

**THE POLITICS OF CHINA-ASEAN ECONOMIC RELATIONS:  
ASSESSING THE MOVE TOWARDS AN FTA\*\***

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*This paper studies the strategic/diplomatic aspects of China's decision to form a Free Trade Area (FTA) with the Association of Southeast Asian Nations (ASEAN) in November 2001 and associated developments since then. FTA represents one significant step forward in China's economic diplomacy towards ASEAN, considering China's involvement in the various other venues of regional economic affairs. An in-depth reading of the policy rationale contained in the joint ASEAN-China expert study group's report shows that the FTA decision resulted from a largely diplomatic-political imperative on the part of China. Nonetheless, movement towards an FTA came about after studious Chinese efforts to win over ASEAN's trust for the past decade. In proposing the FTA, China pursues two strategic goals: development of its southwestern provinces and competition with Japan in terms of demonstrating leadership in regional economic affairs.*

**Introduction**

In mid-May 2002, one year and a half after Chinese Premier Zhu Rongji surprised his hosts in Singapore with a proposition to form a Free Trade Area (FTA) with all Association of Southeast Asian Nations (ASEAN) economies by 2010, senior economic officials from the Chinese and ASEAN governments progressed to establish a trade negotiating committee. The committee expects to produce a Framework Agreement on ASEAN-China Economic Cooperation for adoption during the 2002 ASEAN-China summit. Given the prevalent practice of face-saving in Asian diplomatic exercises, it is virtually guaranteed that ASEAN and Chinese leaders will accept the Framework

Agreement, which includes a preliminary trade liberalization program of selected products by the year 2004.

These are significant developments. Among other things, its sustained involvement in the global economic activities since the late 1970s notwithstanding, China had been until the FTA initiative with ASEAN more of a follower than a leader when it comes to dealing with rule-based international economic institutions. Although China did not partake in the ASEAN process of regionalism until 1991, it moved ahead of Japan, which has a much longer history interacting with the ASEAN economies at the market, bilateral-governmental, and regional-institutional levels, in moving towards formal integration with all the economies of ASEAN.

Since its re-entry into the world economy in the late 1970s, China has been a beneficiary of the international economic system. In the 1990s, more and more states pursue the strategy of entering into free trade agreements that offer *preferential* terms of trade among its members while *discriminating* against nonmembers. The establishment of the WTO in 1995, whose explicit intent was to strengthen application of the principle of non-discrimination of its member economies, saw a growth in the number of FTAs. By mid-2000 one hundred and fourteen FTAs were in effect. “Virtually all WTO members were partners in at least one [free trade agreement], and many were partners on two or more.”<sup>1</sup> China was one of the few economies outside of FTA arrangements when it joined the WTO.

Globally, the practice of forming regional economic groupings usually falls into two categories. One is the so-called natural integration, which is largely based on economic merits (as is the case of extending the FTA from Canada and the USA to Mexico). The other is the so-called strategic integration, which is based on an imperative to form a strategic alliance against a third party (as is the case of the process of European economic integration).<sup>2</sup> In either case, together with calculations of market rationale, geography, history, and political strategic considerations do matter in the choice of FTA membership.

Why did China choose formal integration with the ASEAN economies as a group? What does China hope to achieve through the FTA arrangement? To address these and related questions, the immediately following section of the paper reviews the

regional trade/investment institutions both China and ASEAN belong to. Then, the paper examines what the China-ASEAN FTA (here after CAFTA) envisioned to be like. The main source for this examination is the final report produced by the joint China-ASEAN expert group on economic integration, whose recommendation was adopted by the political leaders of ASEAN and China during their summit in November 2001. The third section of the paper reviews major developments in China's pursuit of political-economic relations with ASEAN in the 1990s. The purpose for doing so is to illustrate China's efforts to convince ASEAN that its rise in economic power does not pose a threat to latter. ASEAN is a diverse group in terms of economic development and China has proposed to treat them differently. The fourth part of the paper sheds light on China's rationale in so doing by considering its own regional economic development interests: development of southwestern China. In East Asia, Japan has shown an interest in forming its own FTA with ASEAN as well. The fifth part of the paper therefore examines the seeming competition between China and Japan for influence in ASEAN using the FTA as a tool. The last part of the paper summarizes findings about China's motivations in moving towards a CAFTA.

My basic argument is that China's decision to form the CAFTA is more an act of economic diplomacy towards ASEAN than one based on solid economic rationale. In addition, while the FTA program is what the Chinese state chooses to exercise control/influence over the market it also has the potential of complicating China's political relations with ASEAN in the future.

### **Before the CAFTA Proposal: the channels of economic diplomacy in place**

In order to understand the background of the November 2001 announcement of negotiations towards a CAFTA, we should pay attention to several developments. First, the Asia Pacific Economic Cooperation forum (APEC) already incorporates all members of ASEAN economies as well as China. The "open regionalism" principle that guides APEC is what suits ASEAN's twin goal of rendering equal treatment in diplomatic status while at the same time requiring different schedules of commitment to trade liberalization. APEC's large membership and lack of binding power raise serious questions about its

effectiveness as a regional economic institution. The existence of APEC also allows China an opportunity to demonstrate its role in managing economic affairs across the Asia-Pacific. The fact that the Chinese government portrayed the 2001 APEC meeting in Shanghai as a diplomatic success that is comparable with winning the right to host the 2008 Olympics stands as ready testimony to the significance China attaches to APEC. Still, APEC includes the United States and Japan, which are far more powerful than China and thereby poses limits on Chinese influence in the organization.

