in the banking system has been maintained, generally protected through the three major inflationary episodes that marked the transition.

As a result of these changes, China's financial system began to diverge from the standard command economy model, and resemble that of most market economies. Saving surpluses in the household sector were transferred primarily through the banking system to fund investment in the enterprise and government sectors. The banking system has been fundamentally transformed. First, it has grown enormously in size. Bank lending to enterprises and households increased from 52% of GDP in 1979 to 95% in 1996. M2 (narrow plus broad money) increased from less than 40% of GDP at the end of the 1970's to 109% in 1996. By this measure, China has had a "deeper" financial system than any other major transition economy since 1992. (Caprio and Levine: 16) Broad money reached 101% of GDP in 1994.

In addition, China put in place the basic administrative structures that govern banking systems in most economies. The People's Bank of China (PBC) was made into a central bank, with the potential to control lending and monetary aggregates through reserve requirements and central bank lending. The beginnings of competition have been introduced into the system. However, in the development of capital markets, China's performance was much less evident. This is ironic, given the attention that has been paid to China's stock markets. However, it is indisputable that if we limit our attention to formally recognized and regulated institutions, the capital markets—i.e. financial intermediaries outside the banking system—have been much less steady, and much less impressive. There was very little capital market development during the 1980's. For a period after 1990—when the stock exchanges in Shanghai and Shenzhen were established—capital market development proceeded rapidly. But after 1993, development slowed markedly, and the atmosphere shifted from one of financial permissiveness to a renewed stress on control and regulation. As we shall see, that slow-down was intimately related to shortcomings in the existing financial system. Figure 2 shows the development of the Chinese stock exchanges, relative to GDP, as well as several comparison economies.

Besides the stock market, capital markets also include bonds and other fixed income securities. At the end of 1995, government bonds (including treasury bonds and all other government-backed investment bonds) amounted to 6% of the GDP, also virtually unchanged since 1992. There had even been a contraction in the stock of enterprise bonds outstanding, which peaked in 1992. Between 1992 and 1996, then, the incipient growth of China's capital markets drastically slowed, while the real

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<sup>16</sup> The increase in household saving rates cannot be explained simply by the more rapid growth in household income during those years. Instead, saving behavior shifted upward in response to the changed environment. Barry Naughton, "Macroeconomic Policy and Response in the Chinese Economy: The Impact of the Reform Process." *Journal of Comparative Economics*, XI:3 (September 1987).

economy—and the banking system—continued to grow. As a result, the financial system still displayed the same fundamental characteristics as of 1996 that have marked its development since the beginning of reform. It is a system that has undergone very substantial financial deepening, but in which virtually all of the deepening has been channeled into the banking system. It is a bank-dominated system, and the growth of competition to the state-owned banking system has been real, but much too slow.<sup>17</sup>

We will discuss below, in section IV, the fact that this fundamental characteristic of the financial system up to this time may now be poised for rapid change. A second import caveat to the above generalization is that informal financial markets are very significant, but have been very poorly studied. According to the best available estimates, rural informal financial markets surpassed formal institutions in size of total lending in 1986.<sup>18</sup> In the investment accounts, “other” sources of investment, outside bank loans, enterprise retained funds, and budgetary disbursements amount to about 4% of GDP annually. These correspond to fairly large extra-budgetary funds often controlled by local governments.

### **The Current Transformation**

During 1997, extremely rapid change in a combination of circumstances is creating significant uncertainty in financial markets. Economic stabilization has occurred in a situation in which further enterprise reform and enterprise restructuring is now accelerating. Both factors create significant new stresses on the financial system. Stabilization has a number of important effects. With much lower inflation and only modest changes in nominal interest rates, real interest rates are significantly positive to a degree unprecedented in the transition program. With positive real interest rates, the implicit tax on the banking system has been reduced, and banks have an opportunity to replenish their capital. Moreover, the tendency toward disintermediation is strongly reduced, and policymakers will find it less necessary to impose restrictions on financial innovation in order to maintain the health of the banking system. Overall, stabilization creates favorable conditions for further reform.

But stabilization also brings substantial new stresses to the system. In the broadest sense, the current stabilization is the culmination of the entire market-creating transition process. Firms that were protected for nearly twenty years by the initially underdeveloped market and lack of competition are now fully exposed to tough competition from a variety of competitors. State firms, in particular, have lost the protective market conditions that gave them high profits under the planned economy and during the first decade of reform. Start-up firms and foreign investors that initially enjoyed high profitability in niche markets now find their niches have been invaded by other firms, who may often be leaner and more innovative producers. Under such conditions, all the mistakes of past loans outstanding

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<sup>17</sup> The introduction of competition into the financial system comes in three tiers: (a) Competition among banks (including among state-owned banks, but with private and foreign invested banks obviously the most sensitive), (b) Competition between banks and non-bank financial institutions (NBFIs), and (c) Competition between bank finance and capital markets.

<sup>18</sup> Wu Wiaobo et al, *Zhonggho Nongcun Jinrong de Biange yu Fazhan 1978-1990* (Chinese Rural Finance Change and Development, 1978-1990). Beijing: Dangdai Zhonggui, 1994, pg. 218-220. The estimate is based on household survey data.

are increasingly evident. More firms are under intense competitive pressure, and the dangers of a chain of defaults is clearly increased.

There are some markets in which asset bubbles are poised to burst. China's major cities are now seriously overbuilt. Office space in Beijing is jumping from 1.5 million meters at the end of 1996 to 2.5 million at the end of 1997; Shanghai luxury rents are already down about 20%, with another 10% fall in the cards. (*China News Digest*, 10/08/97) Real estate development has been a favorite target of "hot money" speculation in recent year. Funds have been diverted in substantial amounts, and some of those funds might not now be recovered. Thus, the biggest current danger is that defaults by property companies and defaults by production and trade enterprises might combine to rapidly threaten the solvency of key financial institutions. One can expect the Chinese government to respond promptly to such problems, and move to rectify whatever situation emerges. But such crises can be complex, and not always easy to manage, even by governments with the best of intentions.

The second major factor creating a complex and uncertain environment is the new impetus that has been given to state enterprise restructuring in the wake of the Fifteenth Party Congress. There is no doubt that "restructuring" as defined at the Party Congress involves a much more rapid rate of ownership conversion, increased privatization, and much greater use of joint stock corporations. Government limitations requiring that the state maintain majority or controlling interests are being repealed. Clearly, a flood of new firms is about to be launched onto the formal and informal markets. A number of questions are unresolved.

First, the role of enterprise restructuring in resolving bank debt problems is not yet clear. The banks have substantial stakes in firms that are being restructured. The recently adopted Banking Law has decreed a separation between the commercial and investment roles of financial institutions, thus prohibiting bank ownership of equity. However, this law might be loosely interpreted in reality. Banks might well package loans and sell them as equity stakes, swap them to subsidiaries, or sell convertible bonds. Unquestionably, the conversion of bank debt into equity and convertible bonds will be a non-trivial part of the ongoing restructuring of enterprises.<sup>19</sup> It is likely that the overall trend of financial development will shift. Capital market development is likely to accelerate, while bank expansion is likely to slow.

