

# **China's Engagement in Multilateral Institutions:**

## **Understanding the Trade Creation Impact of the ASEAN-China Free Trade Area**

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## **Executive Summary**

Over the past two decades, the rise of China has caused profound changes in the traditional underpinnings of international relations in Asia. China's speedy economic development and military modernization led to heightened competition and conflicts with fellow East Asian countries in the late 1980s and early 1990s that caused many scholars and policy experts to become concerned with the nature of its rise to power. These concerns evolved into the great "engagement" versus "containment" debate in the 1990s regarding whether to engage or isolate the fledgling power during its ascension. Whether the international community is able to find a proper incentive that leads to the incorporation of China in the regional and international multilateral framework seemed to be the central question of the debate.

Since the early 2000s, however, the Chinese government has implemented a series of liberal policy reforms regarding international relations which significantly improved its diplomatic relations with its neighbors and reassured the rest of the world of the benign nature of its rise to power. In particular, China's increasing engagement in regional multilateral institutions surprised many western policy makers who have traditionally considered China's hostile and suspicious attitude toward such institutions one of the major destabilizing factors in its rise to power.

One prominent example of China's increasing influence in regional multilateral institutions is its role behind the creation and implementation of the ASEAN-China Free Trade Area (ACFTA). Conceived in 2002, ACFTA seeks to promote regional economic

cooperation through the gradual removal of trade barriers and unification of rules and economic practices in East Asia. With the 2010 deadline for the FTA's implementation process fast approaching, the paper seeks determine the economic value of ACFTA through the application of the gravity model of trade. In particular, it hopes to answer the question whether ACFTA functions as an effective instrument promoting regional trade or merely serves to reinforce preexisting economic norms. Through the finding, the paper also hopes to offer some insights onto the question of whether China's newfound enthusiasm in partaking in regional economic cooperation is paralleled by actual effective economic reforms.

The empirical results from the gravity model are inconclusive on the trade creation aspect of ACFTA. However, analysis of other empirical data, including a closer inspection of specific ACFTA policies, do suggest that the FTA accomplished more than simply reinforcing preexisting economic norms. Moreover, the study of China's leadership role behind the creation of ACFTA serve to reflect the new sophistication and confidence behind Beijing's foreign policy and its altered attitude toward multilateral institutions. At the same time, it is important to note that China's avid engagement in regional multilateral institutions and willingness to compromise in certain negotiations do not imply a full acceptance of regional cooperation and integration. There remains a great amount of uncertainty around the question of whether the recent patterns of economic cooperation are indicative of a permanent shift in the basic preferences of the Chinese government that can have long-term impact.

## Table of Contents

I.	Introduction	5
II.	Early Patterns of Engagement	7
III.	The Engagement vs. Containment Debate	10
IV.	Transformations in the China-ASEAN Relationship	
V.	ACFTA—Background	21
VI.	ACFTA—The Trade Impact Debate	24
VII.	ACFTA—Gravity Model	30
	i. Statistical Model	30
	ii. Data	32
	iii. Empirical Results	36
VIII.	Analytical Discussion	40
IX.	Conclusion	45
X.	Acknowledgements	47
XI.	Bibliography	48
XII.	Appendices	50

## **I. Introduction**

Over the past two decades, the rise of China has caused profound changes in the traditional underpinnings of international relations in Asia. The onset of China's rising economic, military, and political powers can be traced back to Deng Xiaoping's visionary "Four Modernizations" reforms in the late 1980s. Since then, China has gradually become a more notable actor in the Asian as well as global balance of power. What have not been so consistent over time are the speculations from foreign scholars and policy makers regarding the nature of China's rising influence. For the greater part of the 1990s, experts on Chinese economy and politics debated whether the rising nation would seek to become a regional hegemon and pose economic and security threats to rest of the region.

Since the early 2000s, however, the Chinese government has implemented a series of liberal policy reforms regarding international relations which significantly improved its diplomatic relations with its neighbors. At the same time, these policies helped to gradually reassure the rest of the world of the benign nature of China's rise to power and its intention to become a more involved and assertive member of the international community. In particular, China's rising engagement in regional multilateral institutions surprised many western policy makers who have traditionally considered China's hostile and suspicious attitude toward such institutions one of the major destabilizing factors in its rise to power.

One prominent example of China's increasing influence in regional multilateral

institutions is its role behind the creation and implementation of the ASEAN-China Free Trade Area (ACFTA). Conceived in 2002, ACFTA seeks to actively promote regional economic cooperation through the gradual removal of trade barriers and unification of rules and economic practices in East Asia. By the end of its implementation in 2010, the FTA will incorporate 2 billion people into a free trade zone, making it one of the largest multilateral economic institution in the world<sup>1</sup>. With its deadline for the implementation fast approaching, a new round of debate has surfaced with a primary focus on ACFTA's economic impact. While some scholars are optimistic about ACFTA's role in promoting economic cooperation in the region, others question the strategic political motivations behind its establishment and are less certain of its trade creation value.

This paper will begin by examining the basis behind the earlier concerns regarding the nature of China's rise to power. It will then analyze the events and political environment in the late 1990s and early 2000s that enabled China's initiation into the regional multilateral framework. Finally, it will focus on the inception and implementation of one particular multilateral institution—ACFTA. Through a gravity analysis on the trade creation value of ACFTA, the paper aims to determine whether ACFTA functions as an effective instrument promoting regional trade or merely serves to reinforce preexisting economic norms. Through this finding, the paper hopes to offer some insights onto the question of whether China's newfound enthusiasm in partaking in regional economic cooperation is paralleled by actual effective economic reforms.

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<sup>1</sup> Dent, C. M. (2005). "Bilateral Free Trade Agreements: Boon or Bane for Regionalism in East Asia and the Asia-Pacific?" *European journal of East Asian studies* 4(2): 287-314.

## II. Early Patterns of Engagement

In order to fully understand the basis behind the western policy makers' concerns regarding China's rise to power, it is worthwhile to sketch a brief outline of the pace of China's economic and military developments during the late 1980s and early 1990s. Deng's reform agenda encompassed wide grounds ranging from agriculture to science and technology. Most importantly, it prioritized economic development and military modernization. The reforms yielded speedy results. By the early 1990s, the Chinese economy was rendering consecutive years of double-digit growth. Economic data from the International Monetary Fund (IMF) indicates that by 1994, China's GDP had climbed to comparable levels to that of the region's leading economic power—Japan. At the same time, perhaps more alarmingly, its military spending also skyrocketed, quickly becoming by far the highest in the region<sup>2</sup>.

While this paper will mainly focus on the economic dimension of China's rise to power, it will nevertheless attempt to give a brief overview on the security dimension of the issue. Indeed, it was China's hostile stance on security-related issues that first caused the international community to become preoccupied with its growing influence. At the same time, it was China's own insecurities regarding territorial claims and boundary disputes that underlined its initial skepticism toward regional multilateral institutions. It was not until after the Chinese government had successfully resolved territory disputes with most of its neighbors that China finally began to be incorporated into the regional

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<sup>2</sup> Segal, G. (1996). "East Asia and the "Constrainment" of China." *International Security* 20(4): 107-135.

economic framework. The economic, especially trade dimension of China's rise to power is thus tightly connected to its security concerns. A basic understanding of the transformations in the Asian security sphere over the past few decades is therefore essential to the discussion of China's rise to power.

Scholars have long voiced concerns regarding the lack of an absolute superpower in Asia and viewed the rise of China as a threat to the power vacuum<sup>3</sup>. Many of such concerns are centered around Japan's economic and militaristic vulnerabilities. Economically speaking, as of 1994, Japan is the undisputed regional leader, accounting for roughly a third of the region's aggregate GDP while contributing to less than 7 percent of the regional population<sup>4</sup>. However, Japan's economic success has significant ramifications. Specifically, some scholars worry that Japan's complete dependence on the import of raw materials and heavily export-driven economy can be seriously challenged by the maturing of China's export sector<sup>5</sup>. Military-wise, Japan has adopted an extremely pacifist stance post World War II, relegating most of its own military defense responsibilities to its ally the United States<sup>6</sup>. Some believe that its weak militaristic capabilities hinder its abilities to protect its economic interests abroad and exert decisive global political influence<sup>7</sup>.

