

# China's Free Trade Agreement Diplomacy

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## **Abstract**

This thesis examines China's bilateral Free Trade Agreement (FTA) diplomacy. I adopt international regime theories to wrestle with how Beijing pursues diplomatic objectives through institutionalized economic relationships. It employs an eclectic approach encompassing three main research paradigms – realism, liberal institutionalism and constructivism - to test how China uses FTAs as a diplomatic means to achieve political ends.

Six of ten FTAs that China has signed are investigated: ASEAN, New Zealand, Pakistan, Chile, Peru and Costa Rica. The China-Singapore FTA (CSFTA) is omitted as it replicates the China-ASEAN FTA (CAFTA) model. Thus, the CSFTA is treated as part of the CAFTA. The China-Iceland FTA and China-Swiss FTA are also left out because both of them came into force in July 2014 and are outside the research period. For the same reason, the China-South Korea FTA and the China-Australia FTA are not included as independent case studies. But all recently concluded FTAs are mentioned from time to time since they are not mutually exclusive, but together constitute a unique network.

A key aspect of this thesis is that it demonstrates that no one international regime theory can fully explain the various dimensions and complexities of China's FTA diplomacy. Instead, it verifies the utility and necessity of eclecticism as a formal analytical tool. As FTAs are institutional mechanisms established to foster economic cooperation, liberal institutionalism remains the leitmotif in FTA studies. However, it cannot fully account for China's security-oriented FTAs, a dimension in which realism has major influence. In addition, FTAs are not purely material mechanisms but are affected by constructivist variables, such as state identities and norms. Strict formulations of institutionalism, realism and constructivism are therefore less convincing than eclectically incorporating all three research paradigms. This eclecticism helps highlight the uniqueness of each case and allows more nuanced understandings of the varying strengths and weaknesses of the FTAs in the case studies.

This thesis finds that China's FTA diplomacy is half-successful in achieving political goals. On the one hand, its mega-economy, huge foreign exchange reserves, large domestic market, and the CCP government's ability to allocate resources, have allowed Beijing to achieve some of its desired outcomes. On the other hand, the PRC is

constrained by its peripheral and international environment, its level of economic development, emerging state capitalism, and big power relations. As a result, in some respects the FTA diplomacy has resulted in either half-wins or failures.



## **Thesis Declaration**

**Name: Yang Li**

**Program: Doctor of Philosophy**

This work contains no material which has been accepted for the award of any other degree of diploma in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where due references have been made in the text.

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## Abbreviation

<u>Term</u>	<u>Definition</u>
ADB	Asian Development Bank
ADIZ	Air Defense Identification Zone
AE	Analytical Eclecticism
AIIB	Asian Infrastructure Investment Bank
APTA	Asia-Pacific Trade Agreement
ARF	ASEAN Regional Forum
ASEAN	Association of South East Asia Nations
BCIM	Bangladesh, China, India and Myanmar Trade Corridor
BIT	Bilateral Investment Treaty
CCP	Chinese Communist Party
CELAC	Community of Latin America and Caribbean States
CEPEA	Comprehensive Economic Partnership for East Asia
CGE	Computable General Equilibrium
CICA	Conference on interaction and Confidence Building measures in Asia
CMI	Chiang Mai Initiative
CNOOC	China National Offshore Oil Corporation
CNPC	China National Petroleum Cop
COFCO	China Oil & Foodstuffs Cooperation
CR	Costa Rica
CRTAS	Cross Regional Free Trade Agreements
DCD	Agricultural Chemical Dicyandiamide
DPP	Democratic Progressive Party (Taiwan)
EAEC	East Asian Economic Community
EAFTA	East Asia Free Trade Agreement
EAS	East Asia Summit
ECLAC	Economic Commission for Latin America and the Caribbean
EHEC	China Harbor Engineering Corp
EHP	Early Harvest Programme
ESCS	European Coal and Steel Community

EU	Europe Union
FIRB	Foreign Investment Review Board (Australia)
FTA	Free Trade Agreement
FTAA	Free trade Agreement of the Americas
FTAAP	Free Trade Area of the Asia Pacific
GAQSIQ	General Administration of Quality Supervision, Inspection and Quarantine (China)
GCC	Gulf Cooperation Council
GSM	Great Mekong Subregion
HSBC	Hongkong Shanghai Banking Corporation
HST	Hegemonic Stability Theory
ICBC	Industrial and Commercial Bank of China
IDB	Inter-American Development Bank
IMF	International Monetary Fund
IR	International Relations
KMT	Kuomintang (the Chinese National People's Party, Taiwan)
LAC	Latin American and the Caribbean
M&A	Mergers and Acquisitions
MFN	Most Favored Nation
MIIT	Ministry of Industry and Information Technology (China)
MOU	Memorandum of Understanding
MSR	Maritime Silk Road
NAFTA	North America Free Trade Agreement
ODI	Outbound Direct Investment
OIO	Overseas Investment Office (New Zealand)
PA	Pacific Alliance
PITD	Pakistan Institute of Trade and Development
PLAN	People's Liberation Army Navy (China)
PRC	People's Republic of China
PSA	Port of Singapore Authority
PSI	Proliferation Security Initiative
PTA	Preferential Trade Agreement
PTT	Power Transition Theory
RCEP	Regional Comprehensive Economic Partnership
RTA	Regional Trade Agreements

SAARC	South Asian Association of Regional Cooperation
SACU	South African Customs Union
SCS	South China Sea
SOEs	State Owned Enterprises
SSM	Special Safeguard Measures
TDAP	Trade Development Authority of Pakistan
TIG	Trade in Goods
TIS	Trade in Services
TPP	Trans Pacific Partnership Agreement
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

## Chapter 1 Introduction

As the World Trade Organization (WTO) negotiating process has become bogged down, many countries have sought to pursue alternative liberalization arrangements to facilitate cooperation and development.<sup>1</sup> In particular, we have witnessed a dramatic increase in efforts in the Asia Pacific to establish bilateral, regional and cross-regional Free Trade Agreements (FTA). Yet belying their superficial focus on institutionalizing and strengthening economic ties, FTAs have increasingly become elements and tools of strategy and diplomacy. Bearing in mind both their domestic and international interests, states seek to painstakingly implant non-economic objectives into these ostensibly economic agreements. China is no exception.

As a belated member in the world's FTA club, China has skillfully adapted to this new form of diplomacy. A key turning point was in 2000 when Beijing floated the plan of an FTA between China and the Association of South East Asia Nations (ASEAN). Chinese FTA building has since gained strong momentum. By 2014, the People's Republic of China (PRC) had enthusiastically woven its own FTA network covering eighteen FTAs with thirty-one economies. China's selection of FTA partners is also not random. Rather, what lies beneath are different and complex diplomatic objectives ranging from showcasing goodwill to securing resource supplies. These objectives are distinct but not mutually exclusive. They serve to collectively maintain the continuity and consistency of China's major diplomatic policies. These burgeoning Chinese FTAs thereby offer fertile ground for IR analysis. We do not yet have an empirically well-grounded, theoretically informed, and analytically balanced assessment of this issue. This thesis

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<sup>1</sup> Caroline Henckels, "Overcoming Jurisdictional Isolationism at the WTO – FTA Nexus: A Potential Approach for the WTO," *The European Journal of International Law* 19, no. 3 (2008); Michael Ewing-Chow, "Multilateral or Regional – WTO “and/or” FTAs? An Academic's view of the Trenches," in *Economic Diplomacy: Essays and Reflections by Singapore's Negotiators*, ed. C L Lim and Margaret Liang (Singapore: World Scientific Publishing Co. Ltd., 2010); Mitsuo Matsushita, "Proliferation of Free Trade Agreements and Development Perspectives", in *Law and Development Institute Inaugural Conference* (Sydney, Australia October, 2010). "The WTO and Preferential Trade Agreements: From Co-existence to Coherence," in *World Trade Report 2011* (World Trade Organization, 2011); Vinod K. Aggarwal and Simon Evenett, "A Fragmenting Global Economy: A Weakened WTO, Mega FTAs, and Murky Protectionism," in *CEPR Discussion Paper* (Centre for Economic Policy Research (CEPR) December, 2013).

seeks to fill these gaps by exploring the underlying diplomatic rationales for Chinese FTAs in their totality.

This chapter contains seven sections. In the first section, I briefly introduce the research background of FTAs. The second section is an overview of China's FTA network. The subsequent literature review situates my work in the context of existing scholarship. In the fourth section, I discern and redefine a few of the key terminologies used in regime theory to set a link between FTAs and international regimes. The fifth section raises the research question, and then briefly introduces the theoretical and empirical significance of the findings. Research design and methodology are outlined in the sixth section. This chapter concludes with a brief preview of the subsequent chapters. My own theoretical framework for thinking about economic diplomacy and its correlation with China's FTA strategy is presented in the next chapter.

## **1.1 Introductory Background**

To establish an FTA is to make institutional arrangements to create a specific trading bloc. The forerunners of these Agreements were largely confined to protocols to reduce tariff and non-tariff barriers in most, if not all, traded items. As these Agreements evolve, tariff-reduction declines in importance. In recent times, FTAs have been extended to cover a variety of non-traded issues such as investment, people movement and sanitary and phytosanitary measures. As of 10 January 2013, with a large number of feasibility studies and negotiations underway, some 546 FTAs have been notified to the WTO, and 354 of these have entered into force.<sup>2</sup>

This shift in FTA content and range has resulted in academic debates on whether FTAs underpin or undermine the centrality of the WTO, which has universal tariff reduction at its core. Politicians seem largely unmoved by these arguments however, as all WTO members are now involved in the creation of a web of usually bilateral FTAs, a trend which seems to contradict the universalistic spirit of the WTO itself.

With regard to the recent proliferation of FTAs, a vast body of work quantifying their economic impacts has been produced by economists. Intriguingly, the findings of this

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<sup>2</sup> This is the latest update data in the WTO Regional Trade Agreements (RTA) Information System database. Although this dataset adopts the term of RTA, it indeed include both regional and cross-regional agreements. Data available at [http://www.wto.org/english/tratop\\_e/region\\_e/region\\_e.htm](http://www.wto.org/english/tratop_e/region_e/region_e.htm)



quantitative work often conflict with one another. For example, many studies have used classical economic theories to assess the economic effects of FTAs, particularly with regard to their influence on trade creation and trade diversion.<sup>3</sup> Krugman and Obstfeld, however, note that there exists an inherent contradiction in this methodology. Accordingly, if establishing FTAs leads to the substitution of laggard producers by advanced imports, then trade creation effects can be expected, together with an increase in national welfare. Nevertheless, if trade diversion occurs (such as the substitution of cheap imports by less advantaged imports from within the trade bloc), then there would be a welfare-reduction. Therefore, they argue that economic approaches in this vein are at their best half-correct, if not very misleading.<sup>4</sup> This argument is further developed in the Asian Development Bank's (ADB) *Asian Development Outlook 2002*, which stresses that the various economic studies supporting or opposing FTAs should go beyond just "trade creation versus trade diversion".<sup>5</sup>

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<sup>3</sup> Jacob Viner started to formally explore FTA's economic effects as early as 1950. He proposes that an FTA normally contains two effects, namely trade creation and trade diversion, so-called Vinerian theory. See Jacob Viner, *The Customs Union Issue* (New York: Carnegie Endowment for International Peace, 1950). A series of journal papers, adopting this approach, have found evident empirical supports that trade creation effects are prevailing while the trade diversion effects are negligible. See C. Magee, "New Measures of Trade Creation and Trade Diversion," *Journal of International Economics* 75, no. 2 (2008).; S. L. and Bergstrand Baier, J. H., "Estimating the Effects of Free Trade Agreements on International Trade flows Using Matching Econometrics," *Journal of International Economics* 77, no. 1 (2009).; and Silva and Tenreyro, "The Log of Gravity," *The Review of Economics and Statistics* 88, no. 4 (2006). Sun and Reed's analysis however suggests a reverse conclusion, which stresses that no trade creation but instead export diversion on agricultural trade can be attributed to the North America FTA (NAFTA). See Lin Sun and Michael R. Reed, "Impacts of Free Trade Agreements on Agricultural Trade Creation and Trade Diversion," *American Journal of Agricultural Economics* 92, no. 5 (2010). For other empirical studies generating similar findings, see D. Trefler, "The Long and Short of the Canada-U.S. Free Trade Agreement," *American Economic Review* 94, no. 4 (2004).; and Crawford Acharya, Maliszewska and Renard, "Landscape," in *Preferential Trade Agreement Policies for Development: a Handbook*, ed. Chauffour and Maur (Washington DC: The World Bank, 2011).