Already, the Chinese government shows signs of being willing to facilitate a large-scale shift of financial structure away from the banking system and towards capital markets. The government has recently given its blessing to creation of mutual funds, and these are likely soon to be joined in the market by other institutional players, including pension funds and insurance companies. The government seems willing to countenance a withdrawal of household funds from the banking system, so long as this is accompanied by some orderly write-down of bad debts. The banking system faces an unprecedented opportunity to deal with its stock of bad debts. A combined program of enterprise balance sheet restructuring and fiscally supported write-offs of bad debt could make a serious dent in the bad debt problem.

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<sup>19</sup> See "Who would bear the risks?" *China Economic News*, August 18, 1997. Pg. 1-2

However, China's banks have yet to resolve the flow problem. Ownership of the state banks continues to be expressed in vague and inconsistent ways that do not provide bank managers with adequate incentives for making appropriate loan decisions. Even more crucial is the potential role of banks as monitors of newly restructured enterprise management groups. Clearly, the banks are important stakeholders in China's corporations. Most SOEs rely on the banks for virtually the totality of their external financing. Moreover, banks provide substantial amounts of long-term capital, which strengthens the argument for long-term links between banks and enterprises, including the formation of financial groups. Obviously this gives the banks a potentially strong role in disciplining enterprise behavior, since enterprises have no alternatives. Banks should be encouraged to put representatives on Boards of Directors, and the current prohibition of banks holding equity should be relaxed (though not eliminated). Banks should be allowed to hold small equity stakes, perhaps for limited periods (up to two years) as part of restructuring efforts. This would help banks gain experience, provide better incentives, and prepare banks for a more active monitoring role in the future.<sup>20</sup> In addition, it is essential that the government move quickly and decisively to restructure the banks themselves. Enterprise restructuring without bank restructuring is unlikely, in the long run, to be successful. Control over financial enterprises ought also to be restructured, and the role of government ownership reduced.

It should be clear that the current period is one of great opportunity. But it is also one of substantial risk. The complexity of the problems facing China's policy-makers has increased sharply. It will be difficult to manage the changes that will emerge rapidly over the next few years. Default risks are substantial. We have already mentioned risks in the industrial and property development sectors. Another key area where financial disorder might arise is in the management of China's embryonic pension funds. Most regions now collect a percentage of wages for investment in pension funds, but oversight over these funds has been abysmal. According to preliminary reports trickling out of China, many of these funds have lost substantial sums of money, and it may well be that significant public scandals are brewing. Without proper management these problems could interact with other weaknesses in the financial system to cause major disruption.

One area where China is clearly different from the Southeast Asian economies is in the links between domestic financial markets and foreign currency markets. It is in the interactions of those markets, both marked by substantial intrinsic volatility, that the Southeast Asian economies have really faltered. China, with its inconvertible currency, and solid, appreciating currency, appears to be immune from these interactive effects. However, this is a short-run appraisal. In the long-run, China's currency may now be overvalued, and the capital account may not be as closed as it appears. It is not at all inconceivable that in the not-too-distant future reductions in the inflow of foreign investment could lead to a beginning of depreciation, which might be accompanied by renewed capital flight.

In short, China's financial situation is quite different from that of the southeast Asian economies, and there is no reason to think that China will suffer from contagion of that region's financial distress. But China's financial system still suffers from important

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<sup>20</sup> In Japan, banks hold 19% of corporate equity, and in Germany the figure is 10%. In the US, banks are prohibited by the Glass-Seagal act from holding equity directly. See Dittus and Prowse, pg. 23.

weaknesses, and these weaknesses are likely to intensify over the next year or two. It will require extreme vigilance and skillful management on the part of China's policy-makers to prevent these weaknesses from leading to financial crises that affect significant parts of China's financial system.

## **IV. SYSTEMS FRICTIONS AND CHINA'S ACCESSION TO THE WTO IN THE CONTEXT OF A TRIALOGUE**

### **Main Issues:**

- Evaluating the scale and form of China's economy
- The WTO debate in China

### **Selected Excerpts:**

"Form, Scale and Limits in China's Trade and Development," by Stephen S. Cohen

"Institutional Implications of WTO Accession for China," by Richard H. Steinberg.

### **Summary: Systems frictions and China's accession to the WTO in the context of a trialogue**

Because of its scale, form, uniqueness of institutions, and regional disparity, the Chinese economy will be difficult for the WTO to absorb and at the same time maintain its political support and efficiency. The authors in this section address the structural difficulties involved in the accession.

The US' main concerns about China include its size as both a producer and as a market. It is too large to receive "exceptional, lenient treatment," as Wolff says. But it is China's form, not its size, which matters more, says Cohen. China seems more liberal than it really is, which could cause concerns about gentle treatment to materialize. Central state planning is neither universally nor effectively implemented, the rapid growth is not necessarily reflective of a sufficiently liberal market, and its exports have been limited to a few product lines. (Wolff 9)

In order to reclaim national prestige and assert itself as a world power, China must move economically from peasant farming and labor-intensive light manufacturing to more "valuable" complex manufacturing, such as automobiles, advanced electronics, telecommunications, and aerospace. Cohen believes that China will develop automobiles as the leading sector. Not only do automobiles themselves count under GNP, but so do their maintenance and repair, which makes this venture "GNP intensive." Emphasis on the auto industry means that short- and middle-term growth rates will increase, but welfare

may not, says Cohen. At the same time, other problems will arise from congestion costs, scale effects, and environmental limits.

China will not develop an open, free-trade, free-market economic system without decisive strategic control. Japan can serve both as an example for China's development, in regards to "developmental mercantilism," and as the critical structuring variable in the trilateral relationship. Its structural adjustment is necessary for Chinese entry. The structural defects in the US-Japanese relationship and Japan's problematic role in the international trade system only compound the difficulties of fitting China into that system. (Cohen 3)

China must attract technology and knowledge from foreign multinational corporations, who will trade technological knowledge and export guarantees for market access and will political defend China's large grade surpluses with the US, says Cohen. China's principal instrument for trade and technological development is its functional control of access to its increasingly large market after WTO accession.

But Cohen cautions that multinational corporations (MNCs) will become political "hostages" because they will do what they are told in order to gain access to China's market. MNCs are also, however, political agents. They will accelerate China's development and "engagement" with the outside world.

The world system will also be unable to accommodate China's presence for very long without major structural adjustments. The structured Pacific system of investment, specific, and trade is analogous to a complex production organization, a factory, that is dependent on a positive trade balance with the US and Europe, says Cohen. This is due to Japan's unwillingness and/or inability to increase imports of manufactured goods. Thus, it is the form of the trade system, not China's size, that causes the difficulties. (Cohen 4) The unsustainable trade asymmetries between Japan, the US, China, and the rest of the world are only reinforced by China's roughly balanced overall trade.