Second, China is an active member of the ASEAN+3 (China, Japan, and South Korea) forum. Created in December 1997, ASEAN used the forum to solicit assistance and advice from the outside world without having to deal with pressure for managing domestic political affairs that comes with the APEC forum, particularly from the United States. The U.S.-backed International Monetary Fund (IMF)'s controversial handling of the summer 1997 currency crisis in Southeast Asia serves as a painful reminder of incompatibility between structural reform conditions attached to IMF lending and a borrowing government's habits in and/or preferences for conducting domestic economic policies. One of the most significant achievements of the ASEAN+3 forum is establishment of mechanisms for intra-group monetary cooperation such as the Chiang Mai Initiative in 2000. The Initiative makes it possible for China, Japan and South Korea to respond to signs of currency duress in an ASEAN economy on bilaterally agreed terms.<sup>3</sup> As part of the Chiang Mai Initiative, China, Japan, and South Korea have signed bilateral currency swap agreements with each other. This ought to provide some assurance to ASEAN. China and Thailand have reached a currency swap agreement while China-Malaysia and China-the Philippines discussions have been initiated.<sup>4</sup> In short, China is well on its way to institutionalizing its role as a lender to other ASEAN+3 member economies.

Third, inflow of investment capital has greatly contributed to China's sustained high-speed growth for the past decades. Among ASEAN countries, China's capacity to absorb international investment capital is viewed as a direct loss. Even Malaysian Prime Minister Mahathir Mohamad, who persistently maintains that China does not pose a military threat to Southeast Asia, argues that:<sup>5</sup>

China is an economic threat for Southeast Asia. It is already a threat in terms of attracting foreign direct investment, and it is going to be a threat to Southeast Asia's world trade.

Indeed, there is empirical evidence to support such rhetoric of “threat”, which in academic terms reflects little more than market-induced movement of factors of production in the age of economic globalization. According to one recent comparative study of Japanese foreign direct investment (FDI) flows in major manufacturing sectors to China and the ASEAN-4 (Indonesia, Malaysia, Thailand, and the Philippines) over the period 1989 to 2000, China has “replaced the NICs [South Korea, Hong Kong, Taiwan, and Singapore] and ASEAN-4 as the largest Japanese FDI recipient in some sectors, such as machinery and textile.”<sup>6</sup> China’s membership in the World Trade Organization (WTO), then, promises to further align the international division of labor in China’s favor. This is because WTO membership can have the effect of assisting to streamline China’s domestic economic governance and therefore making it possible for the Chinese market to more fully realize its potential. China still holds a comparative advantage over most ASEAN countries in labor, particularly in the low-technology sectors. Having just weathered through the worst period of the financial crisis, ASEAN economies needed more than just verbal assurance from China that the latter’s WTO membership poses no threat to Southeast Asia.<sup>7</sup>

Fourth, with or without WTO membership, the governments of China and ASEAN states have to deal with political-diplomatic ramifications in China’s economic ties with virtually all ASEAN member economies due to the existence of “ethnic Chinese business networks” that connect the ethnic Chinese communities in Southeast Asia and the Chinese mainland.<sup>8</sup> Such networks have existed for hundreds of years. The past two decades of sustained and high-levels of economic growth in China contributed to renewed questions about the impact such networks have on the governing capacities of governments in Southeast Asia.<sup>9</sup> More and more studies have come to interpret the ethnic Chinese businesses and their networks in the institutional background of policy environments in Southeast Asian states, downplaying the explanatory power of ethnic/cultural frameworks.<sup>10</sup> On the other hand, precisely because in Southeast Asia, with a few exceptions, a government’s capacity in affecting the economic and societal

changes within its sovereign boundaries is in question, the linkage role ethnic Chinese businesses play in China-ASEAN economic relations continue to be an issue affecting overall relations between a Southeast Asian state and China.

In modern International Political Economy, these developments can be categorized as part of the state-market dynamics. Although IPE as a body of literature is too diverse to offer clear-cut consensus on state-market relations, it is fair to argue that states are “political and economic agents at one and the same time.”<sup>11</sup> Indeed, in the global economy today, changes/shifts in international division of labor have a direct impact on a state’s foreign economic policymaking. Few states in the world today choose to let the market pursue its full potential as described in textbook economics science.

The states of China and ASEAN nations, then, are attempting to influence movements in the markets they govern, amid the complex social-economic realities they face. The following section examines their search to agree on an instrument for achieving that purpose.