<sup>4</sup> Krugman Paul; Obstfeld Maurice, *International economics : theory and policy* (Boston: Pearson Addison-Wesley, 2003).

<sup>5</sup> Asian Development Bank, *Asian Development Outlook 2002: Preferential Trade Agreements in Asia and the Pacific*, Asian Development Outlook (Oxford University Press, 2002).

A series of papers has shown that the Computable General Equilibrium (CGE) assessment is fairly effective in accounting for empirical surveys.<sup>6</sup> Thomas Hertel *et al.* focused their study on the Free Trade Agreement of the Americas (FTAA), and found imports increased in all regions of the world as the result of its ratification. Moreover, ten of the thirteen FTAA regions had experienced welfare-improvements with more than 95% confidence interval in the regression analysis.<sup>7</sup> In an ADB *Economics Working Paper* with a wider dataset (61 concluded agreements), Masahiro Kawai and Ganeshan Wignaraja made similar assessments: FTAs in Asia are not only economically positive, but also assume more importance as a tool of commercial policy. An opposing view is held by Jo-Ann Crawford who surveyed the market access provisions of FTAs (as applied to trade in goods as of November 2010) and concluded that there is little evidence that increased market access in merchandise goods brings on a more favorable trading environment for third parties.<sup>8</sup> Similarly, Axel Berger *et al.* adopt a gravity model to assess the impact of investment liberalization modalities and dispute settlement provisions in FTAs on bilateral FTA flows. They find that investment reacts positively to FTAs only if they offer liberal admission rules, while Agreements with no strong investment provisions may even discourage FDI.<sup>9</sup>

Economic research provides clear-cut methods and standards to evaluate FTAs, both *ex ante* and *ex post*. However, this brief review of the literature on the economic effects of

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<sup>6</sup> The first CGE model was developed in the 1970s, and modified models like the United States Department of Agriculture model and the Western Ontario model to adapt to specific calculation requirement were developed thereafter. Now these full-fledged models prevail in measuring economic influences of different kinds of trade liberalization, both regionally and globally. See Fukunari Kimura, "Bilateralism in the Asia-Pacific: An Economic Review," in *Bilateral trade arrangements in the Asia-Pacific : origins, evolution, and implications* ed. Vinod K Aggarwal; Shūjiro Urata (New York: Routledge, 2005).

<sup>7</sup> Two exceptions are respectively Argentina and rest of South America, which suffer welfare losses because some of their preferential accesses are displaced. Besides, the economic influence of FTAA on Colombia is uncertain. See and David Hummels Thomas Hertel, and Maros Ivanic, and Roman Keeney, "How Confident Can We be in CGE-Based Assessments of Free Trade Agreements", in *NBER WORKING PAPER SERIES* (National Bureau of Economic Research, 2004).

<sup>8</sup> Jo-Ann Crawford, "Market Access Provisions on Trade in Goods in Regional Trade Agreements," in *WTO Economic Research and Statistics Division* (WTO, 2012).

<sup>9</sup> and Matthias Busse Axel Berger, and Peter Nunnenkamp, and Martin Roy, "Do Trade and Investment Agreements Lead to More FDI?: Accounting for Key Provisions Inside the Black Box," in *World Trade Organization Economic Research and Statistics Division* (Geneva: WTO, 2010).

FTAs indicates that the pure economic approach contains several notable drawbacks. First, economic literature has not yet achieved a definitive consensus regarding FTA economic benefits. Whereas welfare improvements are observable, the presence, size and duration of the effects are not consistent across different studies. Even if empirical research on particular FTAs reaches a positive conclusion overall, the effects are hardly uniform across sectors with different comparative advantages. Second, as has been confirmed by a number of economists, a great proportion of aforementioned research results are on the basis of partial econometric models, which, whilst making the analysis feasible, inescapably prejudged and even distorted the realities of a complex world.<sup>10</sup> FTAs also contain many intangible provisions that make the impact of FTAs difficult to assess (i.e. dispute settlement measures, intellectual property rights, etc.). Finally, service trade is even more complicated and difficult to assess because pricings for many services are tailor-made, such as for professional and business services.<sup>11</sup> These factors are mostly non-quantifiable, yet can have considerable impact on the national welfare of participants.

Apart from methodological parochialism, economists have long been boxed in between two seemingly empirical paradoxes. Why would a government refuse to establish FTA(s) with potential partner(s) when empirical research has observed considerable likely gains? Conversely, why would a government agree to ‘sign on’ despite previous feasibility studies warning of potential losses? These problems, as Patrick Cronin explained, are conflicts “between the economic logic of free trade markets and the political logic of the state-based international system”.<sup>12</sup> Therefore, it is necessary to look for alternative approaches such as political rationales underpinning FTAs. As noted by a 2011 WTO report, economic work often ignores “the simple fact that trade policy is decided in a political environment, and governments may face incentives that

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<sup>10</sup> See T.J. Kehoe, "An Evaluation of the Performance of Applied General Equilibrium Models of the Effects of NAFTA on CGE analysis of NAFTA," in *The Fifth Annual Conference on Global Economic Analysis* (Taipei2002).; and Ross McKittrick, R., "The Econometric Critique of Computable General Equilibrium Modeling: the Role of Parameter Estimation," *Economic Modeling* 15(1998).

<sup>11</sup> Juan Marchetti and Martin Roy, "Is there Reciprocity in Preferential Trade Agreements on Services?," in *World Trade Organization Economic Research and Statistics Division* (Geneva: WTO, 2012).

<sup>12</sup> Patrick Cronin, "The Doha Round: Prospects for the Rules-based Trading System," in *International Political Economy State - Market Relations in a Changing Global Order*, ed. Roe Goddard; Patrick Cronin; Kishore Dash (Boulder: Lynne Rienner, 2003).p.369

differ from simple welfare considerations".<sup>13</sup> While recognizing economists' contribution in studying FTAs, this report suggests that scholars should explore these ostensibly economic subjects by considering the political context within which they are formed.<sup>14</sup> As briefly reviewed below, some IR scholars have done pioneering work introducing political criteria to evaluate FTAs.

There is a set of studies that find close relationships between FTAs and participants' domestic politics. William Avery makes such an argument with respect to the NAFTA. He notes that the ratifying of this agreement should greatly attribute to the strategy of targeting side-payments to wavering domestic constituencies.<sup>15</sup> In a similar vein, Yang Jiang explores domestic resistance from China's agricultural and services sectors on the one hand, and the decision-making mechanism that constrains Beijing's bargaining power on the other.<sup>16</sup> Other research focuses on the relationship between FTAs and the conduct of international relations. For instance, the formation of the Asia-Pacific Trade Agreement (APTA) is widely regarded as a pre-emptive signal to the European Union (EU) about the costs of constructing a closed "Fortress Europe".<sup>17</sup> Other scholars view FTAs as an important instrument in power games. In studying Singapore and South Korea's FTA policy, for example, power-balancing considerations prevailed.<sup>18</sup> Some

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<sup>13</sup> WTO, "The WTO and preferential trade agreements: From co-existence to coherence," in *World Trade Report in 2011* (WTO Publication, 2011), p.95

<sup>14</sup> *Ibid.*, pp.95-99

<sup>15</sup> William P. Avery, "Domestic interests in NAFTA bargaining," *Political Science Quarterly* 113, no. 2 (1998).

<sup>16</sup> Yang Jiang, "Australia-China FTA: China's domestic politics and the roots of different national approaches to FTAs," *Australian Journal of International Affairs* 62, no. 2 (2008).

<sup>17</sup> The Asia-Pacific Trade Agreement, signed in 1975, contains Bangladesh, China, India, South Korea, Laos and Sri Lanka. It was previously called the Bangladesh Agreement, and was renamed APTA in November 2005. See John Ravenhill, "Regionalism," in *Global Political Economy*, ed. John Ravenhill (Oxford: Oxford University Press, 2008).

<sup>18</sup> Tan Kok Kong Titus Lee, and He Ruimin, "Do Free Trade Agreements Matter? Evaluating the Impact of FTAs on Singapore's Domestic Exports of Goods," ed. Ministry of Trade and Industry (2011); Netina Tan, "ECFA's Regional Impact and the Taiwan-Singapore FTA Negotiations," (2011); Eul-Soo Pang, "Embedding Security into Free Trade: The Case of the United States—Singapore Free Trade Agreement," *Contemporary Southeast Asia* 29, no. 1 (2007). Stephan Haggard and Chung-In Moon, "Institutions and Economic Policy: Theory and a Korean Case Study," *World Politics* 42, no. 2 (1990); Won-Mog Choi, "Aggressive Regionalism in Korea-U.S. FTA: the present and future of Korea's FTA policy," *Journal of International Economic Law* 12, no. 3 (2009); Hae-du Hwang and Xiangshuo Yin, "Recent Developments on RTAs in North East Asia," *Asia Europe Journal* 6, no. 3-4 (2008); Seungjoo Lee, "Singapore Trade

other FTAs were seen as rewards to key allies. This view is widely applied to studies on FTAs between the US and Middle East countries, and Australia and Japan.<sup>19</sup> A third strand of thinking emphasizes regionalism and posits that regional FTAs incrementally facilitate integration from low politics (trading bloc) to high politics (political union).<sup>20</sup> These perspectives, with different depth and scale, inform many of the notions and methods in my work.

## 1.2 China's FTA Network

Since its accession to the WTO, the People's Republic of China (PRC) has been proactive in forging bilateral FTAs. Just as American bilateralism in the 1990s kicked off a second wave of FTAs, the PRC's activism seems to have pushed over another domino.<sup>21</sup> As of June 2015, China has signed FTAs with ASEAN,<sup>22</sup> Singapore, New Zealand, Pakistan, Chile, Peru, Costa Rica, Iceland, Swiss, South Korea and Australia. Bilateral negotiations with the Gulf Cooperation Council (GCC), Norway, the South

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Bilateralism," in *Bilateral trade arrangements in the Asia-Pacific : origins, evolution, and implications* ed. Vinod K Aggarwal; Shūjiro Urata (New York: Routledge, 2005).

<sup>19</sup> See H. Rosen, "Free Trade Agreements as Foreign Policy Tools: the US-Israel and the US-Jordan FTAs," in *Free Trade Agreements: US Strategies and Priorities*, ed. J. Schott (Washington: Institute for International Economics, 2004); Gregory W. White, "Free Trade as a Strategic Instrument in the War on Terror?: The 2004 US-Moroccan Free Trade Agreement," *Middle East Journal* 59, no. 4 (2005); Higgott R., "After Neoliberal Globalization: The "Securitization of US foreign Economic Policy in East Asia," *Critical Asian Studies* 36, no. 3 (2004); Capling. A., "Preferential Trade Agreements as Instruments of Foreign Policy: An Australia-Japan FTA and its Implications for the Asia Pacific Region," *The Pacific Review* 21, no. 1 (2008).

<sup>20</sup> Glen Atkinson, "Regional integration in the emerging global economy: The," *Social Science Journal* 35, no. 2 (1998); Armand de Mestral, "NAFTA: The Unfulfilled Promise of the FTA," *European Law Journal* 17, no. 5 (2011); Renate Ohr, "Divergence of Convergence as a Consequence of Regional Integration? NAFTA's Impacts on Mexico," *International Economic Integration* (1995); Peter; Robert E. Litan Hakim, *Future of North American Integration* (Washington: Brookings Institution Press 2002); Philippe de and Schulz Lombaerde, Michael, *Eu and World Regionalism : The Makeability of Regions in the 21st Century* (Farnham: Ashgate Publishing Group 2009); Fredrik Söderbaum and Alberta Sbragia, "EU Studies and the 'New Regionalism': What can be Gained from Dialogue?," *Journal of European Integration* 32, no. 6 (2010).