Unless preventative action is taken, says Steinberg, political friction from the accession of a large, transitional economy to the WTO combined with the organization's substantive and procedural rules may weaken the WTO as an international governmental system. China's accession will expand the WTO's jurisdiction to encompass a political and economic system that operates in ways the organization is not designed to govern. This may increase the perceived amount of decision-making gridlock, administrative inefficiency, and ineffective dispute settlement.

China differs from the other WTO members in several fundamental ways which are not accounted for by WTO rules, notes Steinberg. State enterprises continue to play a large role in its political-economic structure, domestic rules and rule-making processes lack transparency, competition policy rules lack meaning and legitimacy, the judicial system is not entirely independent of politics, several regions have considerable corruption, central government authority and regulatory systems regarding the

environment and workers rights are weak, and there are no democratic guarantees.  
(Steinberg)

Unless these differences are addressed by either changing the WTO's constitutional procedures or China's accession instruments or by development of Chinese domestic institutions to more closely approximate Western institutions, the WTO will be weakened as an institution because the differences will generate trade disputes which the WTO cannot resolve to the satisfaction of the members who count, thus leading to decision gridlock.

**Form, Scale and Limits in China's Trade and Development**  
**Stephen S. Cohen<sup>21</sup>**  
**November 1997, Berkeley**

Form may not follow function, but it sure constrains it. And form itself is limited by scale. Form, with its logical concomitant of limits, is central in most intellectual discourses. It does not, however, hold any place in the parlance of conventional economics, not even in the conceptual bag of economics' poor relation, institutional economics.

When I was very much younger I came upon an essay by an eminent Edwardian naturalist which resolved a problem for me and has stuck with me since. It was called "On the Importance of Being the Right Size," written by J.D.B. Haldane. Many of us learned as kids that the common ant is enormously strong. It can carry several times its own weight. Were it to be as big as a boy, it could lift a building and carry it away. Haldane cleared up that mystifying image. An ant could not be as big as a boy. Period. The limit was imposed by the ventilation system. The form could not scale up that far. In the logic of Economics 101, A Diamond as Big as the Ritz would have disappointing value. China is about scale, and scale is about form. Discussion of China's economic development and its entry into the world trade system must focus on form, for that is what gives scale meaning. System truths about, say, Singapore which is roughly the size of Brooklyn, do not scale up to China, almost three orders of magnitude bigger.

I would like to use two cases to illustrate how the constraints of form impose limits on simple extrapolations of present trends, patterns, and institutional arrangements, and pose questions and guideposts for policy—both Chinese and US policy. Before we turn to them, we should note that the operational meaning of limits is not a brick wall, but a steeply rising cost curve that imposes the kind of breathless effort that prevents ants from getting very big.

The first case illustrates the idea of scale and form—it concerns the choice of leading (or driving) sectors. The second, the subject of this essay, concerns China's entry into the system of international trade, in terms of the fit of structures and scale.

China, stripped now of ideology, exhibits a fierce determination to hold the unit, China, together, to reclaim national prestige and to assert itself as a world power—a political, economic and military world power. This means an ineluctably central and growing role for nationalism. To achieve those ends, it must also grow rapidly, especially along lines that define power. This means moving as quickly as possible up the "value chain" from peasant farming and very labor intensive light manufacturing, mostly of commodity or near commodity goods, to complex manufacturing such as automobiles, machine tools and non-commodity chemicals. It means especially advanced electronics, telecommunications, and aerospace which are inherently "dual use" technologies and define military capability.

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<sup>21</sup> Stephen S. Cohen is Professor of Planning and Co-Director, BRIE, University of California, Berkeley.

Outside of the critical dual-use sectors the choice of a leading sector translates, in practical terms, into a choice about automobile lead growth. Should autos and the pattern of development that comes with autos propel development or should housing and urban infrastructure, which generate significantly different urban and developmental forms? There is debate about this within the State Planning Commission, but I think the outcome is foreordained: autos. This has some substantial consequences: economic growth rates, especially in the short and middle term, will read higher, but not necessarily welfare. And limits, or steeply rising effort curves, will assert themselves much faster in the auto model.

This view can be expressed in terms of two well-known characteristics of conventional economic statistics and the kinds of counting and thinking they permit. The categories that structure economic statistics and analysis are not particularly apposite when it comes to considering, that is defining, weighing, and judging alternative forms of development. They were created to compare changes in GNP over a short span, where not too much structural change could be expected. They have a Keynesian, or pure growth bias.

A second characteristic of conventional economic statistics makes them not simply monitors but active participants in development strategy. It is the bias inherent in what gets measured and what does not; what counts as raising GNP and what does not. A quick example is the growth accounting problem posed by immunizations, fifty-cent treatments that statistically lower GNP while fabulously increasing welfare. Cars count. So does their fuel, repair and extensive infrastructure. Involvement from home to work, to school, to visit, to shop, if made by auto is, let us coin a phrase, "GNP intensive." The same movements made by foot, bicycle, or public transit figure only lightly in GNP and therefore generate low rates of recorded economic growth, but high rates of functional mobility. In the auto-based model, higher and higher quantities of GNP are needed to literally get to the same place. The litany is familiar, at least to city planners: congestion costs that rise exponentially especially in megacities of the sort that already dot China and continue to grow, the inherent tendency of the auto model to generate increasing inequality and the costs to the system of dealing with that, land use patterns that maximize individual consumption of durable goods, the scale effects of an automobilized China on energy costs which will compound the GNP intensity of the model (and a good many international political problems as well), and the difficulty and costs of switching later on to a different growth trajectory. And all that comes before environmental limits assert themselves.

These considerations lead us, albeit somewhat indirectly, to a second set of considerations and discontinuities imposed by form. In this case, they concern China's foreign trade strategy.

## II

I say strategy, rather than comparative advantage as economists dutifully intone, because China is not, and is unlikely over the middle term, to become anything like an open, free trade, free-market economic system, or indeed in a capitalist system operating without

decisive strategic control, let alone liberal democracy. The plate tectonics of strategic industrial policy rubbing against the sandy edge of an open market system will generate substantial "system frictions," most noisily with the US but also with a set of frightened developing states such as Thailand, Malaysia, Korea and Mexico who are most likely to bear the early brunt of trade and investment diversion. These are not the simple squabbles the US has with Europe over such matters as veal, landing rights, and even Airbus that flare up and down within the context of fundamental, long term system complementarity, balanced trade and satisfactory mutual interpenetration through direct foreign investment. They are akin to the endless series of "disputes" with Japan, presented energetically by both governments and by American economists as small squabbles, but understood widely as manifestations of long term, system frictions. Indeed, America's troubled trade history with Japan is the ghost at the US-Chinese trade banquet. Its influence on US attitudes and expectations is difficult to overestimate. (Is China to be a giant Japan in its trade patterns and a military power to boot?) Japan's successful "developmental mercantalism" remains the second great lesson for the Chinese leadership, after that of the ex-Soviet Union's devastating experiment with the double impact of simultaneous reform. (Glasnost and Perestroika redefined and reinforced by advice from the IMF and American radical free-market economists.) And it is not just Japan's past history as a model for big-country late developers with a concern for national power. The structural defects in the US-Japanese trade relationship, and the singular and troubling role of Japan in the international trade system (as well as its place in the Pacific system of trade and industrial specialization), compound the difficulties of fitting China into the world trade system. Despite the appearances generated by current negotiations, fitting China into the world trade system is not just a US-China problem; it cannot be just a US-China debate. At a minimum it is a trilateral problem. Japan must be brought in or dragged in because Japanese adjustment, not US adjustment, is the critical structuring variable.