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<sup>3</sup> See: Roy, D. (1994). "Hegemon on the Horizon?" International Security 19(1): 149-168; Montaperto, R. (1995). China as a Military Power, National Defense University, Institute for National Strategic Studies; and Segal, 1996.

<sup>4</sup> Segal, 1996

<sup>5</sup> See: Gibney, F. (1996). Japan: The Fragile Superpower. Tokyo, Tuttle Publishing; Pollack, A. (1993). A 'Made in Japan' Label is Getting Harder to Find. International Herald Tribune.

<sup>6</sup> Roy, 1994

<sup>7</sup> See: Emmott, B. (1989). "The Limits to Japanese Power." Pacific Review 2(3) and Roy, 1994



Japan's lack of military prestige is problematic for the Asian balance of power, especially given the fact that none of the other Asian countries individually can challenge China's military dominance. At the same time, until recently, there lacked any comprehensive multilateral framework among the Asian countries overseeing collective political and security concerns. It was not until the late 1990s that Japan and ASEAN finally decided to include discussions on security issues in the Japan-ASEAN dialogue, which had traditionally focused solely on trade and investment matters<sup>8</sup>.

There is clear evidence that China recognized and sought to exploit this collective security weakness by favoring bilateral negotiations over multilateral talks regarding issues concerning border disputes, political interventions, and trade negotiations<sup>9</sup>. Doing so enabled China to pick on the weak links and advance asymmetrical political and economic demands. One of such instances is exhibited by the much publicized clash between the Chinese and Vietnamese navies in the Spratlys in 1988, during which several Vietnamese ships were destroyed while challenging China's much disputed claim to the territory<sup>10</sup>. By isolating and engaging the weakest member of ASEAN, China was able to get away with its hostile activities and maintain control over disputed territories with few repercussions.

The pull factors mentioned above are not the only forces leading to China's

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<sup>8</sup> Wong, L. F. (2007). "China-ASEAN and Japan-ASEAN Relations during the Post-Cold War Era." Chinese Journal of International Politics 1: 374-404.

<sup>9</sup> See: Wannadi, J. (1996). "ASEAN's China Strategy: Towards Deeper Engagement." Survival 38(3): 117-128 and Whiting, A. (1997). "ASEAN Eyes China: The Security Dimension." Asian Survey 37(4): 299-322.

<sup>10</sup> Segal, 1996

preference for bilateral negotiations. There existed significant push factors that alienated China from multilateral institutions in the region. In the past, China had always believed that it lacked the support and bargaining power to advance its political and economic agendas in a multilateral setting.<sup>11</sup> This fear of defeat and isolation is inherently linked to China's concern over Japan's dominant influence in the region. Japan's close relationship with the United States gave rise to additional skepticism from the Chinese, who considered the United States a real threat to the regional security and believed it was trying to use globalization as a pretext for establishing an American hegemony<sup>12</sup>. Moreover, China has a long-standing emphasis on autonomy and independence and viewed multilateral negotiations as another facet for the West to interfere with its domestic policy<sup>13</sup>. As a result, China took on a minimalist and passive approach to Asia-Pacific regional cooperation prior to the late 1990s.

### **III. The Engagement vs. Containment Debate**

In light of China's hostility and distrust for multilateral institutions, the initial western response regarding China's rise to power was divided roughly into two camps—one that promoted China's inclusion in regional multilateral frameworks and another that

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<sup>11</sup> Sohn, I. (2007). East Asia's Counterweight Strategy: Asian Financial Cooperation and Evolving International Monetary Order, G-24 Discussion Paper Series.

<sup>12</sup> See: Shambaugh, D. (2004). "China Engages Asia: Reshaping the Regional Order." International Security 29(3): 64-99; Yang, Z. (2004). China's FTA Developments, APEC Study Centers Consortium Meeting and Sohn, I. (2008). "Learning to Co-operate: China's Multilateral Approach to Asian Financial Co-operation." The China Quarterly.

<sup>13</sup> Sohn, 2008

advocated for counterbalance and isolation. The liberal school, or the “engagement” school, believed that if the international community were to offer China opportunities and incentives to join the regional and global society, China could be peacefully incorporated into the status quo<sup>14</sup>. Once integrated into the regional and global framework, liberal scholars predicted that economic interdependence would play a significant role in deterring China from acting aggressively toward its neighbors and trading partners. While pinpointing many advantages for the rest of the international community in China’s inclusion in multilateral institutions, the engagement school conceded that it would be difficult to dispel the Chinese government’s suspicions regarding multilateral negotiations and downplay the incentives China has for favoring its current pattern of asymmetrical bilateral negotiations<sup>15</sup>.

On the other hand, the realist camp, or the “containment” school believed that China’s economic ascension might cause it to adopt an expansionist outlook and become a security threat to its neighbors. Containment school scholars cited China’s ongoing land and sea border disputes and its unstable relationships with Japan and Taiwan as catalysts for military conflicts<sup>16</sup>. Alternatively, some realist scholars, and indeed some liberal scholars alike, were concerned that the Chinese Communist Party (CCP) may not be strong enough to hold the country together in light of its robust developments. They claimed a collapsed and chaotic China in itself would present huge security threats to the

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<sup>14</sup> See: Segal, 1996; Shambaugh, 1996 and Wannadi 1996.

<sup>15</sup> Segal, 1996

<sup>16</sup> Ahmad, Z. H. (1993). "Japan and China in Pacific Asia's Evolving Security Environment." Global Affairs 8(1).

rest of Asia<sup>17</sup>. Most importantly, many realists rejected the possibility of successfully engaging China in multilateral negotiations. Denny Roy in particular asserted that economic development would decrease the likelihood of China's cooperation with its neighbors as China began to view the rest of Asia as competitors in the exports market<sup>18</sup>. Injoo Sohn further pointed out that there is no clear gain for an aspiring power in joining an existing multilateral framework dominated by reigning powers<sup>19</sup>.

#### **IV. Transformations in the China-ASEAN Relationship**

Given the widespread doubts over the feasibility of incorporating China into the preexisting regional framework, China's subsequent transformation and avid engagement in the ASEAN Plus Three and the East Asia Forum no doubt presented pleasant surprises to scholars from both camps. The next part of the paper will follow China through the late 1980s and early 1990s to identify some key events that helped bring about this surprising transformation.

The engagement of China in the Asia-Pacific regional framework benefited greatly from the improved diplomatic relationships between China and ASEAN in the 1990s. Historically, beginning with the establishment of the CCP government in 1949, China has enjoyed closer ties with ASEAN than all other Asian countries on account of their close physical proximity, shared language and cultural background, and lack of

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<sup>17</sup> Roy, 1994; Segal, 1996

<sup>18</sup> Roy, 1994

<sup>19</sup> Sohn, 2008

historical conflicts. However, this friendly rapport deteriorated quickly in the 1980s and early 1990s following a series of impasse regarding border disputes, some of which were discussed earlier in this paper. In addition, some ASEAN countries developed security pacts with the United States and Australia in the 1990s, perhaps partially as a response to China's hostile military actions in the region. This caused alarm on behalf of the Chinese government for fear that it was losing influence in Southeast Asia to foreign powers<sup>20</sup>.

The China-Indonesia relationship serves as a prime example to highlight how quickly China's rise to power began to infringe on its healthy diplomatic relations with ASEAN countries. Prior to the late 1980s, China enjoyed the strongest diplomatic tie with Indonesia among all ASEAN countries. Unlike other ASEAN countries such as Malaysia and the Philippines, Indonesia did not lay claims to any part of the Spratlys, which had been the center of the South China Sea dispute<sup>21</sup>. This reduced the possibility of military confrontation between the two nations. However, as China's naval ambitions and demand for natural resources grew in synch with its military modernization and economic development, it eventually sought to lay claim to the northeastern portion of Natuna Island, home to a major natural gas field. This sparked territory disputes with Indonesia. Subsequent negotiations over the disputed land were largely ineffective, as the Chinese refused to engage in multilateral negotiations while the Indonesians saw the futility of bilateral talks. In frustration, the Indonesian Foreign Minister accused China of

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<sup>20</sup> Sheng, L. (2003). China-ASEAN Free Trade Area: Origins, Developments and Strategic Motivations. International Politics & Security Issues Series No. 1, Institute of Southeast Asian Studies.