<sup>21</sup> Yang Jiang, "'Great Power Style' in China's Economic Diplomacy: Filling the Shoes of a Benign Hegemon?," *The Hague Journal of Diplomacy* 6(2011).p.72

<sup>22</sup> Although ASEAN is constituted by ten member countries, this thesis will treat the China-ASEAN FTA as a bilateral one, since it is the first time the states union was treated as a unitary actor in such a free trade deal.

African Customs Union (SACU), and Sri Lanka are underway. Moreover, feasibility studies on FTAs with India and Columbia have all been concluded; new feasibility studies on FTAs with Maldives, Georgia and Moldova have also been launched. China has also committed itself to regional FTA constructions. For example, in 2001, China joined in the Asia-Pacific Trade Agreement (APTA) - formerly known as the Bangkok Agreement – with members including Bangladesh, India, Laos, Republic of Korea and Sri Lanka. China is also negotiating and promoting the Sino-Korea-Japan FTA, the East Asia Free Trade Agreement (EAFTA), and the Regional Comprehensive Economic Partnership (RCEP). In addition, Beijing has shown a great interest in joining the Trans Pacific Partnership Agreement (TPP). In May 2013, the Chinese Ministry of Commerce declared that it was studying the possibility of joining the TPP.<sup>23</sup>

These bilateral and regional FTAs comprise a unique Chinese FTA network and constitute an important part of PRC foreign policy. Some scholars go so far as to claim that a new form of Chinese foreign policy is emerging – FTA diplomacy.<sup>24</sup> Drawing on their studies, this thesis explores *China's FTA diplomacy: what it is, how it functions, and whether and to what extent it is effective*.

### 1.3 Review of the Literature

The research on Chinese FTAs has lagged behind the burgeoning of economic phenomena. Political studies, in particular, present a paucity of both empirical volume and theoretical analysis. This gap is mainly attributable to the fact that the political intentions behind the FTAs are themselves hidden behind economic activities, making

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<sup>23</sup> Zachary Keck, "China May Join US-led Trans-Pacific Partnership Talks " (The Diplomat, May, 2013).

<sup>24</sup> See Jane Drake-Brockman, "Chinese Approaches to Negotiation: Implications of Contemporary Practices for the Future," in *China's Future Diplomacy Research and Public Symposium* (Canberra, Australia 2006); Henry Gao, "China's Strategy for Free Trade Agreements: Political battle in the Name of Trade," in *Asian Regional Workshop on Free Trade Agreements: Towards inclusive trade policies in post-crisis Asia* (2009); James Chieh Hsiung, "Soft Power, Geoeconomics, & Empathy in China's New Diplomacy," in *The 55th annual American Association for Chinese Studies conference*. (Rutgers University in New Jersey, 2013). Many scholars believe that FTA construction is part of a country's economic diplomacy. There are also many China observers who regard China's FTA endeavors as part of its economic diplomacy, see Pang Zhongying, "Does China Need a New Foreign Policy?," in *The Hu Jintao Decade in China's Foreign and Security Policy (2002-12)* (Stockholm 2013); Ellen Frost, "China's Commercial Diplomacy: Promise or Threat?," in *China's Rise and the Balance of Influence in Asia*, ed. William W. Keller and Thomas G. Rawski (Pittsburgh, PA: University of Pittsburgh Press, 2007).

them even harder to discern. When they are inferable, they are difficult to prove due to the lack of substantial information supporting such political studies, with the exception of a few policy releases. The existing literature on Chinese FTAs suffers from a lack of either depth or scope, or both, regarding the political significance of this economic subject.

*Paucity of empirical studies*

While it is beyond my ability to provide a full list of empirical research on all Chinese FTAs, there are key themes within it that are related to this thesis. First, the bulk of studies have focused on the specific experience of the China-ASEAN FTA (CAFTA). For example, Chirathivat uses a CGE model to infer the economic effects of the CAFTA. The results show that the FTA is welfare-improving with China and ASEAN's GDP growth increasing 36% and 0.38%, representing US\$298.6bn and US\$178.7bn respectively. However, ASEAN is a bigger winner in terms of trade expansion with tariff reduction (53.3% of trade expansion rate compared to China's 23.1%).<sup>25</sup> An opposing view is held by scholars such as Tongzon, Wong and Chan, whose studies stress apprehensions amongst ASEAN members that CAFTA will lead to fierce competition rather than opportunities. They conclude that trade and investment expansion will emerge only if both sides can harness the synergies and comparative advantages of their own economies to create complementary benefits. This requirement is particularly difficult for ASEAN countries, each of which is having trouble setting "their house in order" in the short term.<sup>26</sup>

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<sup>25</sup> This view is widely shared by many other researchers on this subject, with varied extents. See Suthiphand Chirathivat, "ASEAN–China Free Trade Area: background, implications and future development," *Journal of Asian Economics* 13, no. 5 (2002); Siow Yue Chia and Chalongsob Sussangkarn, "The Economic Rise of China: Challenges and Opportunities for ASEAN," *Asian Economic Policy Review* 1, no. 1 (2006); Leu Guanyi, "ASEAN's Preferential Trade Agreement (PTA) Strategy," *Journal of Current Southeast Asian Affairs* 30, no. 2 (2011); Donghyun Park; Innwon Park; Gemma Esther B. Estrada, "Prospects of an ASEAN–People's Republic of China Free Trade Area: A Qualitative and Quantitative Analysis," in *ADB Economics Working Paper Series* (Asian Development Bank, 2008); David Roland-Holst, "An Overview of PRC's Emergence and East Asian Trade Patterns to 2020," (Tokyo: Asian Development Bank, 2002); Estrada, "Prospects of an ASEAN–People's Republic of China Free Trade Area: A Qualitative and Quantitative Analysis."

<sup>26</sup> See Jose L. Tongzon, "ASEAN-China Free Trade Area: A Bane or Boon for ASEAN Countries?," *World Economy* 28, no. 2 (2005).; and John Wong and Sarah Chan, "China-Asean Free Trade Agreement: Shaping Future Economic Relations," *Asian Survey* 43, no. 3 (2003).

Other research has specifically analyzed the impacts of the CAFTA, (and the Early Harvest Programme (EHP) in particular), on agricultural trade, again with contrasting findings. Supporters such as Yang Yafei claim that the agricultural structures between China and ASEAN are complementary, as confirmed by the fact that bilateral agricultural trade between the two sides under the EHP has increased by 116.2% and 144.2% respectively during the agreement's five years of operation.<sup>27</sup> In contrast, opponents argue that swiftly expanded imports of ASEAN tropical produce have caused many farmers in Yunnan, Guangxi and Hainan provinces to lose money or, even worse, their major source of income.<sup>28</sup> Apart from the EHP, specific research on CAFTA's impacts on two-way investment is rare. Liu and Gao are two of the few scholars to extend the gravity model to the investment field, and find that the CAFTA has brought obvious positive investment creation and transfer effects.<sup>29</sup> The same criticism applies

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<sup>27</sup> 杨亚非; Yang Yafei, "中国-东盟自由贸易区与广西农业 (The China-ASEAN FTA and its Impacts on Guangxi Province's Agricultural Sector)," *东南亚纵横 (Around Southeast Asia)*, no. 12 (2003).

<sup>28</sup> An empirical survey conducted by the Chinese Agricultural Ministry detected similar findings. According to this survey, depart from discernable economic losses, there exists some structural obstacles to further promote agricultural cooperation between China and ASEAN such as lacking adequate cooperative funding, the disordered export competition, etc. See 陈前恒 ; Chen Qianheng, "关于中国-东盟农业合作状况的调研 - Survey Report on China-ASEAN Cooperation in Agriculture," *东南亚纵横 (Around Southeast Asia)*, no. 2 (2009).; and Jiang Yang, "China's pursuit of free trade agreements: Is China exceptional?," *Review of International Affairs* 17, no. 2 (2010).

<sup>29</sup> 刘志雄 ; 高歌 (Liu Zhixiong ; Gao Ge), " CAFTA 框架下中国对东盟投资效应的实证研究 - Empirical Research on Investment Effect of China to ASEAN under the Framework of CAFTA " *东南亚纵横 (Around Southeast Asia)*, no. 1 (2011). Similarly, Tianshu Liu adopts a modified gravity model and concludes that the formation and implementation of RTAs determines foreign capitals flowing into China. See Tianshu Liu, "Impact of Regional Trade Agreements on Chinese Foreign Direct Investment," *Chinese Economy* 41, no. 5 (2008). Interestingly, whilst the paucity of analysis on CAFTA's impact on bilateral investment, a good body of works tends to focus on China and ASEAN's vying in attracting FDI. See Asian Development Bank, *Asian Development Outlook 2012: Confronting Rising Inequality in Asia*, Asian Development Outlook (Oxford University Press, 2012).; Donghyun Park, "The Prospects of the ASEAN-China Free Trade Area (ACFTA): A Qualitative Overview," *Journal of the Asia Pacific Economy* 12, no. 4 (2007). A serious surveys conducted by the World Bank, similarly predict that the lower-income ASEAN members' FDI condition would be further exacerbate in the aftermath of China's accession to the WTO. See and Min Zhao Sethaput Suthiwart-Narueput, "Regional Impact of China's WTO Accession," in *East Asia Integrates: A Trade Policy Agenda for Shared Growth*, ed. Kathie L. Krumm and Homi J. Kharas (Washington D.C.: World Bank, 2004).; and Elena Ianovichina and Terrie Louise Walmsley, "The Impact of China's WTO Accession on East Asia," in *World Bank Poverty Reduction and Economic Management Network Economic Policy Division* (Washington D.C.: World



to Trade in Services (TIS), an important component of the agreement, which receives even less empirical attention. An exception is the analysis of Zhou Jincheng, who estimates the two sides' comparative advantages in service sectors by calculating the Trade Special Coefficient. This estimation indicates that bilateral trade in services present strong complementarities and has laid a solid foundation for further liberalization.<sup>30</sup>

The quantitative nature of previous works provides a relatively intuitionistic understanding of CAFTA's economic effects. However, these inconsistent and inconclusive findings, similar to earlier literature in the section 1.1, bring more confusion than clarity. Moreover, a large number of studies are based on *ex ante* predictions. I would argue that before and after analysis on participants' economic performances can lend more credibility to the economic effects of the CAFTA, and other Chinese FTAs *ceteris paribus*. Furthermore, extant research on the CAFTA is not as comprehensive as the FTA *per se*. To be more specific, a majority of scholars focus exclusively on trade in goods, leaving studies on trade in services and investment shaky and feeble, a gap this dissertation addresses. Other oversights of prior literature include the absence of analysis of the Great Mekong Subregion (GSM) mechanism on the one hand, and the absence of specific study on the concomitant CSFTA, which appears as a smaller edition of the CAFTA. My work seeks to offset these oversights by offering more comprehensive accounts of these issues.

Another branch of literature has examined China's cross regional free trade agreements (CRTAs). For example, a book-length work, *Cross Regional Trade Agreements*, is one of this field's best efforts to understand why states break geographical constraints to these agreements.<sup>31</sup> In the China chapter, Hoadley and Yang systemically explore the Chinese CRTAs with New Zealand, Australia and Chile. They claim that CRTAs are an important supplement to China's diplomacy, significant not only for their economic

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Bank, 2003). For an opposite opinion, see John Ravenhill, "Is China an Economic Threat to Southeast Asia?," *Asian Survey* 46, no. 5 (2006).

<sup>30</sup> 周金城 ; Zhou Jincheng, "中国-东盟服务贸易发展的现状及战略选择 - The Development Status Quo and Strategy of Service Trade in China and ASEAN " *东南亚纵横 (Around Southeast Asia)*, no. 5 (2012).