### **A CAFTA: the experts group’s report**

Until the outbreak of the Asian financial crisis in 1997, ASEAN was the leader in East Asian regional economic integration.<sup>12</sup> The first FTA in East Asia is the ASEAN free trade area (AFTA), which came into being in late 1992. AFTA set itself a goal of reaching a common effective preferential tariff (CEPT) of zero to five percent before the year 2008. The CEPT agreement covers most manufactured and agricultural products in four categories. Products in the *Inclusion List* have to undergo immediate liberalization. Products in the *Temporary Exclusion List* are protected from trade liberalization for a period of time. The *Sensitive List* contains unprocessed agricultural products that will have longer time frames to integrate with the free trade area. Finally, products in the *General Exception List* are permanently exempted from the free trade area due to national security, public morals, human, animal or plant life, and health concerns.<sup>13</sup>

The target year – binding for the original six member economies (Singapore, Indonesia, Malaysia, Thailand, Philippines, and Brunei) – was moved forward to 2003 in the wake of the Asian financial crisis. But the tariff reduction mechanism actually went in

motion the beginning of 2002. This quickened progress, however, represents a series of compromises allowing for more exceptions of products from the Inclusion List, most notably the Malaysian request for delaying the opening of its auto industry by another three years beyond 2003.<sup>14</sup>

A significant part of the intent of AFTA has been to attract more investment capital from outside the region, which is understood to have gone to China instead of ASEAN. However, ASEAN's share of international investment attracted to Asia's developing countries dropped from the pre-1997 thirty percent to fifteen percent in the year 2000.<sup>15</sup> How, then, would an FTA with China benefit ASEAN?

The drive towards establishing a regional economic institution linking ASEAN and China officially began in November 2000, during the "ASEAN + 3" meeting in Singapore. Subsequent to the meeting, a China-ASEAN expert group on economic cooperation was formed to assess the feasibility of a CAFTA. The group's final report, submitted to the China-ASEAN summit meeting in Brunei in November 2001, makes a positive recommendation on the political initiative articulated a year earlier.

The 37-page report reveals a number of points that offer insights into why a CAFTA is thought to be desirable. First, there is a record of growth in trade and a great potential for more trade between the two economic entities. ASEAN's share in China's foreign merchandise trade increased from 5.8 percent in 1991 to 8.3 percent in 2000. This means that ASEAN was the fifth biggest trading partner of China. China's share in ASEAN's trade grew from 2.1 percent in 1994 to 3.9 percent in 2000, making China the sixth largest trading partner of ASEAN.<sup>16</sup>

Second, China's investment in ASEAN has been small (US\$135.8 million in 1999 or less than one percent of all FDI flows to ASEAN). While no statistical figure of ASEAN investment in China is given, the report notes "until now ASEAN is a net investor in China."<sup>17</sup> Lack of reference to data in this particular aspect should be seen as a reflection of unspoken realities of unease about flow of investment capital from ASEAN to China. Either ASEAN governments (with the possible exception of Singapore) simply do not have confidence in data available to them or they are unwilling to recognize their own weak governance over the markets should they present data that do not reflect

market realities. On the other hand, as mentioned before, the unique role of Hong Kong as an entrepot makes it difficult for reliable data gathering in the first place.

Third, the impact of China's WTO membership on ASEAN, which receives significant treatment in the report (10 out of the 37 pages), is seen to produce opportunities for some sectors of ASEAN export to China, increase competition in exports to third country markets, and lead to an inevitable continuation of the China market attracting more international investment capital than ASEAN does. But the report speculates that as China's economy grows more Chinese investment capital will be directed to the original six ASEAN economies, rather than the present concentration on its four new members.

Fourth, there exist significant policy barriers on trade (tariff and non-tariff barriers, different technical standards, restrictions on services), investment (absence of investment guarantee agreements), and "the absence of long-term visas for business people who regularly commute between ASEAN and China."<sup>18</sup> In other words, the various governments have before them specific areas to liberalize and harmonize in order to reach the goal of market integration.

Overall, the Report presents a fairly candid assessment of the state of affairs in the economic policies China and ASEAN member states are currently adopting towards each other. The Report's framework for action also provides a fairly clear roadmap for the areas that need governmental action in the coming decade. In line with the need to practice "face-saving," the report omits reference to specific ASEAN country names and refrains from being too specific about the areas that China needs to reform.

However, the Report also reveals several areas of challenges that will require persistent political will to push forward formal integration of ASEAN and Chinese economies. First, how is a CAFTA to be negotiated? The report recommends sees "the simplest modality" to be

ASEAN countries extending their CEPT commitments, with perhaps some modifications, to China and the latter drawing up products lists similar to that in the CEPT scheme of AFTA and working out the tariff reduction program.<sup>19</sup>

In other words, China is supposed to adopt ASEAN's zigzagging approach to achieving economic regionalism. If, as mentioned earlier, ASEAN countries have had



difficulties to agree on product lists within the AFTA arrangement, will involving one more member, which is more powerful and have stronger economic ties with partners outside ASEAN, in the negotiation process help smoothen or further complicate the search for liberalization as envisioned in an FTA regime?

Second, the “ASEAN member countries national reports” annexed to the main report provide proof that to start moving in the direction of an CAFTA will require coming to terms over the very basic element of negotiations: standards employed to assess the state of affairs in trade and investment between an ASEAN member economy and China. The main report achieves this goal by relying on two sources of information: WTO reports and Chinese research materials. In the individual national reports, however, there is a much greater reliance on statistics compiled by the various ASEAN governments involved. Such a state of affairs will certainly mean contentions in negotiations over the specific categories of product lists that AFTA has been working to accomplish. It will certainly complicate the search for an agreement over the pace of liberalization. As a matter of fact, the national report from Laos departs from the general rule of optimism by urging caution:

The abolishment of trade barriers between two regions will expand world output, but the right steps of liberalization must be taken as the serious matter, otherwise we could step on the area of land mines.<sup>20</sup>

A lot can change in the ten-year time frame political leaders of ASEAN and China have agreed to abide by in order to accomplish the goal of an FTA. It is premature to even begin making definitive predictions about the prospect of a CAFTA moving from a vision to a reality. But one point is clear: the fact that China and ASEAN to have come to the current stage of pledging formal integration of their economies is already a very significant achievement. The next section recounts the trajectory of change in China-ASEAN economic relations in the 1990s, which provide an important base for the FTA initiative.