<sup>21</sup> Whiting, 1997

harboring expansionist tendency toward Southeast Asia<sup>22</sup>.

China's relationships with the other ASEAN countries followed largely the same pattern as its relationship with Indonesia. On top of territorial disputes, the Chinese government was also guilty of carrying out several attempts to spark communist insurgencies in ASEAN nations and stirring unrest among the ethnically Chinese population in the region<sup>23</sup>. These actions caused ASEAN to view China as a "challenge" and "risk."<sup>24</sup> The souring relationship was certainly one of the factors leading to China's initial exclusion from the ASEAN dialogues.

What caused a transformation in the China-ASEAN relationship? David Shambaugh pointed to ASEAN's reactions after the Tiananmen Square incident as one of the catalysts for a thawing relationship. The West reacted to the incident by ostracizing China and placing it under economic sanctions. The Asian countries took a more moderate approach. Led by Japan and ASEAN, Asian countries chose to abandon the sanctions process and instead engaged China in diplomatic dialogues<sup>25</sup>. This sent out one of the first signals to Beijing that Asia may not be as aligned with western powers as it first thought.

More scholars, however, would point to the Asian Financial Crisis of 1997 as the turning point in the China-ASEAN relationship<sup>26</sup>. This time, China was the one to

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<sup>22</sup> Whiting, 1997

<sup>23</sup> Wannadi, 1996

<sup>24</sup> Whiting, 1997

<sup>25</sup> Shambaugh, 2004

<sup>26</sup> Wong, 2007 and Sohn, 2008

send out a positive signal. During the crisis, western investors saw signs of a collapsing Asian economy and decided to withdraw their investments. This only served to worsen the crisis, as the Asian economy depended heavily on foreign direct investments. Many ASEAN countries suffered from the capital flights and lost their ability to keep their currencies pegged to the U.S. dollar. As a result, the ASEAN currencies experienced rapid depreciation, causing rampant inflation.

China's large pool of foreign reserves and relatively conservative investment policies helped minimize its own exposure to the capital flights. However, instead of taking advantage of its neighbors' economic turmoil, China chose to maintain its currency peg and offered aid packages and low-interest loans to several Southeast Asian countries<sup>27</sup>. The currency peg, in particular, was effective in limiting the scope of the inflation in ASEAN countries and eventually proved instrumental in helping them recover from the crisis. China's benevolent gestures came in stark contrast with the IMF's dictatorial approach to use the crisis as an opportunity to reshape the Asian financial structure<sup>28</sup>. China's reactions to the crisis helped morph its image from a threatening hegemon to a responsible regional power.

Nevertheless, the Asian Financial Crisis did not single-handedly transform the China-ASEAN relationship. Moreover, while the crisis improved the rest of Asia's perception of China, it did less to reassure China of the former's independence from the

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<sup>27</sup> Lum,, et. al. (2009). China's Foreign Aid Activities in Africa, Latin America, and Southeast Asia, Congressional Research Service.

<sup>28</sup> Shambaugh, 2004

West. China's opposition to the Japan-sponsored Asian Monetary Fund (AMF) shortly following the crisis attested to its continued mistrust of Japan and regional multilateral institutions at large. Some attributed this opposition to the AMF to the fact that the proposal was announced by Japan without prior consultation with China<sup>29</sup>. Others claimed that China's response was influenced by its rivaling relationship with Japan<sup>30</sup>. Whatever motivated China to withhold support from the AMF, it was clear that China was not yet ready to embrace the idea of regional cooperation let aside taking a leadership role in multilateral initiatives during the immediate aftermath of the Asian Financial Crisis.

What the Asian Financial Crisis did induce was a vague consensus within the CCP leadership that there might be a need for some type of regional financial cooperation to ensure future regional economic stability. Uncertain how to bring about such cooperation, Beijing began sending observation teams to the ASEAN Regional Forum and the Council on Security Cooperation in the Asia-Pacific meetings to learn more about their negotiation mechanisms. Many experts believed that although China did not actively participate in the meetings during this period, its presence nevertheless enabled it to realize that these institutions were largely operating independent from Washington's influence<sup>31</sup>. In fact, Sohn argued that the United States and other western nations seemed to have largely ignored the presence of these fledgling regional networks.

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<sup>29</sup> Sohn, 2008

<sup>30</sup> Shambaugh, 2004

<sup>31</sup> Wannadi, 1996 and Sohn, 2008



This discovery enlightened China to a potential power vacuum, which in turn facilitated the evolution of China's perception of such organizations in a relatively short period of time from suspicion, to reserve, to open support. By 1999, China had begun to actively participate in a range of regional multilateral institutions, including the ASEAN Plus Three Forum<sup>32</sup>.

Upon China's initiation into the ASEAN Plus Three Forum, it sought to solidify its relationships with the ASEAN countries by quickly and peacefully resolving border disputes and establishing a collective regional security network. In 2002, it signed the Declaration on Conduct in the South China Sea, which officially ended most of the disputes regarding territorial claims in the region<sup>33</sup>. At the 2003 summit, China became the first non-ASEAN country to formally accede to the ASEAN's Treaty of Amity and Cooperation, thus committing itself to the principles of nonaggression and noninterference<sup>34</sup>.

Few scholarly works have been able to pinpoint the exact reasons behind China's sudden shift in attitude regarding its claim over the South China Sea. One possibility is that as China's economic development progressed and its appetite for raw material widened, it might have discovered more efficient and less diplomatically damaging ways of securing raw materials than laying claims to other countries' territories. It has become more evident in recent years that China's foreign aid policy is

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<sup>32</sup> Sohn, 2008

<sup>33</sup> Shambaugh, 2004

<sup>34</sup> Ibid

inevitably tied to its design to secure raw materials and natural resources. Many scholars have pointed out that China's aid packages to developing countries were often offered in return for secured rights to extract raw materials. This claim is backed by the fact that China's strongest bilateral ties are formed with countries that are rich in natural resources<sup>35</sup>. This could signify a change in central policy from an emphasis on owning resources to securing uncontested supply of resources.

Military and security matters aside, it was China's leadership role in fostering regional economic cooperation that truly attested to the engagement school's theory of interdependence. The efforts began with the "Joint Statement on East Asian Cooperation" in 1999, which set up a wide range of cooperation mechanisms including the annual ASEAN Plus Three Economic and Finance Ministers' Meetings<sup>36</sup>. More prominently, along the same line of post-financial crisis initiatives came the Chiang Mai Initiative (CMI). CMI was created largely as a response to the Asian countries' collective dissatisfaction with the IMF's lack of support during and following the Asian Financial Crisis. Prior to the conceptualization of the CMI and on the heels of the 1997 financial crisis, Japan proposed the establishment of the AMF, a regional fund intended to reduce Asian countries' dependence on the IMF in future crisis situations. The proposal failed, however, partially due to Chinese opposition. Alternatively, China suggested a framework of financial cooperation mechanism based on bilateral currency swaps.

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<sup>35</sup> See: Alterman, J., et. al. (2009). "Chinese Soft Power and Its Implications for the United States." Center for Strategic and International Studies and Lum, et. al., 2009.

<sup>36</sup> Wong, 2007

Currency swaps allowed trading partners to conduct bilateral trade with their native currencies while bypassing the U.S. dollar. This option proved extremely attractive to emerging economies in the wake of financial crisis as global trade contractions put heavy pressures on their U.S. dollar reserves<sup>37</sup>. China's suggestion subsequently evolved into a package of sixteen renewable three-month bilateral swap arrangements aimed to strengthen policy dialogue and establish a credit facility to help member countries overcome short-term balance of payments difficulties<sup>38</sup>. This package of currency swaps collectively formed the CMI in 2000.