<sup>31</sup> Saori Katada and Mireya Solís, *Cross Regional Trade Agreements: Understanding Permeated Regionalism in East Asia*, The Political Economy of the Asia Pacific (Springer Berlin Heidelberg, 2008).

potential, but also for their enhancement of China's national power and international leadership.<sup>32</sup> In 2011, the Pakistan Institute of Trade and Development (PITD) conducted a survey on the CPFTA's empirical effects since its inception in 2007—*Evaluation of Pakistan-China FTA*. This reveals that China has successfully made inroads into the Pakistani market in all merchandise categories, both with and without tariff concessions; while only the first two categories have witnessed an increase in Pakistan's exports.<sup>33</sup> Zhou Nianli *et al* estimate the openness of trade in services under the CPFTA, and suggest the Chinese government to grasp opportunities during the process of Pakistan privatization, particularly in sectors such as financial services and transportation.<sup>34</sup> There have also been occasional publications of journal papers on other Chinese CRFTAs. Gachuz for instance, analyses the China-Chile FTA, and warns of the unsustainable risks of being over-reliant on the Chinese market and a new round of Chilean import substitution;<sup>35</sup> while Lanteigne focuses on the China-Iceland FTA, and views Beijing's CRTA efforts as a side-door approach to further engagement with the European economy.<sup>36</sup>

There are a couple of shortcomings in the above works. First, there is a worrying trend of treating China as a unitary actor in FTA decision-making. As Yang Jiang argues, contemporary China's economic policy formulation and implementation is the result of internal political struggles amongst the leadership; and the inter-sectorial and central-provincial fragmentation of powers must be considered. To address this analytical shortcoming, Yang advocates studying China's FTAs with an eye on its "fragmented

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<sup>32</sup> Hoadley Stephen and Jiang Yang, "China's Free Trade Negotiations: Economics, Security and Diplomacy," in *Cross Regional Trade Agreements: Understanding Permeated Regionalism in East Asia*, ed. Saori and Solís Katada, Mireya (New York Springer, 2008).

<sup>33</sup> Addil Khan Miankhel; Sadia Hissam; M Rizwan Aslam; Hammad Mughal, "Evaluation of Pakistan-China FTA," in *Pakistan Institute of Trade and Development's (PITD) Working Papers* (Islamabad: PITD, 2011).

<sup>34</sup> 周念利; 宋鸿飞; 亢梅玲 (Zhou Nianli; Song Hongfei; Kang Meiling), "中巴自贸区服务贸易开放水平评估、提升方向及对策建议 - China-Pakistan FTA: Assessment, Improvement and Suggestions on the Liberalization of Service Trade," *南亚研究 (South Asian Studies)*, no. 04 (2011).

<sup>35</sup> Juan Carlos Gachuz, "Chile's Economic and Political Relationship with China," *Journal of Current Chinese Affairs* 41, no. 1 (2012).

<sup>36</sup> Marc Lanteigne, "Northern Exposure: Cross-Regionalism and the China-Iceland Preferential Trade Negotiations," *The China Quarterly* 202(2010).

authoritarianism”,<sup>37</sup> a feature that is an important part of this thesis. Second, this literature focuses exclusively on a limited number of Chinese CRTAs while ignoring others such as agreements with New Zealand<sup>38</sup>, Peru, and Costa Rica.<sup>39</sup> I would argue that the omitted FTAs, with their different geographic, economic and strategic character, are of no less significance. Their absence may lead to a misreading of China’s FTA strategy as a whole. Certainly there are some articles that attempt to fill this gap.<sup>40</sup>

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<sup>37</sup> Yang Jiang, "China's Pursuit of Free Trade Agreements: Is China Exceptional?," *Review of International Political Economy* 17, no. 2 (2010).

<sup>38</sup> In fact, some Chinese scholars have tried to survey the economic effects of the C-NZ FTA. For example, Fan Ying and Zhao Ji respectively conducted specific research on the bilateral agreement’s impacts on both sides. Their research however lacks both suitable theoretical support and convincing data analysis. This reflects a common failing among the Chinese scholarship, which either follows the suit of Western research paradigms, or flatters the government with inane vague or inane reports. This dissertation therefore tries to avoid making reference to such kind of Chinese language work. Ye and Kessebohm, from a legal perspective, provide a detailed interpretation of some terminology appeared in the C-ZN FTA text in its English version, which leads confusion to the English readers. This research, while important for translators and drafters of legal documents, however presents only a corner of iceberg of this FTA. See 樊莹 (Fan Ying), " 中国-新西兰自由贸易区的经济效应展望 - On the Prospect of the China-New Zealand Free Trade Areas " *外交学院学报 (Foreign Affairs Review)*, no. 4 (2005).; 赵佶 (Zhao Ji), " 中国和新西兰自由贸易协定 (FTA) 的经济效应 - Economic Effect of Free Trade Agreement Between China and New Zealand," *东北农业大学学报(社会科学版) Journal of Northeast Agricultural University (Social Science Edition)* 5, no. 4 (2007).; and Ruiping Ye and Ricarda Kessebohm, "The China-NZ FTA and Waxing Juridical," *Victoria University of Wellington Law Review* 42, no. 2 (2011).

<sup>39</sup> Evan Ellis’s *China in Latin America* is one of this field’s most comprehensive works on relations between the two sides. Nevertheless, although economic relation is rife with the whole book, China’s CRTAs with regional countries can be caught only a word or two in the discourses. There are some other Ellis’s studies on bilateral relationship between China and Latin America published elsewhere, all mentioned the pivotal role of these CRTAs but again only dipped into. See Evan Ellis, *China in Latin America: The Whats & Wherefores* (London: Lynne Rienner Publishers, Inc., 2009).; R. Evan Ellis, "Chinese Soft Power in Latin America: a case study," *Joint Force Quarterly*, 2011/01// 2011.; and Evan Ellis, "The United States, Latin America and China: A “Triangular Relationship”?," in *Inter-American Dialogue 30 Years* (Washington: Center for Hemispheric Defense Studies, the Department of Defense fo the US Government, 2012-05).

<sup>40</sup> See Qingjiang Kong, "China's Uncharted FTA Strategy," *Journal of World Trade* 46, no. 5 (2011).; Guoyou Song and Wen Jin Yuan, "China's Free Trade Agreement Strategies," *The Washington Quarterly* 35, no. 4 (2012).; Ka Zeng, ed. *China's foreign trade policy : the new constituencies* Routledge contemporary China series ; 22 ( London ; New York : Routledge, 2007., 2007); Ka Zeng, "Multilateral versus Bilateral and Regional Trade Liberalization: explaining China's pursuit of free trade agreements (FTAs)," *Journal of Contemporary China* 19, no. 66 (2010).; John Ravenhill and Jiang Yang, "China's

However they are only disconnected vignettes that fail to capture the bigger picture of the Chinese FTA strategy. Further, these works need relevant and theoretical analysis, since empirical studies without theoretical supports are “mostly anecdotal and far from exhaustive”.<sup>41</sup> The dissertation now turns to theoretical study on Chinese FTAs.

### *The Paucity of Theoretical Alternatives*

*A regional view* - A large body of literature has studied China's FTA from the perspective of regional integration, and it reveals two opposing views. A series of working papers conducted by ADB propose that China's FTAs with regional countries, and the CAFTA in particular, are stepping stones to an integrated Asia.<sup>42</sup> Similarly, in its research on Regional Trade Agreements in the Asia-Pacific, the United Nations Conference on Trade and Development (UNCTAD) reveals that an FTA between Japan and Korea has negative coefficients. However, when the agreement extends to encompass China, the coefficients are positive. It therefore follows that “a bloc centered on China might be beneficial”.<sup>43</sup> In a similar vein, Zhang Yunling, in a book-length work studying relationships between China and ASEAN, draws a road map of bilateral and sub-regional FTAs culminating into a “10+3”-based FTA. He underscores the CAFTA as a feasible model for the future EAFTA.<sup>44</sup> Antkiewicz and Whalley extend this argument to the broader area of the Asia Pacific and argue that China is

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Move to Preferential Trading: a new direction in China's diplomacy," *Journal of Contemporary China* 18, no. 58 (2009).; Yanying Zhang, Gaiyan Zhang, and Hung-Gay Fung, "The Prospects for China's Free Trade Agreements," *Chinese Economy* 40, no. 2 (2007).

<sup>41</sup> WTO, "The WTO and preferential trade agreements: From co-existence to coherence."p.98

<sup>42</sup> See Innwon Park; and Soonchan Park Gemma Estrada; Donghyun Park, "ASEAN's Free Trade Agreements with the People's Republic of China, Japan, and the Republic of Korea: A Qualitative and Quantitative Analysis," (Tokyo: Asian Development Bank, 2011); Estrada, "Prospects of an ASEAN–People's Republic of China Free Trade Area: A Qualitative and Quantitative Analysis."; Masahiro Kawai and Ganeshan Wignaraja, "Free Trade Agreements in East Asia: A Way toward Trade Liberalization?," in *ADB Briefs* (ADB, 2010). There are other journal articles confirm with this idea. See David Roland-Holst and John Weiss, "People's Republic of China and Its Neighbours: Evidence on Regional Trade and Investment Effects," *Asian-Pacific Economic Literature* 19, no. 2 (2005).

<sup>43</sup> John Gilbert; Robert Scollay; Bijit Bora, "Assessing Regional Trade Arrangements in the Asia-Pacific," in *Policy Issues in International Trade and Commodities Study Series* (Geneva: UNCTAD, 2011).

<sup>44</sup> “10+3” refers to three Northeast Asia countries (China, Japan and South Korea) plus 10 ASEAN member countries. A “10+3”-based FTA is normally called East Asian Free Trade Agreement (EAFTA). This is more fully explained in the empirical chapter. Zhang Yunling, "Designing East Asian FTA: Rational and Feasibility," in *China and Asian Regionalism*, ed. Zhang Yunling (Singapore: World Scientific Publishing CO. Pte. Ltd, 2010).

weaving an FTA network to foster a gradually integrated region— with itself increasingly sitting in the driving seat.<sup>45</sup> Inspired by the European integration models, this strand of scholarship envisages an FTA-led regionalism in East Asia, one which may lead to a third regional bloc beyond the EU and NAFTA.<sup>46</sup>

There is, however, increasing evidence of discordant findings. Li Xinyi, for example, claims that the vertical specialization-based trade between China and ASEAN is not evident; and he concludes that the CAFTA is too shallow to promote regional integration.<sup>47</sup> Christopher Dent points out that the new bilateral FTA trend in East Asia brings significant impediments to the formation of a regional-wide FTA.<sup>48</sup> Sally and Sen, in a comparative study of China and India's regional FTA strategies, highlight that most of the two countries' FTA initiatives result at best in a partial liberalization, and are unlikely to be building blocks toward an integrated Asia.<sup>49</sup> What may account for these inconsistent conclusions are that the theory of regionalism is essentially Western-grounded and may fail to take into account Asia's unique histories, cultures, and political traditions. Moreover, as Acharya points out, the present crisis in the EU, whether it leads to a weaker or stronger community, renders the Eurocentricism of the regionalism apparatus more difficult "to be emulated by others".<sup>50</sup> Therefore, some IR scholars, from a *realpolitik* perspective, are beginning to seek alternative theoretical tools to analyze questions regarding Asian regionalism.

*A realpolitik view* – Many see Beijing's move into FTAs as predominantly shaped by strategic concerns about the power game. For example, the contours of an integrated

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<sup>45</sup> Agata Antkiewicz and John Whalley, "China's New Regional Trade Agreements," *World Economy* 28, no. 10 (2005).

<sup>46</sup> See Lisbeth Hellvin; Lars Nilsson, "Trade Flows Between Trading Blocs: The Case of the EU's Trade with Asia and NAFTA," (2000); Asia Today, "East Asia Trade Bloc Would Balance NAFTA and EU," (2004-12-10); Wieslaw Michalak; Richard Gibb, "Trading Blocs and Multilateralism in the World Economy," *Annals of the Association of American Geographers* 87, no. 2 (1997).

<sup>47</sup> Xinyi Li, "Free Trade Agreements and Vertical-Specialisation in East Asia," *Asia Europe Journal* 7, no. 1 (2009).

<sup>48</sup> Christopher M. Dent, "Bilateral Free Trade Agreements: Boon or Bane for Regionalism in East Asia and the Asia-Pacific?," *European Journal of East Asian Studies* 4, no. 2 (2005).

<sup>49</sup> Razeen Sally and Rahul Sen, "Trade Policies in Southeast Asia in the Wider Asian Perspective," *The World Economy* 34, no. 4 (2011).