### **China-ASEAN Economic Relations since the early 1990s**

The evolution of China's political-economic relations with ASEAN (as a group and/or individual member states) has received extensive scholarly attention and there is little necessity to re-state their asymmetric nature for the entire period of the Cold War. The political/diplomatic isolation China faced in the wake of the 1989 Tiananmen Square crackdown gave impetus for China to treat its relations with ASEAN states in a global strategic context: to see to it that a multi-polar world take shape.<sup>21</sup> At the diplomatic level, China's main strategy was to demonstrate itself to Southeast Asian states that a rising China does not pose a threat to its small neighbors, arguing that the notion of a "China threat" was nothing more than a political tactic employed by governments and intellectuals in the West.<sup>22</sup> Indeed, China spared no effort in attempting to foster a public image of cooperation, friendliness and common interests with ASEAN. This overall strategic goal has led the Chinese government to intensify high-level consultations with ASEAN governments and to subscribe to the rules and norms of diplomatic engagement ASEAN has created. The general atmosphere of political relations between China and ASEAN has improved, although it is clearly not without problems.<sup>23</sup>

A twin part of post-Cold War China's strategy was to strengthen its economic ties with Southeast Asian states, beginning at the bilateral level. This is by and large a continuation of what China had been doing since the 1970s. For China, trade with a Southeast Asian state could and should take place before the flag (i.e., diplomatic ties). A case in point is that by 1989 China had made direct trade possible, including the signing of formal trade agreements, with all the six ASEAN member states before it was able to establish formal diplomatic ties with half of them (Brunei, Singapore, and Indonesia). Such pragmatism made it possible for total trade between China and ASEAN in 1989 to increase more than 20 times the 1970 total.<sup>24</sup> Prior to 1989, China signed bilateral investment Treaties (BIT) with three ASEAN member states (Thailand, 1985; Singapore, 1986; Malaysia 1988). By 2000, China signed BITs with all the ten ASEAN members except Myanmar.

In the realm of economic diplomacy, China after 1989 began to more actively involve itself in regional economic groups. As mentioned before, in 1991 China joined APEC and shares equal representation with Hong Kong and Taiwan. While ASEAN as a group is important in moving forward with the APEC process, China entered into a

consultative relationship with ASEAN as a group in 1993. Since then, there have emerged a total of five parallel frameworks for dialogue between China and ASEAN: China-ASEAN political consultation at senior official level, China-ASEAN Joint Committee on Economic and Trade Cooperation, China-ASEAN Joint Committee on Scientific and Technological Cooperation, China-ASEAN Joint Committee on Cooperation and ASEAN Beijing Committee.<sup>25</sup> Such joint committees make it possible for senior officials of ASEAN and China to enhance mutual understanding and exchange ideas. China-based scholarly assessment of activities such committees generate echo complaints by scholars based outside China: “broad” or “unfocused” (*Wu Xu* in Chinese).<sup>26</sup> But again, the so-called “ASEAN way” of diplomacy places value in the process rather than time-driven policy outcome, much less legalized ones. Besides, the very original intent of ASEAN engaging its powerful neighbors is to cash in on group power to offset disparities in negotiating power in a bilateral forum.

By far the most significant measures in the economic realm China took towards Southeast Asia came in the summer of 1997. First, through making a monetary contribution to the International Monetary Fund (IMF)’s currency stability loans to Thailand and Indonesia, China demonstrated the end of its history as “a self-serving Group of One both within and outside the multilateral economic institutions.”<sup>27</sup> Meanwhile, China practiced its diplomacy related to the crisis with a balancing act. It refrained from partaking in either of the extremes in the debate about a proper IMF way of handling the crisis. On the one hand, through participating in the IMF-sponsored macroeconomic policy packages, China demonstrated its acquiescence to the Fund’s role. On the other hand, it did not echo the Fund’s demands for policy reforms by affected Southeast Asian governments. Nor did it endorse calls for rejecting the Fund as a lender of last/first resort. Instead, the Chinese leadership concentrated on taking a lesson from the crisis and pushing through more structural reform of its own economy.<sup>28</sup>

Second, since the outbreak of the crisis, whether or not the Chinese government would choose devaluation of the Renminbi (RMB, Chinese currency) to protect its own trade interests became a subject of daily scrutiny of the media in the region and beyond. China has thus far kept its pledge not to devalue the RMB, thus removing an important external variable that might have caused another round of competitive devaluation of