Following the success of the first round of swaps, ASEAN Plus Three decided to double the scope of the arrangements in 2005 to a total value of \$60 billion<sup>39</sup>. The new agreements further expanded the ability for ASEAN countries and the Republic of Korea to borrow from China and Japan. Some have argued that the funding mobility provided by the CMI is much more generous than the IMF quota for most ASEAN countries<sup>40</sup>.

In addition to the bilateral swap arrangements, the CMI also outlined a broad set of objectives for financial cooperation that involves policy dialogues, monitoring capital flows and reforming financial structures. For example, the ASEAN Plus Three launched a regional surveillance mechanism called the Economic Review and Policy Dialogue aimed to pinpoint the financial and economic vulnerabilities among member states and

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<sup>37</sup> Murphy, M., Wen Jin Yuan (2009). "Is China Ready to Challenge the Dollar?" Center for Strategic and International Studies.

<sup>38</sup> Ibid

<sup>39</sup> Henning, R. (2009). "The Future of the Chiang Mai Initiative: An Asian Monetary Fund?" Peterson Institute for International Economics.

<sup>40</sup> Ibid

bring about a better understanding on the conditions under which the swaps would be beneficial<sup>41</sup>. Such policy coordination made CMI more than simply a short-term funding relief mechanism and led some scholars to postulate that it has the potential to develop into a more comprehensive facility that could lead to exchange rate cooperation and monetary integration in the region in the long run<sup>42</sup>.

In fact, there have already been developments since the CMI that facilitated the establishment of more permanent institutions to address Asia's long-term financial stability. In May 2008, the finance ministers of the thirteen countries announced progress toward agreeing on "rigorous principles" governing a common regional fund to better address the concerns brought up in Chiang Mai. Subsequent negotiations led to the creation of the Asian Bond Fund (ADF)<sup>43</sup>. Originally valued at \$80 billion, the fund doubled in size after participating nations agreed to step up on contributions in light of the new financial crisis. As the fund's primary contributors, China and Japan both agreed to shoulder 32 percent of the financing<sup>44</sup>. The creation of the ADF, especially viewed in light of the previous failure of the AMF, reflects significant improvements in the negotiation and coordination capabilities of the ASEAN Plus Three and more importantly, lays foundation for cooperative rather than competitive relationship between China and Japan.

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<sup>41</sup> Henning, 2009

<sup>42</sup> McKinnon, R., Gunther Schnabl (2004). "The East Asian Dollar Standard, Fear of Floating, and Original Sin." *Review of Development Economics* 8(3): 331-360.

<sup>43</sup> Henning, 2009

<sup>44</sup> "Key Asian Nations Sets up \$120b Crisis Fund." *China Daily* (May 3, 2009).

The fact that the CMI materialized out of China's initial proposal is significant. Among all Asian countries, China holds the largest pool of foreign reserves and faces the least short-term balance of payment concerns. The swap arrangements thus have more value to ASEAN than to China. The fact that China actively pursued the CMI indicates its recognition of the importance of regional financial stability. Much like what the engagement school predicted, China's own economic stability invariably depends on the economic stability of the region. It would be hard for China to benefit, in the long run, from the collapse of markets of its suppliers and consumers. To further attest to this interdependency, many Asian countries have again employed bilateral swap arrangements in response to the recent financial crisis. The Japan-Korea swap grew from the equivalent of \$3 billion to \$20 billion. A new China-Korea swap worth \$26 billion was subsequently announced in 2008. Swaps between China, Malaysia, and the Philippines were also renewed and expanded<sup>45</sup>. Moreover, China's financial engagement has endeavored beyond Asia to include ever bigger agreements with Argentina and Brazil, both of which are China's key suppliers of natural resources<sup>46</sup>.

## **V. ACFTA—Background**

In November 2000, Chinese Premier Zhu Rongji convened with representatives from Japan, the Republic of Korea, and all ten ASEAN nations at the ASEAN Plus Three Summit. It was at this summit that Zhu first proposed the establishment of a free trade

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<sup>45</sup> Henning, 2009

<sup>46</sup> Murphy and Yuan, 2009

area (FTA) encompassing China and the ASEAN nations. This proposal will later formally evolved into ACFTA. The proposal for ACFTA marked the first time since the establishment of CMI in which China actively undertook the leadership role in the formation of a new regional economic collaborative. At the meeting, Zhu substantiated his initial vision with a proposal to create an expert group under the framework of the China-ASEAN Joint Committee of Economic and Trade Co-operation to examine the feasibility of the FTA<sup>47</sup>.

Encouraged by favorable recommendations from the expert group, China resumed its push for the FTA the following summer at a meeting of senior ASEAN and Chinese economic officials in Brunei. This time, China was prepared to supply more concrete provisions regarding the FTA, including details on tariff reductions and a timeline for the implementation process. This original timeline called for a seven-year phase-in period starting in 2003. China's assertiveness in the proposal process and the rapid pace of negotiation clearly left ASEAN countries unprepared and skeptical. As a result, China's enthusiasm was initially met with only lukewarm responses from ASEAN, which countered by proposing a ten-year phase-in period but declined to commit to a specific starting date<sup>48</sup>.

Had China been rebuffed by ASEAN's lack of enthusiasm and commitment, the establishment of the FTA would have been aborted, or at the very least, delayed. However, China surprised its ASEAN counterparts by introducing a revised proposal at

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<sup>47</sup> Sheng, 2003

<sup>48</sup> Ibid

ASEAN-China Summit in November 2001, a mere three months after the last round of failed negotiations. Premier Zhu was once again the Chinese spokesman at the summit, bringing with him a proposal that fully reflected China's willingness to compromise. This revised version included a ten-year phase-in period as desired by ASEAN with a negotiable starting date. In addition, to reassure ASEAN of China's commitment, China offered to open its own market in certain key sectors five years before ASEAN reciprocate. Finally, China agreed to grant additional preferential tariff treatment on some goods from the four least developed ASEAN countries: Laos, Cambodia, Myanmar and Vietnam<sup>49</sup>.

The concessions from China succeeded in compelling ASEAN to reconsider the proposed FTA in a more serious and timely manner. Following several rounds of intense consultation with China on the issue, ASEAN finally accepted the proposal at ASEAN-China Summit in Cambodia in November 2002. Under the final agreement, China and six ASEAN countries would gradually open up their markets and eliminate most tariffs by 2010. The four least developed ASEAN countries, Laos, Cambodia, Myanmar and Vietnam, would be granted five additional years to implement the changes. In addition, China agreed to accord the three non-WTO ASEAN members—Vietnam, Laos and Cambodia—the most-favored-nation status. This entitled the non-WTO members to the same treatment as WTO members in guaranteeing them the lowest applicable tariff rate<sup>50</sup>. The Framework Agreement on ASEAN-China Comprehensive Economic Co-Operation

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<sup>49</sup> Sheng, 2003

<sup>50</sup> Ibid

was signed at the summit to serve as a legal instrument governing future ASEAN-China economic cooperation. From here on, China and ASEAN would be spending the next several years negotiating the details on the trade liberalization policy in each micro-sector.

## **VI. ACFTA—The Trade Impact Debate**

From its inception in November 2000 to its conclusion in November 2002, the negotiation process behind ACFTA took roughly two years. On a first glance, especially in light of ASEAN's passive stance throughout the majority of the process, it would appear that China formalized and pushed through the FTA at incredible speed. Under a closer look, however, ACFTA was a result of long-time planning on the part of Chinese policy makers executed at a well-timed strategic moment.

Scholars have differing opinions regarding the motivations behind the creation of ACFTA. This in turn leads to diverging opinions on the actual economic impact of the FTA. These diverging opinions can be roughly grouped into three categories. The first group of scholars place high emphasis on the potential for further trade liberalization and economic cooperation in East Asia. Their attitude toward ACFTA is best described as hopeful optimism. The second group of scholars hold concerns over East Asia's emerging trend of regionalism and cautions against its hasty departure from engagement in international multilateral institutions such as the IMF and WTO. The last group of scholars harbor the most skepticism toward ACFTA. They are concerned with the



political motivations behind the establishment of ACFTA and openly doubt its economic value. The paper will first present these competing claims before applying the gravity model on the trade data to empirically test for ACFTA's economic impact.