<sup>50</sup> Amitav Acharya, "Comparative Regionalism: A Field Whose Time has Come?," *The International Spectator: Italian Journal of International Affairs* 47, no. 1 (2012), pp.11-12

Asia remain in continuous flux, mainly due to the inconclusive debates on a “10+3” or “10+6” based EAFTA, a situation shaped by leadership rivalry between China and Japan.<sup>51</sup> Consequently, it is fairly easy to find literature arguing that Beijing wields the instrument of FTAs to acquire a more favorable position in the process of regional integration and in particular, to “steal a march” on Japan.<sup>52</sup> For example, Mie Oba finds that China’s pursuit of FTAs has not only changed the power configuration in Asia but also generated “an increasingly acrimonious rivalry” between China and Japan for political leadership in this region.<sup>53</sup> Other scholars’ findings confirm the view that the CAFTA is not primarily for economic gains, but rather, it is a diplomatic coup and part of China’s competition with Japan.<sup>54</sup> Scholarship in the realist vein, concerning deep political cleavages in Northeast Asia, is quite pessimistic about the future of an integrated Asia.<sup>55</sup> Applying this theory to the Sino-America rivalry, Thomas Christensen argues that the CAFTA “provides an important means by which to prevent the United States from penetrating the Southeast Asian region by way of bilateral military alliances and building an encircling ring around China”.<sup>56</sup>

Yet the theoretical endeavors listed above are inadequate because most of them work within the paradigm of regionalism while leaving aside China’s FTAs with non-regional countries. Yet the latter, I contend, are of equal theoretical significance. Furthermore,

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<sup>51</sup> “10+3” refers to ten ASEAN members plus China, South Korea and Japan. “10+6” means “10+3” countries plus Australia, New Zealand and India.

<sup>52</sup> See Kevin G. Cai, “Chinese Changing Perspective on the Development of an East Asian Free Trade Area,” *Review of International Affairs* 3, no. 4 (2004); Barry Desker, “In defence of FTAs: from purity to pragmatism in East Asia,” *Pacific Review* 17, no. 1 (2004).

<sup>53</sup> Mie Oba, “Regional Arrangements for Trade in Northeast Asia: Cooperation and Competition between China and Japan,” in *Asia’s New Institutional Architecture: Evolving Structures for Managing Trade, Financial, and Security Relations*, ed. Vinod K. Aggarwal and Min Gyo Koo (Springer Berlin Heidelberg, 2008).

<sup>54</sup> Yuzhu Wang, “China, Economic Regionalism, and East Asian Integration,” *Japanese Journal of Political Science* 12, no. 2 (2011); John Ravenhill, “The New Trade Bilateralism in East Asia,” in *East Asian Multilateralism: Prospects for Regional Stability*, ed. Kent Calder; Francis Fukuyama (Baltimore: Johns Hopkins Press, 2008); Wang Yuankang, “China’s Response to the Unipolar World: The Strategic Logic of Peaceful Development,” *Journal of Asian and African Studies* 45(2010).

<sup>55</sup> Cai, “Chinese Changing Perspective on the Development of an East Asian Free Trade Area.”; Kevin G. Cai, “Is a Free Trade Zone Emerging in Northeast Asia in the Wake of the Asian Financial Crisis?,” *Pacific Affairs* 74, no. 1 (2001).

<sup>56</sup> Thomas J. Christensen, “Fostering Stability or Creating a Monster? The Rise of China and U.S. Policy toward East Asia,” *International Security* 31, no. 1 (2006).

realist works focus mainly on China's strategic motivations in building FTAs but provide no explanations as how and to what extent these motivations can be realized. More importantly, realist studies tend to interpret China's activities from the perspective of its regional motivations, which correctly define the Chinese FTAs as building "security-embedded" economic ties.<sup>57</sup> However, what if we explore China's motives through its activities? Realism then gets bogged down since Beijing and Tokyo have taken a decisive step toward an integrated Asia by starting negotiations on the China-Japan-South Korea FTA. Besides, a country's foreign economic activity cannot be fully understood without considering its domestic context, another notable deficiency in the literature.<sup>58</sup>

There is a paucity of coherent theoretical approaches to China's FTA strategy. Any alternative theoretical approach must go some way to answering diverse questions such as: is it only aspirations for leadership in the process of East Asian regionalization that underpins China's FTA policy? If so, does China have the same aspiration in other regions, like Latin America? And is Japan still the PRC's potential rival? *Ceteris paribus*, does China want to use the Sino-Pakistan FTA to promote regional integration in South Asia? If the relationship between Pakistan and India became warm, what practical payoffs might China derive? Moreover, China makes asymmetric concessions in the CAFTA. If it is, as many realist researchers indicated, a unilateral gift that Beijing provides as a reward to ASEAN, can we expect that similar concessions will be made to develop other partners such as New Zealand and Iceland? Leaving these questions unanswered for now, I contend that regionalism and realism have, at best, done only half the work needs to effectively interpret Chinese FTA strategies. To address these

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<sup>57</sup> Vinod K. Aggarwal and Min Gyo Koo, "The Past, Present, and Future of Asia's Institutional Architecture," in *Asia's New Institutional Architecture: Evolving Structures for Managing Trade, Financial, and Security Relations*, ed. Vinod K. Aggarwal and Min Gyo Koo (Springer Berlin Heidelberg, 2008).

<sup>58</sup> The paucity of analysing FTA from participants' domestic dimensions is a common problem in FTA studies. The only book-length work on this issue, to the best of my knowledge, only contains a chapter-length study on relations between China's domestic politics and its FTA strategies. See Wan Ming, "The domestic political economy of China's preferential trade agreements," in *Trade policy in the asia-pacific: the role of ideas, interests and domestic institutions*, ed. Vinod and Lee Aggarwal, Seungjoo (London: Springer Science, 2011). Another exception is a journal article comparing China and Japan's domestic political economies and the respective impacts on their FTA policies. See Heidetaka Yoshimatsu, "Domestic Political Institutions, Diplomatic Style and Trade Agreement: A Comparative Study of China and Japan," *New Political Economy* 15, no. 3 (2010).

gaps, this thesis introduces international regime theory, which is congruent with China's FTA activities, and has explanatory powers well beyond those of current IR scholarship. Of course, as suggested by some IR scholars, a theory is not necessarily correct just because it shows that others are wrong.<sup>59</sup> Insofar as regionalism and realism provide crucial steps forward the political perspective of China's FTA strategy, I will of course refer to them when necessary. The next section turns to the introduction of some basic definitions of international regime theory, and discusses its adequacy for analyzing Beijing's FTA diplomacy.

#### **1.4 Definitions and the Argument for International Regime Theory**

*International regime, international institution, international agreements, and FTAs*

There is no commonly agreed definition of an international regime. Some theorists stress regimes organizational roles in shaping countries' patterned-behaviors. For instance, Sidney Verba defines regimes as "generally accepted regular procedures for handling a problem and to normatively sanctioned behavior patterns".<sup>60</sup> Likewise, Keohane identifies regimes by "the existences of explicit rules that are referred to in an affirmative manner by governments, even if they are not necessarily scrupulously observed".<sup>61</sup> Others oppose these 'thick' substantive definitions, instead emphasizing that international regimes reflect participants' *convergent-expectations*. Kratochwil and Ruggie, for example, claim that 'verbal behaviors' (i.e. rationales and justifications for behavior) that are brought forward within regime implementations, together with pleas for mutual-understanding or tolerance of non-observance, have much more explanatory

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<sup>59</sup> Barbara Koremenos, Charles Lipson, and Duncan Snidal, "Rational Design: Looking Back to Move Forward," *International Organization* 55, no. 4 (2001).

<sup>60</sup> Sidney Verba, "Sequences and Development," in *Crises and Sequences in Political Development*, ed. L. Binder (Princeton: Princeton University Press, 1971).p.300

<sup>61</sup> Robert O. Keohane, "The Analysis of International Regime: Towards a European-American Research Programme," in *Regime Theory and International Relations*, ed. Volker Rittberger (Oxford: Clarendon Press, 1993).p.28. Others belong to the "behavioural approach" camp include Oran Young and Ernst Hass, whereby the former equate regimes as "practices consisting of recognized roles linked together by clusters of rules or conventions governing relations among the occupants of these roles", and the latter defined regimes as "arrangements peculiar to substantive issue-areas in international relations that are characterized by the condition of complex interdependence: neither hierarchy nor anarchy prevails and states rarely practice self-help". See Oran R. Young, *International Cooperation: Building Regimes for Natural Resources and the Environment* (Ithaca: Cornell University Press, 1989).p.12; Ernst B. Haas, "Words Can Hurt you; Or, Who Said what to Whom about Regimes," in *International Regimes*, ed. Krasner Stephen (Cornell University Press, 1982).p.27



powers than thick overt behavior models.<sup>62</sup> Cox offers a definition that is more subjective: regimes are “the power relations prevailing at their point of origin and tend, at least initially, to encourage collective images consistent with these power relations”. Eventually, regimes will assume lives of their own, and become either a battleground of contradictory initiatives, or stimulate emerging rival regimes reflecting diverse tendencies.<sup>63</sup>

These definitions have been criticized as radically separating object from subject,<sup>64</sup> thus leaving room to explore a middle ground. Experimentations along this line include the work of March and Olsen, who conceptualize regimes as “a relatively stable collection of practices and rules defining appropriate behavior for specific groups of actors in specific situations”.<sup>65</sup> In a similar vein, Hasenclever and his colleagues assert that regimes are “deliberately constructed, partial international orders on either a regional or a global scale, which are intended to remove specific issue-areas of international politics from the sphere of self-help behavior”.<sup>66</sup> I would argue that both the *patterned-*

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<sup>62</sup> Ruggie was in the opposing camp of positivism in an earlier article published in *International Organization* in 1982, whereby he proposed his representative concept of “embedded liberalism”, he highlighted the significances of social purposes and intersubjectivities. Four years later, in an article co-authored with Kratochwil, Ruggie again remarked subjectively that regimes are conceptual entities rather than concrete creations. Ruggie readjusted his understanding toward international regimes in a book published in 1998, whereby he proposed the new concept of “epistemic communities”, which he referred to as the “purely cognitive level” of a regime. But here he admitted that regimes are constituted by concrete entities as well, such as organizational plans, energies, and financial commitments, etc. He See Friedrich Kratochwil and John Gerard Ruggie, "International Organization: A State of the Art on an Art of the State," *International Organization* 40, no. 4 (1986); John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36, no. 2 (1982).pp.763-768; John Gerard Ruggie, "The New Institutionalism in International Relations," in *Constructing the World Polity: Essays on International Institutionalization*, ed. John Gerard Ruggie (London: Routledge, 1998).pp.55-56

<sup>63</sup> Robert W. Cox, "Social Forces, States and World Orders: Beyond International Relations Theory," in *Neorealism and Its Critics*, ed. Robert O. Keohane (New York: Columbia University Press, 1986).pp.136-137

<sup>64</sup> See Keohane, "The Analysis of International Regime: Towards a European-American Research Programme."; Ruggie, "The New Institutionalism in International Relations."

<sup>65</sup> James G. March and Johan P. Olsen, "The Institutional Dynamics of International Political Orders," *International Organization* 52, no. 4 (1998).p.948

<sup>66</sup> Andreas Hasenclever, Peter Mayer, and Volker Rittberger, "Integrating Theories of International Regimes," *Review of International Studies* 26, no. 1 (2000).p.3

*behaviors* and *convergent-expectations* definitions are important steps toward an understanding of international regimes, but efforts to build a bridge between them are more closely attuned to reality and provide more powerful explanations. My work hence adopts a synthesis of these approaches.