If China enters the Pacific Trade system with a trade structure that defines that system, as it is already doing, that system will not be able to accommodate China for very long without major structural rehabilitation of the kind that flattens eager, but unwary, home buyers. The problem is not just size, but form—the architecture, if you will, of that trade system. The Pacific trade system is a structured system of investment, specialization and trade that link the different Asian economies with one another and with the rest of the world, especially the US and Japan who together play the defining roles in that system. It can best be understood as a complex production organization—more a factory than a fortress (as some have argued) or an international Ricardian system tending towards equilibrium (as most economists posit)—that is, a self-regulating, and self-directing system of shy governments and contestable markets. It is a factory that is heavily dependent on a huge net positive trade balance with the US and Europe (mostly the US), in good part because of a persistent unwillingness or inability of Japan to radically increase imports of manufactured goods to offset its exports.

Over the Long Period, 1980-92, Asia (including Japan) accumulated a trade surplus in manufactures of about \$2 trillion, that is two thousand billion dollars (with the US absorbing about three times as much as Europe). Over the same period Japan by itself

also accumulated a trade surplus in manufactures of just about \$2 trillion. This implies that the trade surplus of Asia (excluding Japan) with the rest of the world was equal to Japan's surplus with the rest of Asia. In brief, Pacific trade, despite the enormous complexities it contains, operates within a neat triangular form. Japan runs a big surplus with the US and a surplus with the rest of Asia. The rest of Asia runs a substantial deficit with Japan (mostly in key components and advanced machinery), but offsets it with a surplus with the US (mostly in final products). And the US absorbs the output of this production system, transforming itself from the world's biggest creditor nation in the early 1980's to the world's biggest debtor. The system's sustainability is limited, and inverse to its scale. Despite violent fluctuations of the yen/dollar rate and a rapid increase in intra-Asian trade so eagerly noticed by economists, this basic architecture has not changed significantly in recent years. What is new is China's rocket-like increase in trade volume from almost nothing a few years ago, to where it is now—in a dead heat with Japan for the honor of the largest surplus with the US. For 1995 China (including Hong Kong and Taiwan) ran a surplus with the US of about \$40 billion and a deficit with Japan of about \$26 billion. So despite the fact that China's trade overall is roughly in balance, it reinforces rather than alters the structure of Pacific trade pattern as it piles huge and rapidly growing numbers (1996 surplus of close to \$50 billion) on an already unsustainable geometry.

### III

China's developmental ambitions mean that it must attract technology and know-how from abroad—and not just from overseas Chinese. It needs the big multinational corporations from Europe, Japan and the US in aerospace, advanced chemicals, complex manufacturing, transportation equipment, advanced tools such as steppers, pharmaceuticals, telecommunications equipment—a whole range of advanced technologies, techniques and know-how—for which the Multinational Corporation (MNC) has become the principal instrument of geographic diffusion. Unlike the case of Japan, MNCs are to be a principal agent for China's ambitious trade and industrial policies. Those MNCs are scripted to play two key parts: 1) trading critical technology, know-how and export guarantees for market access, and 2) politically defending China's massive trade surpluses with the US.

Control of access to China's increasingly giant market is China's principal trade and technological/industrial development instrument. It will be painful to discard although it sits right at the center of the WTO negotiating table. It is, perhaps, prudent to assume that even if trade negotiators reach a successful agreement for WTO accession (successful in US terms), China's control of access will persist at a functional level long after its abolition at the formal level; this has generally been the case with large late developers. The combination of the lure of the giant market, functional control of access, and the existence of competing MNCs from different national bases for almost every key technology will enable China to continue to swap market access for technology and, as advertisers richly imply, "much more." The MNCs will come to China and do what they are told, most often without having to be told. There will be some difficulties, especially

when short-term profitability seems elusive, but those can easily be remedied. Once in, once profitable in a major way (or while seeking entry, expansion, diversification, direct access to customers, etc.), they are transformed into political hostages. Chinese strategists believe that only the likes of Boeing, Ford, Citicorp, AIG, Goldman Sachs and GE will fight off protectionist (as well as human rights, anti-proliferation and environmentalist) forces in the US while China accumulates massive trade surpluses in manufactures with the US. I think that this is a smart political calculation; its soundness is already being proven.

But Multinational Corporations inevitably play a more complex role. They rapidly speed up development, but they also accelerate "engagement" with the outside world; they are political hostages, but also political agents. On balance their major and growing role in Chinese economic development and in China's interface with the world trade and investment system is a major force for openness—openness in society and openness in the economy.

Fitting China into the world system of trade and investment will be difficult. It will necessitate, at the outset, a realistic assessment of how that system will have to change to accommodate the reality of China. To date that assessment is absent, especially in the American debate, where the realists have been sitting in the back seat while squabbling romantics fight to steer. On the one hand there is a small but noisy crowd who rant about keeping China out until it reforms; on the other, a large group that seeks to minimize the problems of system redesign in the hope that everything can be left to the market, if only everyone takes the strict market pledge. Neither approach can contend with the problems sketched out above, such as the necessity of major redesign of the Pacific system of trade—especially Japan's role, or the problem of trade and investment diversion as it hits China's neighbors and America's critical client state neighbors. They do not even face up to such lesser but awkward problems as how the World Trade Organization (the repository of free marketeers' hopes) will function with extensive Chinese participation. The agenda is long and tough. It would be well to have solid US-European cooperation on how to deal with it. To date, we have seen little of that, nor have we seen any signs of Japan considering the implications for its own trade strategy and economic structure. Romanticism is at best a mixed blessing in adolescent fiction; in politics and economics, it is a disaster.

## **Institutional Implications of WTO Accession for China**

**Richard Steinberg<sup>22</sup>**

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### **I. INTRODUCTION: WTO MEMBERSHIP, “SYSTEMS FRICTION,” AND INSTITUTIONAL STRENGTH**

For fifty years, the General Agreement on Tariffs and Trade (GATT) system has fostered the development of liberal multilateralism. Originally a short, fifty-page set of rules that governed trade between just 23 "original" Contracting Parties, with only provisional application because of the failure of several countries to ratify it, the GATT has evolved into one of the world's most well-developed international organizations. The World Trade Organization (WTO) boasts over 120 member states (Members) who have ratified its founding charter and thousands of pages of substantive rules. Perhaps most significantly, the Uruguay Round negotiations bestowed upon the GATT system revised rules of government, which many expect will vastly improve the system's institutional strength.<sup>23</sup> With new dispute settlement rules, clarified rules of procedure for decision-making by the Members, and the formal establishment of a genuine secretariat,<sup>24</sup> many claim that the world's preeminent trade institution is stronger than ever. Their hope is that this revitalized institution can govern itself effectively, advancing international political order and rules-based liberal multilateralism.