Some have credited China's initial conceptualization of ACFTA to Thailand's effort to establish a special economic zone with China's southern provinces in 1995<sup>51</sup>. A special economic zone functions similar to an FTA in that economic laws are relaxed in certain regions to promote trade and attract foreign direct investment. Essentially, it can be viewed as a less formal and more regionalized version of an FTA.

Even before the Thai initiative, however, China had already been experimenting with special economic zones within its borders in selective cities and provinces. Indeed, throughout the 1990s, more and more discussions among Chinese scholars seemed to favor the establishment of additional special economic zones along China's coast and the Yangtze River and Pearl River delta regions<sup>52</sup>. Following the economic successes of several such zones in the early 1990s, most prominently the Pudong New Zone in Shanghai, the State Council's attitude toward selective economic liberalization became more embracing. As a result, fifteen new free-trade zones, thirty-two state-level economic and technological development zones, and fifty-three new and high-technology industrial development zones were established in medium- to large-sized cities since the mid-1990s<sup>53</sup>. These trade liberalization policies within China provided a

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<sup>51</sup> Sheng, 2003

<sup>52</sup> Chirathivat, S. (2002). "ASEAN-China Free Trade Area: Background, Implications and Future Development." *Journal of Asian Economics* **13**: 671-686.

<sup>53</sup> Ibid

healthy foundation for its later efforts to extend similar policies beyond its national borders.

The ever-changing landscape of international trade and the ever-increasing interdependency of the East Asian economies prompted China to take its economic liberalization to a new level. Experts on the trade relationship between ASEAN and China offer several sound reasons as to why economic cooperation within the region is desirable. One key reason for cooperation lies in the fact that bilateral trade between China and ASEAN has been rising consistently over the years. By the early 2000s, the ASEAN-China trade totaled around US \$40 billion, placing ASEAN as China's fifth largest trading partner and in return, China as ASEAN's sixth largest trading partner<sup>54</sup>. The benefit of reduced trade barriers is thus evident. In addition, several studies have analyzed the potential for further expanding the trade linkages between the two regions<sup>55</sup>. These studies all conclude that the ASEAN-China trade has great potential for growth, especially in light of the fact that despite rapid economic development in both regions, they continue to look to the developed world as the primary destination for their exports. These findings support the creation of ACFTA and predict its positive impact on free trade in the region.

On the other hand, some scholars have argued that East Asia as a whole would

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<sup>54</sup> Tongzon, J. (2005). "ASEAN-China Free Trade Area: A Bane or Boon for ASEAN Countries?" The World Economy **28**(2): 191-210.

<sup>55</sup> See: Tang and Wang (2006). "An Analysis of Trade Potential between China and ASEAN within China-ASEAN FTA," University of International Business and Economics and Roberts, B. A. (2004). "A Gravity Study of the Proposed China-ASEAN Free Trade Area." The International Trade Journal **18**(4): 335-353.

benefit more from engagement in preexisting international multilateral institutions such as the IMF, GATT and WTO than the formation of a lattice of regional FTAs. They claimed that the trend towards bilateralism and regionalism as embodied in regional FTAs undermined the concept of multilateralism, uniformity, and nondiscriminatory practices—elements key to the success of multilateral institutions<sup>56</sup>. Despite the strengthening trade relationship among East Asian countries over the years, East Asia still depended more heavily on world trade as opposed to intra-regional trade compared to other major regional trading blocs in the world. As of 2002, when ACFTA was approved, 60 per cent of the European Union's (EU) total trade resulted from trade among EU members. Along the same lines, intra-NAFTA trade comprised 46 per cent of the total trade of NAFTA members<sup>57</sup>. In contrast, intra-regional trade only totaled 33 per cent of total trade in East Asia in 2002. East Asia's more outward-oriented trade model seemed to suggest that it would benefit more from openness to international trade and nondiscriminatory practices as opposed to preferential regional trade agreements. The establishment of ACFTA in November 2002 shortly following China's induction into the WTO in December 2001 then seemed to require additional justification.

When one takes a closer look at the history of East Asia's involvement in trade agreements, it becomes evident that the trend of regionalism only surfaced in the late 1990s, coinciding with a slowdown in multilateral WTO negotiations and the stall of the

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<sup>56</sup> Desker, B. (2004). "In Defence of FTAs: from Purity to Pragmatism in East Asia." The Pacific Review 17(1): 3-26.

<sup>57</sup> Ibid

Doha Round. In December 1999, the WTO Ministerial Conference met in Seattle to launch a new round of global trade negotiations with key focuses on extending trade liberalizations, strengthening anti-dumping reinforcement mechanisms, and achieving substantive agricultural liberalization. Representatives at the meeting failed to reach a consensus on any of the key issues on the agenda. A group of developing countries led by India, Pakistan and Egypt fought adamantly against further trade liberalizations. The United States was unwilling to step up on the implementation of anti-dumping measures while the EU and Japan maintained their well-known stance against agriculture liberalization<sup>58</sup>. This marked the beginning of a series of failed negotiations at the WTO which culminated in the collapse of negotiations at the 2003 Doha Round in Cancún.

The slowdown in WTO negotiations alone would provide some justifications to East Asia's drift toward regionalism. However, the stalemate at the WTO happened to coincide with the aftermath of the Asian Financial Crisis. The economic devastation caused by the Asian Financial Crisis of 1997 could be compared to the effect of the Great Depression of the 1930s on the United States. Indonesia, Thailand and South Korea, being the countries most dependent on foreign direct investment, were among the worst affected economies. Following the onset of the crisis, all three countries looked to the IMF for aid. The IMF took this opportunity to obtain unilateral market liberalization guarantees from the aid recipients, forcing them to further open up their already fragile investment markets. This led to the foreign takeover of many leading domestic

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<sup>58</sup> Desker, 2004

businesses<sup>59</sup>. The regional economic hardship and the seemingly opportunistic responses by the IMF caused the East Asian countries to reconsider the benefit of regional economic cooperation. In fact, prior to the crisis of 1997, East Asia only had one FTA—the ASEAN Free Trade Area (AFTA). After the crisis, a proliferation of FTA negotiations came into motion, resulting in a lattice of FTAs including the *Agreement on New Zealand-Singapore Closer Economic Relations*, the *Japan-Singapore Economic Partnership Agreement*, and ACFTA<sup>60</sup>. Scholars advocating for multilateralism argued that these regional trade agreements would be conducive to free trade only if they operated within the framework of the WTO.

Lastly, some skeptics of ACFTA believed that China's proposal of ACFTA originated from its anticipation for future economic competitions with ASEAN following its entry into the WTO in 2002. Lijun Sheng argued that China was particularly concerned that international forces would exaggerate the impact of the economic competition and drive a wedge into the China-ASEAN relationship. By making economic concessions through ACFTA, China sent out a signal of goodwill at minimal cost to its own economy, thereby pre-empting future problems<sup>61</sup>. If concerns for international relations were truly the main motivation behind the establishment of ACFTA, the FTA would serve minimal trade creation purposes.

As an additional argument to the assertion that ACFTA may not function as

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<sup>59</sup> Desker, 2004

<sup>60</sup> Dent, 2005

<sup>61</sup> Sheng, 2003

effectively in reality as on paper, some scholars claimed that the exclusion of Japan and the Republic of Korea from the membership significantly detracted from ACFTA's economic value<sup>62</sup>. Given the stronger degree of economic complementarities as opposed to competitiveness between China, Japan, and the Republic of Korea, an FTA with the latter two countries would have more trade creation value. Whereas an FTA with Japan and the Republic of Korea would benefit China in forms of the technology transfer, an FTA with ASEAN would almost certainly favor ASEAN and could potentially widen China's trade deficit<sup>63</sup>. Christopher Dent further pointed out that politico-diplomatic competition seemed to be a driving force behind Japan and China's FTA policies<sup>64</sup>. FTAs that resulted from such "competitive bilateralism" would not be as effective in promoting free trade and economic cooperation.