It is necessary then to make a distinction between international regimes and international institutions. The notion of international institution stems from Hedley Bull's omni-interpretation of "the institutions of international society", which includes "the balance of power, international law, the diplomatic mechanism, the managerial system of the great powers, and war".<sup>67</sup> Regimes facilitate the "institutionalization" of portions of international life by regularizing behaviors and grouping expectations, but some international institutions, such as war and the balance of power, far exceed the rights and rules of a conventional regime.<sup>68</sup> Some analysts thus aver that "international regimes are a major type of international institution",<sup>69</sup> but with different annotations.<sup>70</sup> In contrast, other scholars, such as Keohane, argue that leaving aside important theoretical and empirical questions to dwell excessively on definitional issues is

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<sup>67</sup> H. Bull, *The Anarchical Society: A Study of Order in World Politics* (London 1977), p.74

<sup>68</sup> Stephan Haggard and Beth A. Simmons, "Theories of International Regimes," *International Organization* 41, no. 3 (1987), p.496

<sup>69</sup> Scholars following this typology of international institutions include Cohen, who equates both regimes and organizations with a particular form of international institutions, and Kratochwil and Ruggie, who believe that regimes are equivalent to institutions "around which expectations converge in international issue-areas". see Hasenclever, Mayer, and Rittberger, "Integrating Theories of International Regimes."; Kratochwil and Ruggie, "International Organization: A State of the Art on an Art of the State." and Benjamin J. Cohen, *International political economy : an intellectual history* (Princeton, N.J. ; Woodstock : Princeton University Press, 2008), p.111

<sup>70</sup> Ruggie, for instance, differentiates three levels of institutionalization in defining states' collective actions: the epistemic communities, international regimes and international institutions. Here he labels an international regime as the second level of institutionalization, and define it as "sets of mutual expectations, agreed-upon rules, regulations and plans in accordance with which organizational energies and financial commitments are allocated". Barry Buzan, on the other hand, classified institutions as the primary group, which evolves to constitute both the players and the rules of game of international relations (sovereignty, nationalism, diplomacy, territoriality, etc); and the second group that are "recent, instrumental, mainly state-designed expressions of the underlying social structure of modern international relations" (such as regimes and international agreements and organizations). See Ruggie, "The New Institutionalism in International Relations." And Zhang Yongjin and Barry Buzan, "The Tributary System as International Society in Theory and Practice," *The Chinese Journal of International Politics* 5(2012).

counterproductive.<sup>71</sup> In his famous book, *After Hegemony*, he therefore asserts that “regimes ... are institutions”.<sup>72</sup> Likewise, Stein points out that “the role of international institutions ... equates with regimes. Even those who recognized that regimes need not be institutionalized still suggest that institutionalization is one of their major dimensions”.<sup>73</sup> In this regard, this dissertation will follow Martin’s example, and use both terms interchangeably.<sup>74</sup>

Regimes must also be distinguished from international agreements. According to Keohane, it is sensible to define agreements in purely formal terms (explicit rules agreed by signatories) and to regard regimes as emerging when countries recognize the “continuing validity” of such agreements.<sup>75</sup> The conceptualization of regime is agreement-based and suggests that *ad hoc* agreements and regimes in a broader sense are mutually constructive. On the one hand, substantive agreements written down on a piece of paper help bring about intersubjectivity and rule-governed practices, and thus international regimes. On the other hand, regimes expedite the establishment of agreements by providing an overarching ready-made framework of agreed-upon rules and principles.<sup>76</sup> Regimes therefore are embodied in “treaties requiring careful interpretation and adaptation to changing circumstances”.<sup>77</sup> To sum up, in terms of conceptual scope, agreements are smaller than institutions, and institutions are smaller than regimes. These distinctions are important when one considers how they are joined in the case of FTAs.

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<sup>71</sup> Keohane, "The Analysis of International Regime: Towards a European-American Research Programme."p.26

<sup>72</sup> Robert O.Keohane, *After Hegemony -- Cooperation and Discord in the World Political Economy* (Princeton, New Jersey: Princeton University Press, 1984).p.197

<sup>73</sup> Arthur A. Stein, "Coordination and collaboration: regimes in an anarchic world," in *International Regimes*, ed. Stephen D. Krasner (London: Cornell University Press, 1983).p.133

<sup>74</sup> Martin argues that substituting the term institutions with the term institution should not bring any major confusion in practical research. See Lisa L. Martin, "An Institutional View: International Institutions and State Strategies," in *International Order and the Future of World Politics*, ed. T. V. Paul; John A. Hall (New York: Cambridge University Press, 1999).pp.79-80

<sup>75</sup> Keohane, "The Analysis of International Regime: Towards a European-American Research Programme."p.28

<sup>76</sup> Peter Mayer and Voler Rittberger Andreas Hasenclever, *Theories of International Regimes* (Cambridge: The Press Syndicate of The Universtity of Cambridge, 2002).p.19

<sup>77</sup> Oran R. Young, "Review: International Regimes: Toward a New Theory of Institutions," *World Politics* 39, no. 1 (1986).p.122

The forerunners to FTAs were no more than occasional contracts to correct market failures. As long as they proved to be effective, and when *ad hoc* contracts for specific goods in international markets are insufficient, demands to transform previous FTAs into patterned agreements encompassing basic rules, ordering principles and procedures will arise. Booming FTA networks evidence such demands for a “continuing validity” amongst potential partners in the era of globalization. This validity, in turn, implies both subjective lessons, like the benefits of formal dispute settlement arrangements and the delegation of technical tasks to a secretariat,<sup>78</sup> and objective lessons, such as the benefits of economic liberalization and integration. Regime meanings thus lurk below the surface of FTAs, and FTAs run deeper to promote the formation and transformation of international trade regimes. FTAs are both shaped by regimes, and serve to shape regimes? For a number of reasons, there are yet to be any unitary regulatory arrangements or forms for FTAs – for example, there are a huge number of potential partners; there is a wide range of issues available for collaboration, some of which are chosen for negotiation; and some FTAs have similar goals and formats, but with various scopes and depths. These FTAs are neither hierarchically integrated, nor are they fully fragmented. Instead, the seemingly loosely coupled arrangements amongst FTAs are interlinked in a variety of ways -- together they form what Keohane has called “a regime complex”.<sup>79</sup>

For research purposes, I identify an FTA as a formal international regime, and define it as *constructed by signatories to consciously regulate their self-help behaviors in issue-areas of trade, services and investment to achieve respective intentionality*. As this definition is very different from the one most common in the literature, it opens an alternative analytical window on the regime side of FTAs and fills the gaps in this field. The next section turns to *how* to apply international regime theories to the study of Chinese FTAs.

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<sup>78</sup> Robert O. Keohane, "International Institutions: Can Interdependence Work?," *Foreign Policy*, no. 110 (1998).p.85

<sup>79</sup> Robert O. Keohane and David G. Victor, "The Regime Complex for Climate Change," *Perspectives on Politics* 9, no. 01 (2011).p.12

*China's institutional diplomacy and international regime theory as the way forward*

China's rapid economic ascent over the past 30 years is one of the most successful development stories of modern times. Nevertheless, as a rising power, China has missed two critical historical opportunities to take more 'traditional' pathways to make further improvements. One was to endogenously develop via an industrial revolution as Great Britain did in the 18<sup>th</sup> century. The second was to develop exogenously by building military alliances like the United States did in the aftermath of World War II. Worse, alternative pathways to achieve the "China dream" (中国梦) are as yet unclear: in its substantive behaviors, potential rivals are wary of Beijing's efforts to "rejuvenate the Chinese nation"; neighbors resist any possibility of a return to the imperial tribute system; and political slogans such as "harmonious society" and "harmonious world" have failed to make substantial inroads, both domestically and internationally. Fortunately, another pathway for Beijing has presented itself in the form of institutionalization. As Lanteigne declared, "China has chosen a different (and more indirect) path to greater power acquisition via an international system containing more institutions than had ever previously existed".<sup>80</sup>

China's emergent rhetoric and actions in the international political economy indicates that international regimes are becoming a new 'favorite' in Beijing's diplomatic strategy.<sup>81</sup> Economically, China has vigorously engaged multilateral institutional frameworks such as the WTO and the International Monetary Fund (IMF), as well as regional regimes like the ADB and the Chiang Mai Initiative (CMI). Politically, China's active role in institutions like the United Nations (UN) and the ASEAN Regional Forum (ARF) has raised expectations greater political clout, and even leadership. The propaganda blitz on "Jizhijhua" (机制化, institutionalization) has begun in earnest, and

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<sup>80</sup> Marc Lanteigne, *China and International Institutions: alternate paths to global power* (New York: Routledge, 2005).p.1

<sup>81</sup> Chien-Peng Chung, "China's Approaches to the Institutionalization of Regional Multilateralism," *Journal of Contemporary China* 17, no. 57 (2008); Mark Beeson, "Trading places? China, the United States and the Evolution of the International Political Economy," *Review of International Political Economy* 16, no. 4 (2009); Mark Beeson and Yong Wang, "Australia, China, and the U.S. in an Era of Interdependence: Irreconcilable Interests, Inadequate Institutions?," *Asian Survey* 54, no. 3 (2014); John Ikenberry, "America's Challenge: The Rise of China and the Future of Liberal International Order," (New America Foundation, July, 2011); G. John Ikenberry, *Liberal Leviathan: The Origins, Crisis, and Transformation of the American World Order* (USA: Princeton University Press, 2012).

frequently appears in government policies, mainstream media, and particularly in leaders' addresses to various international forums.<sup>82</sup> A strategic aspiration on the part of the leadership to institutionalize foreign activities within institutional frames is thus apparent, though it is still uncertain whether this move is purely utilitarian or reflects a fundamental ideational change.<sup>83</sup> Ostensibly, Beijing, as a relative latecomer in the international regime club, is "concerned and vigilant" about the possibility of being held hostage to rules set by other great powers.<sup>84</sup> In essence, however, it has discarded the pervasive mentality of regarding itself as a victim of imperialism and capitalism, since no nation can assume leadership without moving to embrace institutions in the era of "Institutional Darwinism".<sup>85</sup> It is no exaggeration to say that Beijing's diplomatic strategy is now evolving into an *institutional diplomacy*.

In practical terms, FTA diplomacy constitutes an integral part of China's institutional diplomacy around the world. Three reasons can be discerned. First, an institutionalized economic relationship serves as the basis of a solid diplomatic relation as a whole. This in turn, helps stabilize expectations in other issue areas. Second, the notion of FTAs is a product of the Western-led globalization, and its initial rules and patterns were set by western countries. Accepting these norms is to show that China is prepared to 'play by the rules, rather than be a revisionist in international society. Third, an FTA provides Beijing both a spear and a shield to deal with domestic interest groups. Its "selective liberalization" nature allows the government to protect sectors that it believes are crucial to national economy, whilst providing an "excuse" to promote domestic reforms when necessary or applicable.

In theoretical terms, the institutional nature of FTAs, as elaborated in last section, makes it congruent with that of the international regime theory. The basic assumptions of the theory are: (1) institutionalization is an important component of statecraft; and (2) strategic factors may dominate the process of institutionalization, either domestically, or

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<sup>82</sup> Zhao Chu, "Understanding China's Diplomatic Discourse," (China Change, August, 2014); Liu Guoli, ed. *Chinese Foreign Policy in Transition* (USA: New Brunswick, New Jersey, 2009).

<sup>83</sup> Christopher A. McNally, "Sino-Capitalism: China's Reemergence and the International Political Economy," *World Politics* 64, no. 04 (2012), p.758

<sup>84</sup> Thomas Christensen, "Chinee Relpolitik," *Foreign Affairs* 75, no. 5 (1997).

<sup>85</sup> See T. J. Pempel, "Soft balancing, hedging, and institutional Darwinism: the economic-security nexus and East Asian regionalism," *Journal of East Asian Studies* 10(2010); Jiang, "'Great Power Style' in China's Economic Diplomacy: Filling the Shoes of a Benign Hegemon?."

internationally, or both. To apply this theory to the case of China's FTA policy therefore creates a convenient starting point to explore these FTAs, and to elucidate the internal and external conditions that underpin its institutional diplomacy. Moreover, the aim of this dissertation is to complement, not substitute, previous theoretical approaches. As elaborated in the next chapter, international regime theory including constituents from all traditional paradigms of IR research, thus matches reality more effectively.

### **1.5 Research Questions & Significance**

This thesis tries to explore the following questions. First, how does Beijing use FTAs diplomacy to achieve foreign policy objectives through institutionalizing bilateral economic relations? Second, to what extent can Beijing translate its economic clout into political power? And third, what new insights can international regime theories bring to our understanding of China's bilateral FTA diplomacy?

This thesis is significant in three ways. First, *on the empirical side*, it builds a systematic framework to compensate for the deficiencies of prior studies and to bring the empirical results together. The thesis enables this work to compare across individual cases, to extract the universalities among them, to make *ad hoc* modifications to tailor each case's specialties, and more importantly, to yield a clearer contour of China's FTA strategy as a whole. Moreover, bilateral FTAs spearhead Beijing's economic diplomacy in a broader sense, for example, the "One Belt, One Road" strategy. As we shall see, almost all China's FTA partners are countries along the Belt and Road, and many FTA projects have automatically transformed into parts of the "One Belt, One Road" construction (i.e. the Sino-Pak Economic Corridor). Therefore, a systematic study on China's FTA diplomacy enables us to understand China's economic diplomacy as a whole. Second, *on the theoretical side*, this work expands our knowledge of vital dimensions of international regimes, especially but not only with respect to security issues. It includes key constituents of all traditional paradigms of IR research, and thus complements IR theory generally. Third, from a perspective of method, it introduces political criteria to complement shortcomings of purely economic studies – filling gaps in understanding of the relationship between economic regimes and their political implications.