This paper considers the possible effects of China's accession to the WTO on the WTO's institutional strength—how China's accession could affect WTO governmental processes and the extent of political support for the organization from leading Western trading countries. During the past ten years, in which China has (of course) not been a GATT Contracting Party or a WTO Member, there has been substantial “systems friction” between China and some Western trading countries. The term “systems friction,” coined by Sylvia Ostry<sup>25</sup> (but a notion attributable more accurately to Thucydides<sup>26</sup> and then Machiavelli<sup>27</sup>), is usually thought of as the political tension between countries attributable to their economic interaction in the context of fundamental differences in the organization and operating principles of their respective political-economic structures. The existence of systems friction now associated with China-trade raises the question of whether WTO

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<sup>22</sup> Richard Steinberg is Acting Professor of Law, University of California, Los Angeles.

<sup>23</sup> During the Uruguay Round, Professor Jackson advocated establishment of a World Trade Organization and many of the other organizational reforms that were eventually adopted on the grounds that it would strengthen the multilateral trading system institutionally. See John H. Jackson, *Restructuring the GATT System* (Royal Institute of International Affairs: London, 1990).

<sup>24</sup> Previously, the GATT “secretariat” lacked such a status and existed technically as the staff of the Executive-Secretary of the Interim Commission for the International Trade Organization.

<sup>25</sup> See Miles Kahler, *Regional Futures and Transatlantic Economic Relations* (New York: Council of Foreign Relations Press, 1996), pg. 43.

<sup>26</sup> See Thucydides, *The Peloponnesian War* (The Crawley Translation) (New York: The Modern Library, 1982), especially Book I.

<sup>27</sup> See Niccolo Machiavelli, *The Discourses* (New York: The Modern Library, 1950) Chapter LIX.

accession for China is more likely to reduce and contain the systems friction or weaken the WTO as an institution.

The analysis below suggests that the political friction associated with accession of a large, transitional economy like China's, combined with the WTO's current substantive and procedural rules, may weaken the WTO as an international governmental system—unless some preventative action is taken. Chinese accession will expand the territorial scope of the WTO and the level of trade that it governs. It may also help “lock in” the impressive steps China has taken towards economic liberalization over the last two decades. But it will also expand the WTO’s coverage to include a political-economic system that operates in ways that the WTO’s substantive and procedural rules were not designed to govern. This is likely to add to a perception by some powerful trading nations that on crucial issues the WTO suffers from decision-making gridlock, administrative inefficiency, and an ineffective dispute settlement system. This is not to suggest that Chinese accession will fatally or even substantially weaken the WTO, but unless corrective action can be taken, it is likely to marginally weaken its effectiveness as an international governmental system.

Part II of this paper provides a theoretical prologue that helps frame the analysis. Comparative political theory and international relations theory provide tools for understanding whether the rules of a particular institution are well-suited to effective governance of its constituent social units. These theories suggest considering the extent to which an institution’s substantive and procedural rules are capable of resolving political conflict between social units governed by the institution in a way that is acceptable politically to the most powerful units.

Part III analyzes the extent to which WTO substantive rules may not be designed to fully intermediate trade and political friction between Western liberal, democratic political economies and China’s political-economic system. China is fundamentally different from other WTO members, partly because of its size (which, as suggested by Steve Cohen, does matter)<sup>28</sup>, but also because of its particular political-economic structure: a continuing large role for state enterprises; a lack of transparency of some domestic rules and rule-making processes; a lack of meaningful competition policy rules; a judicial system which, on commercial matters, is in the early stages of development and is not always perceived as independent of politics; considerable corruption in some regions; relatively weak central government authority; weak regulatory systems pertaining to the environment and (ironically) worker rights; and an absence of democratic guarantees. These are differences that are not accounted for by WTO rules. And if the political friction associated with these differences cannot be addressed in another manner—through WTO constitutional procedures or China’s Protocol of Accession—then China’s accession is likely to weaken the WTO institutionally.

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<sup>28</sup> Stephen Cohen, “Form, Scale and Limits in China’s Trade and Development,” *Journal of East Asian Economics* 8(4), (Greenwish: AI Press Inc., forthcoming).

Part IV of this paper examines relevant WTO constitutional procedures, showing that the WTO's judicial, legislative, and administrative processes are unlikely to yield substantive rules or other solutions that could resolve the tensions likely to arise from China's accession. It is suggested that a broad reading of the Article XXIII doctrine of "non-violation nullification or impairment" would help provide a constitutional solution, but an adequately clear definition of that doctrine is unlikely in the immediate future.

Part V concludes by suggesting that Chinese accession to the WTO is likely to generate substantial dissatisfaction by some powerful trading countries with WTO dispute settlement results and a perception of WTO decision-making gridlock and administrative inefficiency in the secretariat—all of which will undermine support for the WTO. The associated weakening of the WTO as an institution may be minimized or remedied to the extent that China's Protocol of Accession addresses the substantive shortcomings of WTO rules identified above, the doctrine of non-violation nullification or impairment is interpreted broadly, and China continues to develop along capitalist-democratic lines.

## **II. THE RELATIONSHIP BETWEEN INSTITUTIONAL RULES, SOCIAL UNITS, AND INSTITUTIONAL STRENGTH: A THEORETICAL PROLOGUE**

Whether a particular set of institutional rules will foster effective government depends not only on the rules themselves, but also on the constituent units of the system. Political scientists and historical sociologists have long studied this relationship in the domestic political context.<sup>29</sup> Whether government is effective depends at least in part on whether procedural and substantive rules fit those participating in the system. If rules and institutions fail to develop along with underlying social or political change, then government suffers, the institutions of government are weakened, and political decay may set in.

At the international level, realist regime theory suggests analogous relationships. These theories suggest that the underlying distribution of power and interests among states will determine regime rules that will in turn yield international behavior desired by politically powerful countries.<sup>30</sup> This resembles Marxist arguments that international structures perform functions demanded by capital,<sup>31</sup> except that (*inter alia*) realists do not necessarily embrace an underlying economic dynamic, particularly not a Marxist dynamic. A corollary of realist regime theory must be that if a regime's rules do not yield outcomes favored by powerful states, then those powerful states are likely to withdraw support for that regime. An international institution's substantive rules and constitutional procedures must together create outcomes supported by nation-states with power.

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<sup>29</sup> See, for example, Samuel B. Huntington, *Political Order in Changing Societies* (New Haven: Yale University Press, 1968); G. Bingham Powell, *Contemporary Democracies: Participation, Stability and Violence* (Cambridge: Harvard University Press, 1982); and Seymour Martin Lipset, *The First New Nation* (New York: W.W. Norton, 1979).