## **VII. ACFTA—Gravity Model**

The only way to test the merits of the competing claims on the trade impact of ACFTA is through actual study of the empirical trade data. The following sections will introduce the statistical model used in this study, explain the construction of the variables, and give an in-depth discussion on the empirical results.

### **i. Statistical Model**

The basic model used in this paper to evaluate the economic impact of ACFTA is

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<sup>62</sup> Lum, et. al., 2009

<sup>63</sup> Sheng, 2003

<sup>64</sup> Dent, 2005

the gravity model of trade. The model predicts bilateral trade flows based on the economic sizes and distance between the trading partners. It was first applied to international trade by Dutch economist Jan Tinbergen in 1962<sup>65</sup>. The model is renowned for its empirical robustness and has since been used on various occasions to evaluate the effects of multilateral trade agreements both ex ante and ex post<sup>66</sup>.

The basic form of the gravity model takes on the form:

$$TF_{ij} = G \frac{M_i M_j}{D_{ij}}$$

where  $TF_{ij}$  represents trade flow between countries  $i$  and  $j$ ;  $M_i$  and  $M_j$  stand for the economic mass of each country;  $D_{ij}$  stands for the distance between the two countries and  $G$  is a constant. Based on the layout of this model, the amount of trade between two countries should be positively correlated with the product of their economic sizes and inversely correlated with the distance separating them.

Aside from the basic information on economic size and distance, additional variables can be incorporated into the model to account for different economic scenarios. In this study, three additional control variables, two intermediate variables and one test variable are added to the standard gravity model. These variables are then regressed against the data on trade flows using an Ordinary Least Squares (OLS) regression.

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<sup>65</sup> Roberts, 2004

<sup>66</sup> See: Rose, A. K. (2004). "Do We Really Know That the WTO Increases Trade?" American Economic Review **94**(1): 98-114; Goldstein, et. al. (2007). "Institutions in International Relations: Understanding the Effects of the GATT and the WTO on World Trade." International Organization **61**(1): 37-67 and Roberts, 2004.

ii. Data

Two sets of countries were included to construct the data set used to estimate the gravity model. The ten ASEAN countries involved in the FTA make up the experimental group. In addition, eight other Asian countries outside of ACFTA were randomly selected to form the control group. The complete list of countries involved in this empirical study is provided in Appendix I. Trade data in relation to China, distance from China, and annual GDP data for all eighteen countries were collected. The data set spans from 1990 to 2008. In addition to the traditional elements included in a basic gravity model—GDP and distance—the main data table also included a list of other factors that have plausible contributions to trade patterns in order to create a more controlled environment. These factors include: membership in ACFTA, preferential status within ACFTA, membership in WTO, geographical proximity to China, access to sea, and presence of common language. The overall model can be described by the following pair of equations:

$$\begin{aligned} \log(X_j) = & \alpha_0 + \alpha_1 \log(GDP_i \cdot GDP_j) + \alpha_2 \log(Dist) \\ & + \alpha_3 Member + \alpha_4 Effective + \alpha_5 (Member \cdot Effective) \\ & + \alpha_6 WTO + \alpha_7 Neighbor + \alpha_8 Landlock + \alpha_9 Language \end{aligned} \quad (1)$$

$$\begin{aligned} \log(M_j) = & \beta_0 + \beta_1 \log(GDP_i \cdot GDP_j) + \beta_2 \log(Dist) \\ & + \beta_3 Member + \beta_4 Effective + \beta_5 (Member \cdot Effective) \\ & + \beta_6 WTO + \beta_7 Neighbor + \beta_8 Landlock + \beta_9 Language \end{aligned} \quad (2)$$

The paper will now provide a brief description on the definition and construction of each variable involved in the above equations.



### *Measures of Trade*

Data on bilateral trade are obtained from the IMF's *Direction of Trade Statistics* (DOTS). Import is denoted with the variable  $M$ ; export is denoted with the variable  $X$ . All import and export data are taken from the perspective of China. Hence, the index on the variables  $M$  and  $X$  refer to China's trading partner. It is an international convention for countries to exclude the cost of insurance and freight (c.i.f.) in their export figures but include such fees in import figures. Since all trade data are collected from China's point of view, there exist some minor discrepancies in the method for calculating imports and exports—namely, import are calculated with c.i.f. but exports are calculated without.

The choice to record all data from the perspective of China came out of consideration for both consistency and convenience. Not all countries follow the international convention in recording their imports and exports. Choosing to substitute China's import figures with the corresponding trading partner's export figures does not necessarily guarantee the exclusion of c.i.f.. It is therefore more consistent to record all export data with c.i.f. and all import data without. More importantly, the systematic inclusion of c.i.f. in import figures should have minimal impact on the results of the empirical analysis. The difference in data caused by the difference in calculation method should be small. There is also no reason to believe this small difference would lead to any significant changes in the patterns of trade.

### *Size and Distance*

The variable of economic size in the gravity model is estimated with GDP in this

study. GDP data is obtained from the 2009 edition of the World Bank's *World Development Indicators*, which lists GDP data in terms U.S. dollars for most countries in the world from 1960 to the present. The  $GDP_i \cdot GDP_j$  term in the equations refers to the product of the GDPs between country i, which is by default China throughout this study, and country j, which represents China's trading partner.

Distance is reflected by the *Dist* variable in the model and is defined as the shortest air travel distance from the geographical center of China to that of its trading partner as estimated by Google Map.

#### *Variable of Interest*

The goal of the study is to determine if membership in ACFTA is indeed a significant factor in shaping the pattern of trade. To construct the variable of interest, two intermediate variables—*Member* and *Effective*—were used. *Member* is a dummy variable reflecting a country's membership status in ACFTA. It is coded as "1" for members and "0" for nonmembers. *Effective* is another dummy variable specifying whether ACFTA is in effect. The data set contains trade data from 1990 to 2008 whereas ACFTA became effective in late 2002. Hence, only entries from member countries after 2002 receive a "1" in this variable. The variable of interest, *Member·Effective*, is the product of the variables *Member* and *Effective*. The ACFTA effect only becomes active for member countries after 2002. In other words, the desired effect only presents itself when *Member·Effective* equals to 1.

### *Other Control Variables*

The *WTO* variable takes on the value “1” when the country in question is a member of the WTO. This variable may differ for the same country across the time span of the study depending on when the country officially obtained WTO membership. By default, all entries under this variable are “0” prior the organization’s creation in 1995.

The *Neighbor* variable takes into account the geographical proximity of the country of interest with respect to China. Countries that share a land border with China receives a “1” in this column. Otherwise, this variable takes on the value “0.”

*Landlock* is a dummy variable used to gauge a country’s access to sea. It is coded as “0” for a completely landlocked country and “1” otherwise.

Lastly, *Language* reflects whether the country of interest has Mandarin Chinese as one of its official or recognized languages. If so, the variable takes on the value “1.” Otherwise, it takes on the value “0.”

### *Preliminary Expectations*

Based on the underlying theory behind the gravity model, the coefficient on the  $GDP_i \cdot GDP_j$  term is expected to take on a positive sign while the coefficient on the *Dist* variable is expected to be negative. Moreover, membership in the WTO, neighbor status and shared language are all factors that intuitively should boost trade. It is therefore expected that the coefficient on these variables should be positive. On the contrary, a land-locked country faces higher transaction cost, which is a hindrance to trade. Taken into consideration the way the *Landlock* variable is coded—a completely land-locked

country is coded as “0”—the coefficient on this variable is also expected to be positive.

The coefficient on the *Member-Effective* variable should offer some insight on the trade creation value of ACFTA. Assuming the other control variables are sufficient to account for the other factors that influence trade overtime, the *Member-Effective* variable should be picking up the signals specific to the implementation of ACFTA. While examining the coefficient on this variable alone would not produce a definitive conclusion on the economic value of ACFTA, a positive and significant coefficient would offer support to the claim that ACFTA has indeed led to more economic liberalization and cooperation between China and ASEAN.