## 1.6 Research Design

To provide a comprehensive analysis of China's FTA diplomacy, it is necessary to look at all extant bilateral FTAs because they are diverse in their schedule, structure, breadth and depth, reflecting the variety of economic and diplomatic objectives that Beijing is pursuing through its various partnerships. Nevertheless, prior studies on Chinese FTAs have mainly been based on a case-by-case approach. Biases in such studies are "inevitable in the selection of what is relevant and what to discard".<sup>86</sup> In this context, logic that is rational for one FTA may be injudicious for others. This thesis tries to address this problem by encompassing the China-ASEAN FTA, China Pakistan FTA, China-New Zealand FTA, China-Chile FTA, China-Peru FTA and China- Costa Rica FTA. The China-Singapore FTA (CSFTA) is omitted since it is a remake of the China-ASEAN FTA (CAFTA). Besides, many of Singapore's diplomatic activities are carried out under the ASEAN framework. Therefore, Singapore is treated as a part of ASEAN and I'll exclusively explore the CAFTA. The newly signed FTAs with Iceland, Swiss, South Korea and Australia are also left out since they are outside the research period.

In order to provide an in-depth analysis within reasonable limits, this thesis observes *two limits*. First, since "economic diplomacy" means using economic leverage to achieve political goals, which makes FTAs less economically effective than economists anticipate, political analysis will constitute the bulk of this dissertation. Of course economic analysis is still necessary because these agreements are economic in nature, and convincing political interpretations can hardly be achieved without thorough economic analysis. Second, I will exclusively focus on China's bilateral FTAs. The reasons for this are twofold. Since most regional/minilateral FTAs are still under negotiation or discussion, there is not enough material to test the hypothesis developed here. In addition, bilateralism is the most basic and conventional form of diplomacy that allows a country to use limited resources to maximize diplomatic outputs. For example, a bilateral FTA serves as a convenient forum for China to foster the "Complete Market Status" requirement to diminish the impact of the antidumping duties on its exports, but it would be much harder if China had to bargain with several countries simultaneously. As a result, "Beijing prefers bilateral to multilateral approaches to economic diplomacy,

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<sup>86</sup> Joseph S. Nye Jr, "International Relations: the Relevance of Theory to Practice," in *The Oxford Handbook of International Relations*, ed. Christian Reus-Smit and Duncan Snidal (New York: Oxford University Press, 2008).p.649



and avoid risky commitments that compromise sovereignty”.<sup>87</sup> Therefore, I will select China’s bilateral FTAs as case studies while referring to regional FTAs when direct linkages are discerned. By doing so, this thesis will contribute to exploring bilateral relationships between China and its FTA partners on the one hand, and the possible shaping of regional FTAs on the other.

Although this thesis aims to study China’s bilateral FTA diplomacy, the third-party factor always plays an important role. For example, in the China-ASEAN FTA case, Japan is a key variable; in the China-Latin American FTA cases, America becomes a crucial factor, in the China-Pakistan FTA case, India’s role is indispensable, and in the China-New Zealand FTA case, Australia is an important element. Noting that bilateral relations always shape, and are shaped by third parties, I will employ Lowell Dittmer’s “strategic triangle” as an analytical toolkit.<sup>88</sup> According to Dittmer, a “strategic triangle” may be understood as a sort of transactional game among three players.<sup>89</sup> In each triangle, each player’s position can be ascertained through observing and comparing the three bilateral relationships. The advantage of this approach is that if the relations among three actors are simplified to be either positively valued relationship (abbreviated “amity”) or relatively negative relationship (abbreviated as “enmity”) only four configurations are possible (See Figure 2.1).<sup>90</sup> In Figure 2.1, the full line and dashed line respectively, represent “amity” and “enmity”. The Unit Veto Triangle refers

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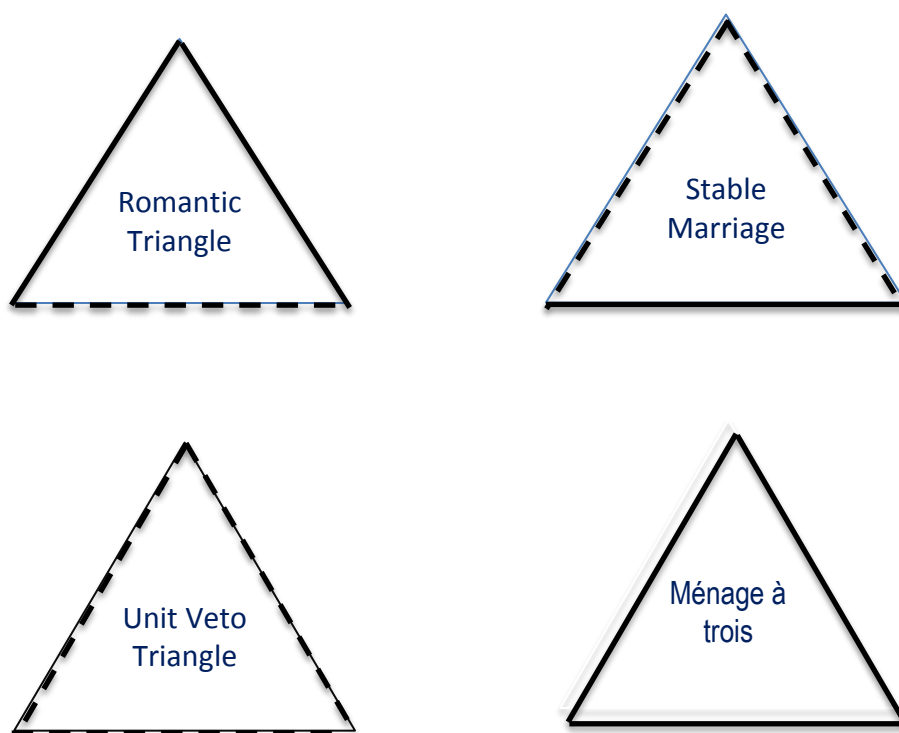
<sup>87</sup> Jiang, "'Great Power Style' in China's Economic Diplomacy: Filling the Shoes of a Benign Hegemon?".p.80

<sup>88</sup> The notion of a “strategic triangle” was first developed by IR scholars in the early 1970s to explore the triangular relationship between the US, China and the Soviet Union in the background of the Sino-America diplomatic normalization. See Michel Tatu, *The Great Power Triangle: Washington - Moscow - Peking* (Paris: Atlantic Institute, 1970). For decades, this approach has been widely extended to explore other trilateral relationships in the Asia Pacific. See Michael J. Green, "Japan, India, and the Strategic Triangle with China," in *Asia Responds to its Rising Powers: China and India*, ed. Travis Tanner Ashley J. Tellis, and Jessica Keough (Natl Bureau of Asian Research, 2011).. In latest years, Dittmer becomes a spokesman for the “triangular” approach, who intensively use it in studying power relations such as the China-Australia-US relations, . See Lowell Dittmer, "Sino-Australian Relations: A Triangular Perspective," *Australian Journal of Political Science* 47, no. 4 (2012); Lowell Dittmer, "Taiwan's aim-inhibited quest for identity and the China factor," *Journal of Asian and African Studies* 40(2005); Lowell Dittmer, "The Strategic Triangle: An Elementary Game-Theoretical Analysis," *World Politics* 33, no. 4 (1981).

<sup>89</sup> Dittmer, "The Strategic Triangle: An Elementary Game-Theoretical Analysis."p.485

<sup>90</sup> See *ibid.*; Dittmer, "Sino-Australian Relations: A Triangular Perspective."

to the situation in which the relationships between each player and both others are negative; Stable Marriage means that a relationship between two actors is better than either has with a third ‘pariah’; the Romantic Triangle features better relationships between the ‘pivot’ and two ‘wing’ players than either has with the others; and the Ménage à trois consists of positive relationships among all three.<sup>91</sup>



While Chinese business and politics are often intertwined, analysts need to be able to determine whether any particular trans-governmental regime is driven largely by commercial forces or by state preferences. Hence, this research draws on recent advancements in the subfields of both quantitative and qualitative methodology. Quantitative analysis in all case-works will cover trade in goods, trade in services, as well as bilateral investments. In FTA studies, this is also called “standard analysis”, namely analyzing the economic effects of FTAs on aspects such as tariff-reduction, trade facilitation, investment liberalization, etc. Specifically, the Early Harvest Programme and its economic effects will also be studied where applicable. This is because EHPs normally focus on agricultural liberalization, one of the toughest issues in both WTO and FTA negotiations. Concessions made under the EHP framework help us to observe China’s sincerity in establishing an FTA.

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<sup>91</sup> See Dittmer, "The Strategic Triangle: An Elementary Game-Theoretical Analysis." pp. 664-665

For qualitative analysis, my primary objective is to show the hidden politics of FTAs. But in reality, political motivations can be abundant and complicated – this task is too large for a single thesis. In this empirical work, I have selected the most illustrative motivations. Generally speaking, the motivation should meet three criteria: (1) being a representative issue(s) in bilateral relations; (2) being closely linked to economic relations; and (3) being affected (either positively or negatively) by the establishment and implementation of FTAs. This sort of selection is needed if we are to understand in depth how FTAs work.

## **1.7 Thesis Structure**

This thesis contains seven chapters. Chapter Two begins with an argument for analytical eclecticism, both theoretically and empirically. As such, two compromises are made between realism and liberalism, and between rationalism and constructivism. This chapter then constructs a theoretical framework that captures the various ways of using economic regimes to produce diplomatic outcomes. To operationalize this framework, I employ Robert Putnam’s “Two-Level Game” approach to explain both domestic and international factors that enable such manipulation. Specifically, Chinese FTAs, as the empirical locus of my work, are referred to regularly to link yet unconnected research paradigms within the framework of regime theory.

Chapter Three focuses on China’s first FTA, the Sino-ASEAN FTA. It shows how Beijing uses the CAFTA to compete with Japan in leading regional integration; to relieve political pressures over the South China Sea frictions; and to create a peaceful and responsible image in East Asia. By discerning causal relationships between these motivations and China’s CAFTA diplomacy, this chapter concludes that the CAFTA is a good platform for political bargaining, but whether and to what extent Beijing can achieve its desired diplomatic results is still an open question.

Chapter Four focuses on China’s first bilateral FTA with a developed economy: the China-New Zealand FTA. It shows how China utilizes the CNZFTA to pursue its strategic goals both domestically and internationally. The domestic dimension analyses the potential impact of the CNZFTA on China’s simultaneous efforts at promoting nation-wide dairy reforms, which are divided in two distinct phases. It finds that China’s decision to liberalize trade to New Zealand is less about being pro-liberal economic reform and more about political expediency, if not a downright hard-nosed

calculus of national interest underpinned by realist outlooks. The international dimension analyses the CNZFTA's "spill-over" effects by linking it with the ongoing negotiation of the China-Australia FTA and the TPP. The results of the analysis show that the CNZFTA serves an ideal case to look at China's domestic policy and international strategy simultaneously, which is in congruence with the analytical framework set out in the thesis.

Chapter Five focuses on the China-Pakistan FTA. Using an eclectic approach, it finds that Beijing's political objectives lying beneath the CPFTA face many challenges. First, the CPFTA was designed in part to be an institutional lever to counter-balance India and the US's power projection in South Asia, but this objective was constrained by Pakistan's unstable domestic political economy. Second, the CPFTA was part of the continuum of Sino-Pakistan friendship. Nevertheless, the partners began to show some fissures due to a series of policy missteps and responses to unexpected challenges to the trade deal. One main reason is the growing "norm-diversion" between Beijing and Islamabad – whilst the former's diplomatic mentality has gradually transformed into a realism-liberalism mixture, the latter still maintains a *realpolitik* diplomatic thinking. Third, China tries to use the CPFTA as a bridge to extend its influence to the India Ocean and the Middle East, but this ambition is constrained by its new power posture of avoiding confrontation and being conciliatory with other big powers.