<sup>30</sup> See Stephen D. Krasner, editor, *International Regimes* (Ithaca: Cornell University Press, 1983)

<sup>31</sup> See Jurgen Habermas, *Legitimation Crisis* (Boston: Beacon Press, 1975)

Thus, history is littered with the remains of international institutions that collapsed or were weakened because their rules were not well-matched with underlying power and interests. The League of Nations and the International Trade Organization are but two examples of international institutions that were still-born because of such rules. And the UN General Assembly and the World Intellectual Property Organization may be present-day examples of institutions that have been weakened in their international role because of procedural rules that do not reflect underlying power and interests.

This framework begs the question of whether China's accession to the WTO will strengthen or weaken the institution and its government, given the WTO's existing substantive and procedural rules.

### **III. WTO'S SUBSTANTIVE RULES AND THE CHINESE TYPE OF MARKET ECONOMY: "SYSTEMS FRICTION" WITHIN THE INSTITUTION**

As suggested above, there is currently considerable systems friction between China and Western capitalist economies. The nature of that systems friction may be seen through alternative lenses. Neoclassical economics uses a deductive-axiomatic model to show that free trade between two liberal economies will yield optimally efficient outcomes.<sup>32</sup> These conclusions are shattered, however, if the assumption of liberal constituent economies is suspended. From a strategic trade theory perspective,<sup>33</sup> trade relations between a *laissez-faire* system and an economy with strong doses of state intervention are also likely to yield an unsatisfactory outcome, at least from the vantage of policy-makers in the liberal system. Hence, whether embracing optimal efficiency or national economic welfare as a goal, it is not difficult to understand why some in the West are not completely satisfied with Chinese trade relations.

In a particular institutional context, the analysis of systems friction should be somewhat different. Here the question becomes the extent to which the rules of an international institution adequately account for and permit a process of intermediation to take place between different political-economic systems. If the rules perform this function well, then it is likely that the systems friction will not be played out within the institution. However, if the rules do not perform this function well, then the institution is likely to suffer from the effects of systems friction and experience governmental problems and diminished political support from those countries perceiving inadequate rules.

Unfortunately, many dimensions of China's political-economic system are not accounted for by current WTO rules. This is not surprising since those who drafted the GATT and participated in the Uruguay Round negotiations did not give much, if any,

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<sup>32</sup> See David Ricardo, "On the Principles of Political Economy and Taxation," *Works and Correspondence*, edited by Piero Straffa (Cambridge: Cambridge University Press, 1951) Pg. 133-49; and Charles P. Kindleberger and Peter Lindert, *International Economics*, Sixth Editions (Homewood, IL: R.D. Irwin, 1978)

<sup>33</sup> For a description of strategic trade theory, see Paul Krugman, *Rethinking International Trade* (Cambridge: MIT Press, 1990)

consideration to how the organization might intermediate relations between Western systems and the Chinese type of market economy. WTO rules do not fully address at least eight factors that could become sources of systems friction within the WTO.

First, even according to the most generous estimates of the extent to which China's market has liberalized, at least 35% of Chinese gross domestic product is still produced by state-owned enterprises. Action by state-owned enterprises has the potential to undermine the four fundamental rules of the WTO system. For the most part, the GATT assumes that economic decision-making is made by atomistic producers and consumers based on price, but state-owned enterprises do not always make decisions based on price.<sup>34</sup> For example, it is not difficult to see state-owned enterprises that consume computer chips or steel deciding to purchase all of their consumption from state-owned chip or steel manufacturers. This would effectively undermine the GATT's Article III national treatment provision. Similar arguments can be made about how state-owned enterprises may engage in behavior that would undermine the GATT Article I commitment of most favored nation (MFN) treatment, the Article II commitment to a schedule of concessions, and the Article XI commitment against maintaining quantitative restrictions.<sup>35</sup>

GATT Article XVII was intended to discipline activity by state enterprises<sup>36</sup> but the draftsmen could never have anticipated that this article would sufficiently address problems created by the accession of a country as big as China's and with such a large role for state enterprises. The primary requirement of Article XVII is that state enterprises shall make purchases or sales "solely in accordance with commercial considerations." But this discipline cannot be effective in cases where the reason for purchases or sales by state enterprises is not transparent, like those that are sure to be encountered in China.

Second, more broadly, the WTO system assumes that members' laws, regulations, and administrative and legislative processes are transparent. This is crucial to the effectiveness of many of the GATT's main principles. For example, true national treatment (Article I) requires that both domestic and foreign producers know the rules of the game. Similarly, a lack of transparency about rules or regulations affecting imports could have the same effect as a quantitative restriction (Article XI). The formulation of rules also demands a transparent process so that foreign interests can be represented to ensure that the rule is not discriminatory in its effect. And, as suggested in the preceding paragraph, any meaningful discipline on state enterprises entails transparency.

GATT Article X requires the publication of trade regulations prior to their application, but this discipline is not broad enough to cover all of the kinds of

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<sup>34</sup> On this point, generally, see Donald C. Clarke, "GATT Membership for China?", 17(3) *University of Puget Sound Law Review* 517 (Spring 1993)

<sup>35</sup> For this kind of analysis applied to state-trading enterprises, see John A. Jackson, *The World Trading System* (Cambridge: MIT Press, 1989).

<sup>36</sup> The title of Article XXVII is "State Trading Enterprises," but the text makes clear that the article applies to all state-owned enterprises, not just state trading enterprises. See John A. Jackson, *World Trade and the Law of GATT* (Michie Press, 1969)

transparencies encountered in China. For example, the WTO has no meaningful requirement of procedural transparency, except, perhaps, in the context of formation of technical, sanitary, and phytosanitary regulations. More problematic, the existence of transparency is difficult to monitor since, by definition, governments do not broadcast non-transparent directives or "administrative guidance." In short, it is often very difficult to know at any given moment whether a pattern of behavior may be explained as an Article X violation.

Third, China lacks any meaningful competition policy and the WTO system does not require a member to have a competition policy. While there are few complaints at this time about anti-competitive activities in the private sector in China, it does not take great imagination to see that such problems could arise in the future. For example, to the extent that China continues to reduce the role of state-owned enterprises, government authorities could decide to give a legal monopoly to certain currently state-owned enterprises, particularly in the early phases of privatization. This is a pattern that has been followed in some other Asian countries and in Eastern Europe. Monopolistic or monopsonistic behavior is the private sector analogue to discriminatory behavior by state-owned enterprises and can eviscerate the effectiveness and meaningfulness of basic GATT rules just as effectively.

Fourth, the WTO system implicitly expects that members will have an effective and impartial judicial system, which is crucial to the effectiveness of many WTO obligations. For example, it is difficult to see how a country with a judicial system that is slow, corrupt, or not independent of domestic political influence could offer reliable and impartial enforcement of its laws. Yet reliable and impartial contract enforcement may be the sine qua non of equitable trade and investment relationships. A weak judicial system may be less troubling in issue areas where WTO rules require enforcement of particular topics in domestic law, e.g. intellectual property, but even in that context it is unclear whether a WTO dispute settlement panel would be willing to condemn an entire legal system as ineffective or lacking impartiality. China's legal system is developing quickly, but most observers continue to question its impartiality in cases involving foreigners.