### iii. Empirical Results

Export data between China and the ten ASEAN countries as well as the eight control countries are regressed against the eight variables defined in the previous section in a standard OLS model according to Equation 1. The test statistics, along with their corresponding standard errors and t Ratios are listed in Table 1. Given the large size of the data set, any statistic with a absolute t ratio above 1.96 is statistically significant at the 5% level. Test statistics which are significant at the 5% level or above are marked with an asterisk in the table.

Coefficient	Term	Estimate	Std Error	t Ratio
$\alpha_0$	Intercept	-0.0096	2.1376	-0.00
$\alpha_1$	<i>Log (GDP<sub>i</sub>:GDP<sub>j</sub>)</i>	1.0475	0.0386	27.13*
$\alpha_2$	<i>Log (Dist)</i>	-0.5843	0.2739	-2.13*
$\alpha_3$	<i>Member</i>	-0.4555	0.0835	-5.45*
$\alpha_4$	<i>Effective</i>	0.0229	0.1019	0.22
$\alpha_5$	<i>Member-Effective</i>	0.0012	0.1244	0.01
$\alpha_6$	<i>WTO</i>	0.0257	0.0776	0.33
$\alpha_7$	<i>Neighbor</i>	-0.4410	0.0789	-5.59*
$\alpha_8$	<i>Landlock</i>	0.7271	0.1233	5.90*
$\alpha_9$	<i>Language</i>	-0.7397	0.1399	-5.29*

Table 1: test statistics on export data regressed according to Equation 1.

A preliminary study of the test results indicate that with a few exceptions, most of the coefficients on the control variables carry the expected sign. China exports more goods to countries with higher GDP ( $\alpha_1 > 0$ ). Its export volume decreases with increasing geographical distance between itself and its trading partner ( $\alpha_2 < 0$ ). These two coefficients are both highly statistically significant, in line with the layout of the gravity model which implies that trade increases with increasing economic size of the trading partner and decreases with increasing geographical distance between the trading partners. In addition, the coefficient on the *WTO* variable, albeit statistically insignificant, does carry the expected sign ( $\alpha_3 > 0$ ). Countries with easy access to sea, as reflected by the coefficient  $\alpha_8$ , does indeed conduct more trade with China.

The effects of two control variables turned out contrary to expectations.  $\alpha_7$ , which captures the effect of neighbor status in export, is negative and statistically significant. This suggests that China actually exports less to its neighbors than to the rest of the Asian countries included in the study. A closer inspection of the economic landscape of Asia actually suggest this finding is justifiable.

Of the eighteen countries included in the study, seven borders on China. Among

which, three are members of ASEAN. Coincidentally, these three countries—Laos, Myanmar and Vietnam—are the three least economically developed members of ASEAN. The remaining four non-ASEAN neighbors of China are Bhutan, India, Nepal, and Pakistan. Bhutan and Nepal are both land-locked countries and rank among the smallest economies in Asia. It has already been established that land-locked countries face high transaction costs that inhibit trade. Pakistan bears the least cultural resemblance to China among the eighteen countries surveyed. This no doubt also serves as an inhibitor of trade. Overall, six out of seven of China's neighbors have specific qualities that serve as barriers to trade. On the other hand, the remaining ASEAN countries, as well as the most developed Asian economies (ie. Japan and the Republic of Korea), do not share a border with China. Given China's strong economic ties with ASEAN, Japan, and the Republic of Korea, it is then not entirely implausible that neighborhood status fails to become a propeller of trade in this particular instance.

The negative coefficient on the *Language* variable is more difficult to explain. Of the eighteen countries included in the data set, only one country—Singapore—shares a common language with China. This hardly forms a large enough sample to properly test the effect of this variable. The negative and statistically significant statistic could well be a coincidence. Given the circumstances, another set of regressions are performed which excluded the *Language* variable. However, the results from this second set of regressions do not differ significantly from the results listed in Table 1 and therefore will not be discussed in detail here. Results from those regressions are shown in Appendix II.

The variable of interest that measures the trade creation impact of ACFTA is *Member-Effective*. Unfortunately, the coefficient on this variable, although positive, is statistically insignificant and fails to offer any insight on whether the creation of ACFTA is correlated with an increase in export from China to ASEAN. It is also worth noting that the *Member* and *Effective* variables are present solely for the construction of the variable of interest. The coefficients on these two variables, consequently, do not bear any real significance.

Table 2 lists the relevant test statistics on the import regression. The construction of the OLS model used here bears strict parallel with the one discussed above. The only difference lies in the fact that import data replaces export data as the response variable, as shown in Equation 2. The signs and levels of significance on most coefficients mirror the ones from Table 1. The rationales behind these findings have already been discussed and will not be repeated here.

Coefficient	Term	Estimate	Std Error	t Ratio
$\beta_0$	Intercept	-14.5955	3.2660	-4.47*
$\beta_1$	$\text{Log}(GDP_i/GDP_j)$	1.4860	0.0596	24.95*
$\beta_2$	$\text{Log}(Dist)$	0.5497	0.4183	1.31
$\beta_3$	<i>Member</i>	-1.0999	0.1281	-8.59*
$\beta_4$	<i>Effective</i>	0.4940	0.1574	3.14
$\beta_5$	<i>Member-Effective</i>	-0.3199	0.1907	-1.68
$\beta_6$	<i>WTO</i>	0.0947	0.1185	0.80
$\beta_7$	<i>Neighbor</i>	-0.7727	0.1199	-6.45*
$\beta_8$	<i>Landlock</i>	0.5088	0.1878	2.71*
$\beta_9$	<i>Language</i>	-0.6498	0.2125	-3.06*

Table 2: test statistics on import data regressed according to Equation 2.

Two things are worth additional attention regarding Table 2. First, the coefficient on the  $\text{Log}(Dist)$  variable is now positive and statistically insignificant. This fails to reflect the basic layout of the gravity model. There is no clear reason to explain why

greater physical distance fails to correspond to reduced import in this case. However, given that the data set contains only information regarding Asian countries, there is not a lot of variation in the distance variable. Most surveyed countries fall within a 2000 to 4000 kilometers distance range from China, which translates to very small variations when the data is logarithmically transformed. It is possible that there are more extraneous signals impacting imports than exports and the weak signal is masked by other factors in this regression.

More intriguingly, the coefficient on the *Member-Effective* variable is now negative with a t ratio of -1.68. While the t ratio is statistically insignificant at the 5% level, it becomes significant at a less rigorous 10% level. The following section will provide more in depth analysis on the significance of this finding.

### **VIII. Analytical Discussion**

As discussed above, the coefficients on the *Member-Effective* term in both the import and export regressions are statistically insignificant at the 5% level. This means the study fails to produce substantive evidence for or against the claim that ACFTA has significant real economic value.

Given the time span of the data set and the timeline for the implementation of ACFTA, the lack of a definitive finding is not entirely surprising. As mentioned before, China and six ASEAN countries will fully implement ACFTA policies by the end of 2010 while the four remaining ASEAN countries will have until 2015 to implement said



policies. The most recent data on the trade flows in East Asia from the IMF dates to 2008. This means while the study utilizes all available information, it is only able to include six-years worth of data since ACFTA's initial implementation in late 2002—a relatively small and unreliable sample to draw strong inferences upon.

Moreover, while the nominal implementation process for ACFTA began in late 2002, negotiations on the details of the agreements regarding the opening of each micro-sector went on for the next several years. For example, the negotiation on industrial trade liberalization was scheduled for completion in June 2004 but failed to come through due to disagreements regarding the composition of a list of “sensitive items” to be excluded from the agreement. It was not until early 2005 that China and ASEAN were able to commence the elimination of tariffs on non-sensitive industrial products<sup>67</sup>. In fact, only a few sectors had achieved advanced degrees of liberalization by 2008.