Southeast Asian currencies because of the overlap in Chinese and Southeast Asian exports in major international markets.<sup>29</sup> Against this background, the Chinese leadership refrained from engaging in public debates about whether or not its decision to devalue the RMB in 1994 may have been as a direct cause for the Southeast Asian crisis. In January 1998, an article published in the *People's Daily* did take on the criticism directly. In its view, when China unified the market and the official exchange rates of the RMB in 1994, the exchange rate of the RMB against the US dollar did depreciate to 8.7 to 1. However, since the nominal exchange rate was 8.09 RMB to the dollar in 1993, the actual drop in 1994 was only seven percent after the integration, instead of 33 percent or 50 percent as had been calculated.<sup>30</sup> Independent and academic inquiry into a possible causal relationship between China's 1994 devaluation of its RMB and the competitive power of Chinese made products against Southeast Asian exports in third markets has yet to emerge, although one study "points unequivocally to some rivalry effects from China on the ASEAN-4's exports to the United States from 1980 to 1994."<sup>31</sup> But it is unscientific to insist that the 1994 change in Chinese currency policies amounted to a direct cause of the region-wide crisis in 1997. For our purpose of inquiry in this paper, it is significant to note that the Chinese government did not choose high-profile finger-pointing tactics (i.e., arguing against its responsibility) during the crisis.

Third, China played a careful role in the post-crisis debate about the wisdom in establishing a regional monetary regime to function more gently to a government whose macro-economic situation suddenly worsens (i.e., without the strict demands for policy changes that comes with an IMF lending decision). This debate involves three proposals: a Japanese proposal for an Asian Monetary Fund (AMF), the United States insistence on no change to the IMF mechanism and its philosophy, and warm receptivity of the AMF proposal from ASEAN quarters. China did not express public endorsement of the AMF idea when it was made public in October 1997. But in December 1998, China announced at the ASEAN summit meeting in Hanoi a proposal of regular discussions among deputy finance ministers of the "ASEAN plus three" members, thereby indicating China's interest in being an active participant in efforts to build a new regional financial institution.

As mentioned in the introduction, since then China has demonstrated its willingness to be a full partner under the Chiang Mai Initiative. At the operational level, the Initiative still recognizes the relevance of IMF conditions, which are to be linked to lending by regional governments. It thus represents a compromise of the three positions when the idea of an AMF was floated.<sup>32</sup> China's demonstrated willingness to accept IMF monitoring of its policies towards managing regional macroeconomic stability marks an important departure from its usual insistence on independence in Chinese foreign policy making. For ASEAN states, then, this represents a welcome change. A rising and unilateral China is certainly not in the interest of ASEAN nations.

Fourth, for ASEAN countries, a serious test of whether or not China would return to a nationalistic path of the 1950s in dealing with the treatment of ethnic Chinese in Southeast Asia came in May 1998 in Indonesia, when large-scale riots broke out. Indonesian Chinese came under attack and their plight drew significant international media coverage. Indeed, the riots led to calls in Hong Kong (already part of China) for Beijing to apply economic sanctions on Jakarta. The Chinese government at first just watched the situation unfolding in Indonesia. Then it allowed the Mainland-based media to conduct a brief but controlled publicity campaign to express sympathy for fellow Chinese in Indonesia. But in the end Beijing chose stability of the Indonesian regime over either siding with the Indonesian Chinese or treating the Harbibie government's handling of the riots as insufficient protection of human rights.<sup>33</sup> In other words, the message the Chinese government has sent is that it valued government-to-government relations with Southeast Asia rather than the political ties with the ethnic Chinese populations there.

I have thus far focused on those aspects of China's handling of its economic relations with Southeast Asia that have an impact on the macro-economic situation in the regional economy and that can demonstrate China as a good neighbor for Southeast Asian states. A review of developments in bilateral economic ties between China and each of the ten ASEAN economies is beyond the scope of this paper and indeed unnecessary for the purpose of our inquiry.

At this juncture, it is important to note that ASEAN is a body for intra-regional consultation and China's bilateral political-economic relations with the ASEAN member states vary. At a risk of over brevity, among the ASEAN member states, Myanmar comes

closest in trusting China, whereas the Philippines is perhaps the furthest away. The South China Sea territorial dispute remains the key issue that makes the Philippines and other direct parties to the dispute wary of China's strategic intentions. ASEAN as a group has thus far failed to present a united front in dealing with China over the South China Sea dispute. But it seems there is sufficient momentum to accept China that those wary members find it difficult to resist the band-wagon of formal engagement with China.<sup>34</sup>

### **China-Southeast Asia Economic Ties: border trade**

As such, faced with obvious differences in China's political-economic ties with ASEAN member states, why did China move ahead with what promises to be a protracted negotiation with so many different members? A partial yet significant answer can be found in China's own development agenda. As Long Yongtu, China's vice ministry of foreign trade and a key high-ranking official in the China-ASEAN discussions pointedly emphasized:<sup>35</sup>

ASEAN economies are important export markets for provinces in China's southwestern region. Formation of the CAFTA will be a significant boost to these provinces' exports, which in turn is conducive to China's national strategy to develop the entire western region.