Fifth, the existence of wide-spread corruption (e.g. bribery, kickbacks, etc.) can also undermine WTO rules if nationals from some countries are permitted to engage in corrupt activities while those from other countries are prohibited from doing so. US nationals are prevented from engaging in specified corrupt activities under the Foreign Corrupt Practices Act, whereas nationals from many European countries are not so constrained. The absence of WTO disciplines on corrupt practices, combined with US restrictions on such activities by US nationals, can yield patterns of purchasing, investment, procurement, and regulatory administration (including customs) in countries with widespread corruption that are inefficient and undermine crucial GATT rules such as MFN treatment and national treatment. Many US businessmen have alleged that precisely such patterns exist in parts of China, particularly in the southeast.

Sixth, the relative weakness of a central government with respect to sub-federal entities (such as provinces, states, and local government) is likely to reduce the effectiveness and meaningfulness of WTO undertakings. The Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 reiterates the obligation of Article XXIV:12 that each member "shall take such reasonable measures as may be available to it to ensure" observance of the provisions of WTO agreements by regional and local governments and authorities within its territories. However, the failure to define "such reasonable measures as may be available to it" and the impracticability for some central governments to do so suggests that WTO obligations will be less effective in national systems that are de-centralized in practice than in highly centralized countries. The extent to which sub-central government authorities refuse to obey central government rules in China and the apparent impotence of the central government to change that behavior are notorious.

Seventh, the WTO lacks rules to ensure minimal standards of environmental and social regulation in member states. This raises the possibility that big differences in the stringency of regulatory regimes across WTO Members may attract investment and jobs away from countries that have relatively stringent standards and towards countries, like China, that have relatively lax environmental or workers' rights standards.<sup>37</sup>

Eighth, WTO rules do not provide an exception from general WTO obligations for trade actions taken in response gross human rights violations. Article XX(e), which permits trade restrictions relating to the products of prison labor, is about as far as GATT goes. Yet many in the US believe that there should be some linkage between US-China trade relations and Chinese progress on human rights and democratization, more generally.<sup>38</sup>

In summary, WTO rules are weak or absent on several issues that are likely to be sources of systems friction between the US and China. Weak or missing rules in these areas may be understood as a relic of the WTO's history. The institution was never expected to intermediate trade relations between Western *laissez-faire* democracies and a political economic system like that of China's, which appears to be transitioning from a centrally planned, communist system to something as yet not fully defined. Thus, the WTO's substantive rules are not equipped to address the systems friction that would likely accompany Chinese accession.

#### **IV. WTO CONSTITUTIONAL PROCESSES AS SOLUTIONS TO SYSTEMS FRICTION WITH CHINA?**

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<sup>37</sup> See C. Leigh Andersin, Richard R.W. Brooks, And Robert A. Kagan, "Adversarial Legalism, Transaction Costs, and the Industrial Flight Hypothesis," BRIE Working Paper No. 93 (Berkeley: Berkeley Roundtable on the International Economy, forthcoming)

<sup>38</sup> For evidence of demand for this linkage, see Title IV of the Trade Act of 1974, as amended (the "Jackson-Vanik Amendment.")

Even if existing substantive rules do not address sources of systems friction, it is possible that operation of the WTO's constitutional processes could provide a solution. More broadly, in assessing how well an institution is likely to absorb a new social unit, it is important to analyze how that institution's governmental processes will function after the new social unit joins it. The analysis that follows suggests that the WTO's judicial, legislative, and administrative systems will have difficulty resolving the systems friction associated with China's entry into the world trading system. Combined with the WTO's substantive shortcomings, this may have the tendency to create a perception in some Western countries that the WTO is a weak and inadequate institution, providing fodder for those in the US who would like to see more "unilateral" action and weakening support for the WTO by at least one major trading power.

### **The Judicial Process: WTO Dispute Settlement**

WTO dispute settlement is unlikely to render decisions that resolve the systems friction associated with China's entry into the world trading system. In cases where a complainant can show that China has violated WTO rules, the WTO dispute settlement system is likely to render ineffectual decisions that require China to change its behavior and comply; moreover, if compliance is not forthcoming, the Uruguay Round Understanding on Dispute Settlement ensures an automatic right to retaliation by the injured WTO Member. But the problem is not with potential violations of WTO obligations by China. It is the weakness or absence of WTO rules in key areas that is likely to yield dissatisfaction with WTO dispute settlement by some countries. WTO dispute settlement is unlikely to provide a remedy for behavior by China that does not violate a WTO rule. The preceding section of this paper identified several sources of systems friction that are not adequately addressed by WTO rules.

GATT Article XXIII:1(b) provides a basis for the possibility of a successful claim by a complainant based on a theory that another member has imposed a measure that nullifies or impairs a benefit, whether or not that measure conflicts with WTO obligations. Claims based on this "non-violation nullification or impairment" theory were relatively rare in GATT jurisprudence. Moreover, many commentators and GATT panel reports have suggested a relatively narrow reading of this doctrine. For example, at least one panel has stated that the doctrine is intended to protect the balance of tariff concessions, a principle that can be used to argue that the complainant must have negotiated a tariff concession with the respondent on the product that is the subject of the claim.<sup>39</sup> Similarly, some have read the text of Article XXIII:1(b) literally to suggest that the doctrine supports a claim only if it is based on the "application" by another member of a measure, not if the claim is based on the failure to apply a measure, i.e. a failure to enforce competition policy rules could not be the basis of a non-violation nullification or impairment claim. And even more limiting is the suggestion that the doctrine could be invoked successfully only upon a

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<sup>39</sup> 1990 Panel Report on "EEC-Payments and Subsidies Paid to Processors and Producers of Oil Seeds and Related Animal-Feed Proteins." L/6627 adopted on 25 January 1990, 37S/86, 126-7, 144.

showing that the complainant had no reasonable expectation of the measure complained of at the time that it negotiated the associated tariff concessions.<sup>40</sup>

At this time, it is unclear how narrowly or broadly the non-violation nullification and impairment doctrine will be construed by WTO dispute settlement panels and the Appellate Body. A panel decision is expected soon in the US-Japan film dispute, and that decision is expected to address the issue; however, an appeal is almost certain and it is unlikely that the parameters of the doctrine will be fully fleshed out in the near term. A broad reading of the doctrine would provide an important (though incomplete) lubricant for systems friction associated with behavior that is not addressed by WTO rules. Such a reading would not require the losing party to change its behavior, but would authorize "compensation" for the complainant. In contrast, a narrow reading of the doctrine would render the dispute settlement system incapable of resolving the political tension associated with behavior that is not covered by WTO rules.