Putting the stalemates in the negotiation process aside, some effects of trade liberalization only become observable after the FTA has been fully implemented. This means ACFTA may not achieve its full potential until after 2015. Previous studies on the economic impact of NAFTA and EU point to ramifications of evaluating the economic impact of a FTA several years prior to its full implementation. This study, therefore, is examining the FTA mid-way through its implementation process and can thus only gauge the initial impact of the first round of trade liberalizations.

In addition, there are two key aspects to the economic impact of an FTA—the

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<sup>67</sup> Dent, 2005

trade creation impact and the foreign direct investment impact. In other words, trade liberalization policies not only promote trade within the region but also make the regional more attractive to foreign investors. Given the level of importance East Asian economies place on foreign direct investment, there is little doubt that ACFTA aims to promote both objectives. The gravity study here only captures ACFTA's impact on regional trade. It does not touch on its impact of foreign direct investment, which contributes to a significant portion of ACFTA's economic value.

With that said, the negative coefficient on the *Member-Effective* variable in the import regression shown in Table 2 does still call for some explanation. While the coefficient is statistically insignificant at the 5% level, it is significant at the 10% level. This reflects a weak trend in the data indicating that Chinese imports from ASEAN has been decreasing since the passage of ACFTA—a trend that goes against the trade creation theory of FTAs. However, it is important to realize that this weak evidence does not imply ACFTA is the cause to the decrease in trade. In fact, while there is no immediate explanation to why ACFTA would reduce Chinese import from ASEAN, there are a number of reasons that can account for this decrease in import volume without implicating ACFTA.

First, over the past decade, China has been aggressively pursuing its export-oriented economic policy, widening its trade surpluses with most of its trading partners by both pushing up its export levels and constraining its import in most sectors aside from raw materials. The *Member-Effective* coefficient may be picking up residual signals

from this general trend of import contractions. Moreover, as China became more and more dominant in the low to medium-low level manufacturing exports sector, its appetite for raw materials grew. Evidence suggests China is increasingly turning toward Latin American and African countries for cheap supplies of raw materials, sometimes using strategic foreign aid packages as leverage. This diverted trade away from ASEAN.

While the gravity model fails to offer any significant input on the trade creation value of ACFTA, a closer look at several already implemented policies does seem to support the claim that ACFTA is contributing to actual trade liberalization at least in select sectors. One of the first realized element of ACFTA was the “Early Harvest Programme” (EHP), which remove tariffs on select agricultural and forestry products. In 2005, 5 per cent of the Chinese products under EHP had an applied tariff rate of greater than 15 per cent. By 2006, all these tariffs were scraped<sup>68</sup>. This achievement is especially significant considering the WTO has failed many times in the past to push through agricultural liberalizations on the international level due to opposition from Japan and EU. ACFTA’s regional setting allows China and ASEAN to reach a breakthrough on this particularly tricky subject. In addition to the agricultural sector, similar across-the-board reductions in tariff rates were also observed under the Trade in Goods Agreement, which became effective in July 2005 and covered some 4000 types of goods.

In summary, the coefficients on the variable of interest in the import and export regressions do not provide either supportive or disapproving evidence on ACFTA’s trade

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<sup>68</sup> Tang and Wang, 2006

creation value. Among the factors studied, the economic size of China's trading partner and access to sea seem to be the only two reliable predictors of bilateral trade. Despite its best efforts, there is no way for the study to control every extraneous variable that influenced trade in East Asia over the past two decades, especially given the pace of transformation in the economic landscape of the region during this time period. There is thus a possibility that the study failed to pick up the actual impact of ACFTA among all the other factors influencing trade.

## **IX. Conclusion**

China's leadership role behind the creation of ACFTA serves to reflect the new sophistication and confidence behind Beijing's foreign policy. It demonstrates China's capability of becoming a responsible regional power and contrasts with its earlier antagonistic and narrow foreign policy approaches. This affirms the earlier "engagement school" theory that economic interdependence can serve as a stable incentive in incorporating China into the regional framework. At the same time, however, China is not content with merely being a member of the preexisting regional multilateral institutions. Instead, it seeks to create and reinvent new regional institutions to better serve its economic, political, and foreign policy agendas as well as to assert its role as a rising regional leader. The negotiation behind the CMI and ACFTA no doubt provide valuable experience for China as it prepares take on more responsibilities as a regional leader and forge additional economic bonds with more important trading partners.

Of course, China's avid engagement in regional multilateral institutions and willingness to compromise in certain negotiations do not imply a full acceptance of regional cooperation and integration. It remains aloof and defensive on many issues revolving around security and economic integration. For example, on the matter of currency valuation, China's earlier lack of engagement and preference for bilateral over multilateral negotiations resurface. Some have pointed to its refusal to float its currency as an indication that it may continue to act as a roadblock in regional exchange rate and monetary integration—the logical next step in further regional

economic cooperation<sup>69</sup>. Others refer to China's increasingly skeptical stance toward the U.S. dollar as evidence that China may be promoting East Asia's departure from the Dollar Bloc while seeking to increase the influence of its own currency<sup>70</sup>. In light of these political motivations, one may need to view China's enthusiasm behind the CMI and ACFTA with caution.

Overall, there is still a great amount of uncertainty around the question whether the recent patterns of economic cooperation are indicative of a permanent shift in the basic preferences of the Chinese government that can lead to long-term impact. While the gravity model is not able to provide conclusive evidence on ACFTA's trade creation value, other empirical evidences do point toward actual policy changes on the part of China toward free trade. Whether these changes simply reflect China's reactions to specific economic incentives on a case-to-case basis or a substantive change in the attitude of the CCP towards free trade is a question that warrants an entire new research project. What this paper does accomplish, however, is mapping out the history of China's involvement in regional multilateral institutions and providing original analysis on the motivations behind its transformation. The study of ACFTA, in addition, attempts to provide empirical evidence to quantify the impact of the newly created regional institution. While the results from the empirical study is inconclusive, it nevertheless succeeded in shedding some light on the nature and extent of China's involvement in regional multilateral institutions.

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<sup>69</sup> Makin, A. (2008). "The Inflexible Yuan and Global Imbalances." Global Economy Journal 8(3).

<sup>70</sup> McKinnon and Schnabl, 2004

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## XII. Appendices

### Appendix I: A List of Countries Included in the Study

<b>ACFTA Members</b>	<b>Nonmembers</b>
Brunei	Bangladesh
Cambodia	Bhutan
Indonesia	India
Laos	Japan
Myanmar	Republic of Korea
Malaysia	Nepal
Philippines	Sri Lanka
Singapore	Pakistan
Thailand	
Vietnam	

## Appendix IIA

### Test Results on Export Data Excluding the *Language* Variable

Parameter Estimates				
Term	Estimate	Std Error	t Ratio	Prob> t
Intercept	-3.560531	2.10981	-1.69	0.0924
Log (GDP*GDP)	1.0523203	0.040135	26.22	<.0001*
Log (Dist)	-0.218837	0.275539	-0.79	0.4276
WTO[0]	0.0148051	0.080604	0.18	0.8544
Member[0]	-0.52668	0.085687	-6.15	<.0001*
Effective[0]	0.0321107	0.105937	0.30	0.7620
Member x Effective[0]	0.0010952	0.129296	0.01	0.9932
Neighbor[0]	-0.411079	0.081809	-5.02	<.0001*
Landlock[0]	0.6324047	0.126845	4.99	<.0001*

## Appendix IIB

### Test Results on Import Data Excluding the *Language* Variable

Parameter Estimates				
Term	Estimate	Std Error	t Ratio	Prob> t
Intercept	-17.80608	3.132208	-5.68	<.0001*
Log (GDP*GDP)	1.489157	0.060321	24.69	<.0001*
Log (Dist)	0.8831755	0.409048	2.16	0.0316*
WTO[0]	0.0847522	0.11998	0.71	0.4805
Member[0]	-1.165529	0.127898	-9.11	<.0001*
Effective[0]	0.5012096	0.159373	3.14	0.0018*
Member x Effective[0]	-0.317162	0.193128	-1.64	0.1015
Neighbor[0]	-0.745484	0.121087	-6.16	<.0001*
Landlock[0]	0.4295458	0.188383	2.28	0.0232*