To achieve this goal, when China initially proposed the FTA with ASEAN, it offered an "early harvest package". The package includes two essential elements. One, items such as tropical resources, agricultural products, food, textiles and electronics, in which some ASEAN member economies enjoy a labor advantage over China, will be included in the initial round of tariff reduction negotiations. Two, "special and preferential treatment" will be extended to Cambodia, Laos, Myanmar and Vietnam. This implies unilateral tariff reduction over selected items on the part of China and a delay for those four economies to reciprocate by five to eight years after a unified trade and investment liberalization scheme is in place. The concession granted to the four ASEAN economies already has led to complaints from other ASEAN members. For example, in May 2002 the Malaysian minister of international trade plainly stated that Malaysia should be "practical" and emphasized the importance of pursuing bilateral economic ties in participating in CAFTA negotiations.<sup>36</sup>

On the other hand, Long's positive vision may stem from the fact that Laos, Myanmar and Vietnam share a land-border with China. Through those countries goods made in China can reach Cambodia as well. In China's southwest, Yunnan and Guianxi are located right along the border. Closely behind them are Sichuan, China's most populous (and rich in low-cost labor) province and Guizhou, one of China's poorest provinces. All of these provinces are land-locked, making it commonsensical to seek land transportation routes for the movement of exports and imports. Historically, Guianxi province and Vietnam as well as Yunnan province and Myanmar have had close cross-border trade ties. Normalization of diplomatic ties served as a boost in cross-border trade between Guianxi province and Vietnam.<sup>37</sup> Now that China and Vietnam has reached agreement on their border demarcation, promoting border trade is one mechanism to assist these Chinese provinces to expand their export markets. Indeed, China's offer to finance construction/upgrade of the Pan-Asian Railway connecting China's Yunnan Province with the four Indo-Chinese states and eventually reaching Malaysia is the clearest indication of China's pursuit of its self-interest in this regard.<sup>38</sup> In anticipation of the CAFTA, Yunnan is speeding up expressway construction between western Yunnan and Myanmar, southwestern Yunnan and Laos and Thailand, and between southern Yunnan and Vietnam.<sup>39</sup>

When one looks at the trade and investment aspect only, increased cross-border trade and investment is indeed conducive to economic growth in the four Indo-Chinese states as well as the Chinese provinces that enjoy a geographical endowment. China's western region in general and southwestern provinces in particular lag far behind those Chinese provinces along the Pacific coast in their level of development. Hence since the early 1990s, China has persistently promoted cross-border trade with all its neighboring countries.<sup>40</sup> Since 1998, China has made it a strategic imperative to speed up economic development in those provinces through massive infrastructure investments and injection of development funds.

In view of domestic governance in China, faster development in its southwest is conducive to the goal of equitable development within. At a strategic level, a more evenly developed China is conducive to providing a positive external environment for development of ASEAN as a whole.

However, history has shown that impact of border trade between China and the Indo-Chinese states goes far beyond growth or decline in trade/investment statistics. Border trade has had implications on issues of ethnic-national identity and indeed, the Indo-Chinese states' capacity to govern their own territories.<sup>41</sup> Indeed, proliferation of smuggling and other illegal across both the land and maritime borders between China and ASEAN, poses new challenges for domestic control in both China and ASEAN states so affected.<sup>42</sup>

Taking these factors into consideration, the “special and preferential treatment” China has promised to Cambodia, Laos, Myanmar, and Vietnam may turn out to be a mixed blessing. How these states manage and/or perceive increased economic activities with China will have an impact on their performance in the negotiation towards a CAFTA. It is conceivable that the Indo-Chinese states are unwilling to commit themselves to a binding trade agreement that may push them into economic dominance by China.

For China as well, intensified economic activities along its southwestern border are also likely going to have political/strategic implications. The central government of China would not want to see its border provinces drawing closer to political forces beyond its border, either.

In short, movement towards an FTA is likely to be complicated by Indo-Chinese sensitivities about border trade with China, though perhaps not always loudly expressed. This may become a factor in China's relations with those states in particular and ASEAN as an entity in general, beginning with the process of FTA negotiations. Whether or not special consideration of the stages of development of the four new ASEAN members is sufficient remains to be seen.

### **A Sino-Japanese Competition?**

Postwar Japan has through aid, trade, and investment solidified its unchallenged role as the leader of economic development in Southeast Asia. The historical trend of Japan continuing to lead Southeast Asian economies into the future in a “flying geese” pattern came into question in the “lost decade” of the 1990s. The perception gap between an economically growing China and a stagnant Japan results in concerns about loss of



Japanese leadership in Southeast Asia to China. In reality, however, it was not until August 2002 for China to register as a larger export market than Japan for the five larger ASEAN economies (Singapore, Thailand, the Philippines, Indonesia and Malaysia).<sup>43</sup> In terms of development aid and research as well as policy response to Singapore's programs of reaching beyond ASEAN in trade/investment liberalization, Japan has been ahead of China as well.

One Japanese account holds that "China, having closely watched Japan's trade policy shift [to embrace preferential trading arrangements], decided to join the regional trend of exploring FTAs."<sup>44</sup> Zhang Yunlin, chairman of a China-ASEAN expert group who compiled the FTA feasibility report for Chinese and ASEAN leaders, saw the sequence differently. Noting that under the ASEAN+3 forum, discussions towards FTA with ASEAN since 1999 had not made much progress, "progress in CAFTA negotiations will propel Japan and Korea to engage the entire ASEAN region".<sup>45</sup>

In any case, the November 2001 announcement of China-ASEAN negotiations towards an FTA received wide attention in Japan. The *Asahi Shimbun* observed that "in contrast with the Japanese, shackled by farm interests, Chinese political leaders have convinced ASEAN members that a free trade area would benefit everyone."<sup>46</sup> The pro-business *Nikkei Shimbun* called on the Koizumi government to conduct a "policy review" that is "based on a broad new regional strategy, rather than narrow domestic concerns."<sup>47</sup>

The seeming Chinese strategy to seek a greater leadership role in regional economic affairs centered on offering to have agricultural products included in the trade liberalization package to be negotiated. For, Japan's choice of Singapore as its FTA partner in ASEAN implies an unwillingness to open Japanese markets to agricultural exports from ASEAN, since Singapore does not have an agricultural base to speak of.