Moreover, since the WTO dispute settlement process permits relatively swift and automatic action against a country that acts unilaterally i.e. retaliation without WTO authorization, a narrow reading of the doctrine would leave the US with the uncomfortable choice of either simply bearing the brunt of systems friction or taking unilateral action that contravenes its WTO obligations and would weaken the institution.

### **The Legislative Process: WTO Consensus Decision-making**

While there are specific voting procedures and proportions required to amend the GATT 1994, to grant waivers, to approve accessions, or take certain other actions, the vast proportion of WTO actions are taken according to the practice of consensus. The WTO body concerned is deemed to have decided by consensus on a matter submitted for its consideration if no Member, present at the meeting when the decision is taken, formally objects to the proposed decision.<sup>41</sup> The consensus decision-making practice means, therefore, that very little legislative action can be taken in the WTO if China (or any other country) objects to it.

This decision-making practice is likely to render the WTO legislative process incapable of adopting new rules that would address sources of systems friction identified in the preceding section. China is likely to block a consensus on any rule that would discipline Chinese practices that contribute to systems friction and that are not already disciplined.

In assessing the WTO's constitutional capacity to address systems friction, it is important to consider the relationship between the operation of its judicial and legislative processes. In particular, a broad reading of the nonviolation nullification and impairment doctrine, which would result in authorized "compensation" for Western countries facing

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<sup>40</sup> For a discussion of the basis for this argument, see John H. Jackson, *World Trade and the Law of GATT*, pg. 179.

<sup>41</sup> Article IX, Agreement Establishing the World Trade Organization, fn 1.

injury from Chinese practices (regardless of whether the Chinese practices are permitted under WTO rules) would likely facilitate legislative solutions to systems friction-- even under the consensus rule. The availability of compensation would provide bargaining leverage for those Members seeking a rules-based solution. In at least some situations, it is likely that China and other Members would reach agreement on a rules-based approach to some practices that have led to a non-violation nullification or impairment finding.

But in the absence of a broadly construed non-violation nullification or impairment doctrine, it is hard to see anything other than legislative gridlock on proposals for meaningful new rules relating to state-owned enterprises, transparency, domestic judicial systems, and other topics that are likely to be sources of systems friction with China.

### **The Administrative Process: The WTO Secretariat**

WTO accession is not likely to render the WTO Secretariat more efficient or effective. The WTO Secretariat, like its GATT precursor, has not been considered to be very bold or effective. That is understandable because the Secretariat serves at the pleasure of the Members and cannot afford to take any action, depict any matter, or frame any issue in a manner that a powerful Member or coalition of Members would perceive as contrary to their interests. In so far as China would bring a host of new interests and practices into WTO debates, its accession would marginally water down further the WTO Secretariat's courage and effectiveness. And if China were to insist upon the application of UN staffing rules in the WTO, then this effect would likely be magnified.

## **V. CONCLUSIONS: CATCHING THE TIGER BY THE TAIL VERSUS CONTAINING IT<sup>34</sup> ALTERNATIVE PATHS FOR THE WTO**

Without solutions to the problems suggested in the foregoing analysis, the systems friction now being experienced with regard to China trade might be exacerbated by Chinese accession to the WTO. Ultimately, "systems friction" is a political concept. It is certain to operate even under circumstances that neoclassical economists might find acceptable. Since China is not currently a WTO member, anarchy<sup>42</sup> reigns in trade relations between China and the countries of the West: China and Western countries negotiate their trading relationships in a state of nature. This permits some Western countries to threaten retaliation or otherwise demand change in Chinese behavior, regardless of WTO rules. As a political device, this works. Chinese behavior changes marginally and Western government officials gain domestic political cover for maintaining a largely open trade and investment relationship with China.

In the worst case, this changes with China's accession to the WTO. The substantive rules and governmental processes of the WTO are intended to end anarchy and constrain unilateral behavior, but in the case of accession for China, WTO rules may

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<sup>42</sup> "Anarchy" in the sense that power and authority is decentralized, held only by the constituent units of the system—the states. See generally Kenneth Waltz, *Theory of International Politics* (Menlo Park: Addison-Wesley, 1979)

attempt to do so without providing adequate procedural or substantive lubricants for systems friction. This creates a risk that the WTO's governmental processes will become deadlocked and incapable of resolving China's trade tensions with some powerful trading countries, undermining the strength of the institution and weakening political support for it. In this view, whatever benefits are attributable to Chinese accession (and there are many) would be offset by serious costs to the institution—the WTO will have "caught the tiger by the tail."

Some might believe that WTO accession for China would be worth this cost. They might argue that: US unilateralism should be constrained, systems friction should not stand in the way of liberalization, the "lock-in effect" on Chinese reforms associated with WTO accession is far more important than these institutional effects, or that WTO accession for China is likely to help ameliorate systems friction (and adverse institutional developments in the WTO) by virtue of the WTO's normative and cognitive impact on Chinese government officials and Chinese policy.

Regardless of how one strikes this balance, the foregoing analysis makes clear that three sets of factors could reduce systems friction and make the WTO a more effective institution in dealing with China. First, a broad interpretation of the doctrine of nonviolation nullification or impairment would help. It would help some powerful Western trading countries tolerate Chinese accession to an instrument the substantive rules of which does not discipline behavior that is likely to be a source of political friction. Many Chinese practices that are not WTO-illegal but which do impact trade, could then be addressed by WTO-authorized compensation for liberal countries without condemning Chinese behavior. This would not merely resolve domestic political pressures associated with systems friction, but would also be a source of bargaining leverage for liberal trading countries in negotiations to develop rules-based solutions to China-trade systems friction.

Second, China's Protocol of Accession must be tailored to address as many of these problems as possible. Ultimately, the analysis presented here explains why China's Protocol cannot be a typical protocol modeled on those of countries who have preceded it in the accession queue. Commitment and deadlines pertaining to tariffs, quotas, and non-tariff barriers are not enough. Nor is it enough to also promise to phase in new domestic statutes in China on Uruguay Round topics like intellectual property and investment. China's Protocol of Accession should also include meaningful and verifiable commitments pertaining to state enterprises; transparency; the assertion of central government control over regional and local policies; corruption; the adoption and enforcement of competition policy; the adoption, maintenance, and enforcement of more stringent regulatory regimes; the development of the judicial system; and other matters. To the extent that this is not possible, the Protocol of Accession should except otherwise WTO-illegal trade actions by other WTO Members that are taken in reaction to Chinese behavior in these areas. Perhaps China could declare its acceptance of an interpretation of the non-violation nullification or impairment doctrine that would permit "compensation" to Members in response to Chinese behavior in these areas. Negotiations on these matters will not be easy.

Third, ultimately, of course, the argument here suggests that the best solution to these problems would be if China were to become more like us. The faster and more completely China evolves into a system with a small role for state enterprises, a well-developed judicial system, a more modern and effective regulatory system, greater central government control over regions and localities, and a more democratic character, the better it will fit in with existing WTO rules that were designed for countries modeled on Western democratic liberalism.