The timing of China's decision to form an FTA with ASEAN may also have to do with the ongoing difficulty in resolving a bilateral trade dispute that began with Japan's imposition of temporary safeguard measures on imports of three items of agricultural from China in June 2001. The projected contrast between Japan that is protective of its domestic agricultural interests and China that is open to agricultural imports is only too obvious.

By the end of 2001, the Japanese government, “apparently in response to the China-ASEAN agreement”, proposed negotiating a “comprehensive economic cooperation accord” with ASEAN. Such an accord, to be completed within five to ten years, would include promotion of cooperation in areas of investment, energy, and intellectual property rights as well.<sup>48</sup> Thus far Japan has made little progress in this direction. On the other hand, as more salient Japanese assessment shows, it is in Japan’s interest to pursue FTA arrangements in East Asia by exploring Korea, Taiwan, and Hong Kong as partners. Across the Pacific, it is certainly in Japan’s interest to explore formation of an FTA with the United States, in addition to the Japan-Mexico and Japan-Chile negotiations already under way.<sup>49</sup>

Japan also responded to another Chinese project aimed at building up its influence in Southeast Asia – the launching and hosting of the Bo’ao Forum for Asia, symbolically based in Bo’ao, Hainan island. The Forum, which copies the World Economic Forum based in Davos, Switzerland in format, provides a venue for informal exchanges of opinions among East Asian leaders. In April 2001, when the Bo’ao Forum was formally launched, Koizumi traveled to Hainan and delivered a speech that outlines Japan’s commitment to be engaged in Asian affairs, including those in Southeast Asia and as far as in Central Asia.<sup>50</sup>

Then in January 2002, again against the background of Japanese media challenging the government not to lose regional leadership to China, Koizumi visited five Southeast Asian countries. On his last stop in Singapore, he signed the Japan-Singapore Economic Agreement for a New Age Partnership and delivered a speech outlining his vision for future relations between Japan and ASEAN. Koizumi’s “Initiative for Japan-ASEAN Comprehensive Economic Partnership,” which he said the Japan-Singapore agreement served as an example, would include ASEAN members as well as Australia and New Zealand. Judging from his statement that “the role of the United States is indispensable” in such a joint effort, Koizumi’s vision might have a pan-Pacific structure in mind.<sup>51</sup>

There can be different interpretations of the policy implications stemming from the vision Koizumi enunciated. One possibility is that it amounts to a carefully crafted presentation of Japan’s policy towards ASEAN: Japan would not approach ASEAN at the

expense of interests of its major strategic partners in the entire Asia-Pacific. If this were true, then inclusion of more members would certainly increase difficulties in a negotiation process. Indeed, under APEC, the most inclusive regional economic grouping of the Asia-Pacific, even a non-binding approach to trade and investment liberalization is problematic. In this sense, it would indeed be a miracle for Japan to attempt to take on itself the task to harmonize the interests of all the fourteen members he made specific reference to.

Another possibility is that trade liberation through FTA arrangements with other ASEAN members, let alone one that includes members beyond the ASEAN region, was not what Koizumi had in mind in the first place. Under this scenario, the purpose in such making such statements is to raise awareness for governments throughout the Asia-Pacific region to rise to jointly manage the challenges of a rising China.

The Japanese government's inability to overcome domestic resistance to further liberalization of its agricultural sector will continue to be one a formidable challenge when one thinks about the prospect of a Japan-ASEAN FTA. On the other hand, agriculture is by no means the only issue for ASEAN in pursuing economic integration with Japan. For example, by mid-August 2002, it was reported that Chinese negotiators were "having second thoughts" about having such agricultural items as rice, sugar, tapioca and rubber included in the "first batch" of the package being negotiated with ASEAN.<sup>52</sup> Still ASEAN and Chinese negotiators are forging ahead with their FTA negotiations. It remains to be seen if such developments can be interpreted as ASEAN agreeing to allow China to exclude some agricultural products from tariff reduction, as AFTA's CEPT scheme allows. If so, there is little reason for ASEAN to insist that Japan must include agriculture under the scenario of formal negotiations towards a Japan-ASEAN FTA. Indeed, should Japan move into FTA negotiation with ASEAN before the conclusion of CAFTA negotiations, such acts can serve as an external factor making China take ASEAN states more seriously than if without it.

In short, through diplomatic acts Japan has indicated that it is determined not to fall behind China in the competition for political goodwill from the Southeast Asian region, although Japan is currently behind China in conducting economic diplomacy to demonstrate engagement with all economies ASEAN encompasses. FTA formation has

become one instrument in the competition between China and Japan to win ASEAN's favor on the front of economic diplomacy.

## **Conclusion**

There is no doubt that economic relations between China and ASEAN has developed very rapidly in the past decade. When AFTA was launched in 1992, China was viewed as a potential institutional partner at best.<sup>53</sup> A change in China's treatment of ASEAN as a regional actor in the immediate aftermath of the Cold War and, more fundamentally, China's reaction to the Asian financial crisis brought about the necessary change in the regional geo-strategic matrix to make the announcement of ASEAN and China moving to form an FTA possible.

As the joint ASEAN-Chinese expert group's report admits, the levels of existing integration among China and ASEAN economies are low, in spite of the impressive records of growth in the past decade. In other words, a CAFTA is not yet one of natural integration. Nor does not appear to be a strategic one. For both China and ASEAN, there is no viable "third party" market to target. As a result, "open regionalism," an idea that informs the APEC process, becomes the guide for formal integration. "Since seven of the ASEAN members and China are also APEC members, the year 2020 sets an absolute deadline" for liberalization.<sup>54</sup> So, it seems that formal integration of ASEAN and Chinese economies are tactical in nature. For lack of better vocabulary, the term "tactical" in this context refers to a policy commitment that has more to do with setting in motion a momentum rather than cashing in on past achievements or hedging against a formidable adversary or rivalry in trade. The result of a tactical economic integration may help to harmonize economic dynamism within the FTA. At the same time, it can turn out to be little more than an exercise in economic diplomacy. So, what we have begun to witness seems to be yet another Asia-Pacific case of selective legalization in international trade, investment and monetary affairs.<sup>55</sup>

In the event that a formal CAFTA turned out to be ineffective, having the mixed record of AFTA in mind, in what ways will China matter to economic development in Southeast Asia in the future? Over issues like regional security, territorial disputes, and

bilateral economic relations, developments in China and its foreign policies matter to Southeast Asia, as it has been for the past millennia.<sup>56</sup>

In the area of applicable lessons of development, however, China matters much less to Southeast Asia than other major powers do. Since the late 1970s, China's economic development has been driven not through conformation with any particular internationally promoted development paradigm or ideology. For instance, China rejected the so-called Washington Consensus for the transformation of less-developed economies or the "shock-therapy" prescribed to the "transition" (i.e., from centrally-planned to market) economies following the formal end of the Cold War.<sup>57</sup> Instead, the primacy of growth and stability (*fazhan, wen-ding*) informs economic, societal, and political policymaking at all levels of the Chinese governing apparatus. As Chinese Vice Premier Li Lanqing made clear in a 1994 speech to a conference in Singapore on the future of ASEAN, Vietnam and China, China's foreign economic strategy was to "strengthen South-South cooperation and push for North-South cooperation simultaneously."<sup>58</sup> In other words, the movement towards a CAFTA is significant but it by no means implies a fundamental departure from Chinese foreign economic strategy of "cooperation with all" nations but focusing on the big powers.<sup>59</sup>

Last but not least, in the immediate wake of announcing the move towards a CAFTA came public discussions about forming a "free-trade zone" linking China (the Mainland) and Hong Kong.<sup>60</sup> Consultations – on the principal premises of "one country, two systems" formula and WTO rules – formally started in January 2002. The goal in such discussions is to eliminate tariff and non-tariff barriers of trade between the Mainland and Hong Kong.<sup>61</sup> The Mainland-Hong Kong scheme of closer economic ties may or may not result in a formal agreement, given Beijing's insistence on Hong Kong affairs being domestic. And we should note that this scheme should not to be confused with the Australia-New Zealand arrangement as it is impossible for Hong Kong to open its labor market to the Mainland. Nevertheless, such mechanisms will most certainly mean that Southeast Asian economies must learn to adjust to new dynamics in the transformation of Hong Kong's role as a gateway to the vast Mainland market of China.

In short, what we can conclude with certainty in looking at developments in China's economic relations since the 1990s, and particularly the movement towards the

CAFTA is that there has been a change from China riding the bandwagon of ASEAN-style of economic integration without structural reciprocity to China working with ASEAN to reach a common set of policy instruments in trade and investment. That change is possible thanks in part to China's change of its overall foreign policy orientation towards the Southeast Asian region dating back to the early 1990s. Implications of the CAFTA on the future developments in ASEAN-China relations, however, are less clear. Future research efforts ought to pay attention not only to the process of economic diplomacy itself but also the project's impact on domestic governance and regional politics, by taking such issues as border trade and Japan's future role in ASEAN into consideration.

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#### End Notes

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<sup>3</sup> Pradumna B. Rana, *Monetary and Financial Cooperation in East Asia: the Chang Mai Initiative and Beyond*, The Asian Development Bank, Economic and Development Research Department, Working Paper Series No. 6 (February 2002).

<sup>4</sup> This information is true as of May 10, 2002. See "The Joint Ministerial Statement of the ASEAN +3 Finance Ministers Meeting," at [http://www.mof.go.jp/english/mf\\_review/348\\_02.htm](http://www.mof.go.jp/english/mf_review/348_02.htm)

<sup>5</sup> Mahathir Mohamad, "China's ascent spurs race to capture market share," at <http://www.nni.nikkei.co.jp/FR/NIKKEI/inasia/future/2002weekly05.html>

<sup>6</sup> Yuqing Xing, "Japanese Direct Investment in China: the Consequence of Hollowing out, or just another Stop of Flying-Gees?" Paper presented to the Second Korea-China Economic and business Forum on Economic Integration and Structural Changes in East Asia in the Era of Globalization, Seoul, South Korea, July 2-7, 2002.

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- <sup>19</sup> Report, p. 32.
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