Chapter Six focuses on China's bilateral FTA with three Latin American and the Caribbean (LAC) countries: Chile, Peru and Costa Rica. It identifies three of Beijing's geo-political motives embedded in these FTAs: (1) to isolate Taiwan; (2) to secure resource supplies; and (3) to engage with Latin America's regional integration. It finds that neo-liberalism and realism provide contending interpretations and predictions for China's policy actions in LAC. An eclectic review of C-LAC FTAs demonstrates that the paradigms coexist. Endeavors to secure resource supply, and to engage in Latin American integration by weaving a cross-regional FTA network, demonstrate that Beijing is inclined to neo-liberalism in making foreign policies, particularly in the economic realm. This inclination however varies in incidence. When it comes to high politics, such as with the Taiwan issue, the zero-sum character of pure realism is still hard to transcend. Therefore, the roles of C-LA FTAs are best understood through a synthesis of the two paradigms.

The Conclusion summarizes the thesis by again linking China's FTA diplomacy with international regimes. Reviewing all the studied cases, this chapter finds that the FTA diplomacy covers a wide spectrum of IR factors – power, interests and history. The absence of any one factor results in a biased and incomplete explanation of FTA diplomacy in contrast to the explanatory power of the eclectic rubric laid out here. The conclusion also notes the strengths and weaknesses of China's FTA diplomacy and, more importantly, assesses its value in the bigger context of China's grand strategy and global foreign policy.

## Chapter 2 Theoretical Framework

### 2. Introduction

Most International Relations (IR) scholarship focuses on explaining international regimes' diplomatic functions in general terms, but there is a paucity of theoretical efforts to explain exactly how economic regimes generate political consequences. This chapter helps fill this void by providing a framework that specifies the full range of ways in which economic regimes may be used to achieve diplomatic objectives. In addition, it advocates eclecticism as an analyzing methodology. This study serves the purposes of opening up new avenues for productive investigation by establishing empirical connections between theoretical vocabularies that are normally seen as unconnected. It also helps to better depict the complexity of China's FTA diplomacy.

This chapter contains two sections. The first section begins with an argument for analytic eclecticism, both theoretically and empirically. As such, comprises will be made between realism and liberalism and between rationalism and constructivism respectively. The second section will outline a theoretical framework that captures the various ways in which economic regimes can be manipulated to produce certain political outcomes. Specifically, Chinese FTAs, as the empirical locus of this work, are regularly referred to in order to tailor yet un-connected research paradigms within the framework of regime theory.

### 2.1 An Argument for Analytical Eclecticism in Regime Studies

As an important subfield of IR theories, international regime theories contain a similar research paradigm division – realism or *power-based theories of regimes*, neoliberal or *interest-based theories of regimes*, and *constructivism or knowledge-based theories of regimes*.<sup>92</sup> In practice, however, this 'trichotomy' addresses only one facet needed for

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<sup>92</sup> Generally, standard IR theories can be outlined as realism, liberalism and constructivism. Sometimes they are subdivided into neo-realism, neo-liberalism (also named as neo-liberal institutionalism), and so on. For their differences, see Joseph M. Grieco, "Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism," *International Organization* 42, no. 3 (1988).p.494; and

understanding regimes – each paradigm is constrained by the selection of actors and mechanisms that are considered appropriate for pursuing research programs within particular boundaries of time and geography. As a result, certain concepts are privileged over others, selected methodological norms and practices are favored while others are ignored or treated less seriously. Some aspects of social reality are stressed while others are neglected.<sup>93</sup> Moreover, exclusive focus on a single paradigm risks devaluing the contribution of others and claiming superiority, which in its essence leads to “partial analysis”.<sup>94</sup> Some scholars have identified the weaknesses of such divisions in the growing literature on international regimes. Andreas Hasenclever *et al*, for example, stated in *Theories of International Regimes* that, “[T]o the extent that power, interests, and knowledge interact in the production of international regimes, continuing to invest large amongst of each school’s intellectual resources into sharpening differences and demonstrating superiority over competitors may hamper rather than further progress in our understanding of international institutions”.<sup>95</sup>

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Daniel W. Drezner, "Is Historical Institutionalism Bunk?," *Review of International Political Economy* 17, no. 4 (2010). This taxonomy is extended into international regime studies. For example, Andreas Hasenclever *et al* adopted this trichotomy in their specific analysis of international regimes, titled *Theories of International Regimes*. A caveat needs to be made here: scholars mentioned in this chapter/thesis do not necessarily specialize in regime analyses. Rather, most of them study international relations in a broader sense. I quote their analyses only when they specially refer to international regimes, directly or indirectly. See Jennifer Hochschild, "Symposium 1: Ian Shapiro's The Flight From Reality in the Human Sciences," *Qualitative Methods: Newsletter of the American Political Science Association Organized Section on Qualitative Methods* 3, no. 2 (2005); Andreas Hasenclever, *Theories of International Regimes*.

<sup>93</sup> Rudra Sil and Peter J. Katzenstein, "Analytic Eclecticism in the Study of World Politics: Reconfiguring Problems and Mechanisms across Research Traditions," *Perspectives on Politics* 8, no. 02 (2010).p.413

<sup>94</sup> Kenneth Waltz proposed this viewpoint as early as 1959. See Kenneth N. Waltz, *Man, the State, and War: A Theoretical Analysis* (New York: Columbia University Press, 1959).p.229. See also Sil and Katzenstein, "Analytic Eclecticism in the Study of World Politics: Reconfiguring Problems and Mechanisms across Research Traditions."; Katzenstein Peter, "Coping With Terrorism: Norms and Internal Security in Germany and Japan," in *Rethinking Japanese Security: Internal and External Dimensions*, ed. Katzenstein Peter (New York: Routledge, 2008); Peter J. Katzenstein, "Identities, Interests and Security: American-European Security Relations," *Amerikastudien / American Studies* 42, no. 1 (1997).

<sup>95</sup> Andreas Hasenclever, *Theories of International Regimes*.p.211

In their pioneering article “Japan, Asian-Pacific Security, and the Case for Analytical Eclecticism” published in *International Security* in 2001, Katzenstein and Sil have made some useful attempts at using analytical eclecticism (AE) in their regional studies. Their work provides a useful approach for addressing problems engendered by the paradigmatic ‘trichotomy’. In 2004, Katzenstein and Sil, developed their ideas further in *Rethinking Security in East Asia*.<sup>96</sup> In 2008, they then developed their AE approach into a formal methodology in the *Oxford Handbook of International Relations*.<sup>97</sup> In their latest works, Katzenstein focuses more on promoting AE within the framework of regional studies but Sil turns to a stricter methodological research approach.<sup>98</sup> At present, whilst IR literature adopting the AE methodology is gradually becoming common, it is rarely observed in international regime studies. In the remainder of this section, in addition to explanations of the theoretical significance of using AE, what follows is a justification of the application of the AE methodology when studying international regimes.

As Katzenstein and Sil put it, “[T]he making of practically relevant knowledge cannot wait for the emergence of a definitive consensus on methodological procedures or axiomatic principles that may reveal ‘final’ truth”.<sup>99</sup> Grounded in pragmatism, Sil defines AE as:

A problem-driven approach featuring the extractions, adaptation, and integration (but not synthesis) of discrete concepts, mechanisms, logical

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<sup>96</sup> See Peter Katzenstein and Rudra Sil, "Rethinking Asian Security: A Case Study for Analytical Eclecticism," in *Rethinking Security in East Asia*, ed. Peter Katzenstein and Allen Carlson (California: Stanford, 2004).

<sup>97</sup> Peter Katzenstein and Rudra Sil, "Eclectic Theorizing in the Study and Practice of International Relations," in *The Oxford Handbook of International Relations*, ed. Christian Reus-Smit and Duncan Snidal (New York: Oxford University Press, 2008).

<sup>98</sup> See Peter J. Katzenstein and Nobuo Okawara, "Japan, Asian-Pacific Security, and the Case for Analytical Eclecticism," *International Security* 26, no. 3 (2001); Sil, "Rethinking Asian Security: A Case Study for Analytical Eclecticism."; Sil, "Eclectic Theorizing in the Study and Practice of International Relations."; Peter J. Katzenstein, "'Walls' between 'Those People'? Contrasting Perspectives on World Politics," *Perspectives on Politics* 8, no. 01 (2010); Gunther Hellmann et al., "Pragmatism and International Relations," (Wiley-Blackwell, 2009).

<sup>99</sup> Sil, "Eclectic Theorizing in the Study and Practice of International Relations." p.113



principles, and interpretive moves normally embedded in emergent research traditions, each identified with distinct styles of research reflecting distinct combinations of ontological and epistemological principles.<sup>100</sup>

At the first glance, to achieve this goal is not an easy task - each paradigm is based on its unique theoretical hypothesis, reasoning logic, empirical research, and understandings of the relationship between them. Nevertheless, eclectics argue that this task is possible if researchers “follow the road of problem-driven rather than paradigm-driven”.<sup>101</sup> Therefore, rather than positioning themselves on any single paradigm, eclectics draw illumination from a pragmatist understanding of power, interests, and norms. In practical research regarding particular cases, the deployment of AE is to respect hypotheses in ways that reflect the parameters and profiles of each paradigm while keeping the focus on the same empirical phenomenon.<sup>102</sup> The fundamental aim is to understand how “the range of relevant factors deemed important by capable scholars working within research traditions combine to affect outcomes of interest to scholars and practitioners”.<sup>103</sup>

When it comes to international regimes studies, a multitude of works in the eclectic vein are already in play, as reflected in Robert Cox’s efforts to achieve a compromise between the realist Hegemonic Stability Theory with constructivists’ core notion of common norms and shared understandings.<sup>104</sup> In another case, Oran Young compared different leaderships during the process of regime formation through a comparison between structural leaders (realism), entrepreneurial leaders (liberalism) and intellectual leaders (constructivism) to argue that the emergence of a regime relies on

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<sup>100</sup> Rudra Sil, "Simplifying Pragmatism: From Social Theory to Problem-Driven Eclecticism," *International Studies Review* 11, no. 3 (2009).p.649

<sup>101</sup> Sil, "Eclectic Theorizing in the Study and Practice of International Relations."p.110

<sup>102</sup> Amel Ahmed and Rudra Sil, "When Multi-Method Research Subverts Methodological Pluralism—or, Why We Still Need Single-Method Research," *Perspectives on Politics* 10, no. 04 (2012).p.937

<sup>103</sup> Sil, "Simplifying Pragmatism: From Social Theory to Problem-Driven Eclecticism."p.649

<sup>104</sup> Cox, "Social Forces, States and World Orders: Beyond International Relations Theory."; Robert W. Cox, "Gramsci, Hegemony and International Relations: An Essay in Method," *Journal of International Studies* 12, no. 2 (1983); Robert W. Cox, "Beyond empire and terror: critical reflections on the political economy of world order," *New Political Economy* 9, no. 3 (2004).

the interplay of all three forms of leadership.<sup>105</sup> Elsewhere, Ovodenko and Keohane argue that a functional argument (realism and liberalism) will not stand by itself in explaining institutional diffusion without the inclusion of the constructive variable of “ideas”.<sup>106</sup> While most contributors embrace theoretical pluralism and, in occasional cases, have applied this approach, they nevertheless lack an explicit method, like AE, to address substantive problems. The following section is an attempt to fill this methodological gap in extant regime studies. To be more specific, it is a process to disclose overlaps across clusters of paradigms. Out of these overlaps, we can develop fruitful dialogue using a curiosity to learn something new about the regime world we are studying.<sup>107</sup>

### *Compromises between realism and liberalism*

The core dissension within the rational dichotomy between realism and liberalism is the yardstick for weighing the value of an international regime – should it be relative gains in the realistic domain, or absolute gains from a liberal perspective? A simple case can nonetheless prove that this pair-variable is complementary. In the Cold War era, American leaders chose to sacrifice absolute gains in exports and economic growth to avoid the Soviet Union gaining advantages relative to the US; conversely, liberal-style absolute gains were emphasized by the US to win support from its western allies and Japan.<sup>108</sup> Political leaders’ cost-benefit calculations are thus not fixed but change with the context within which they are embedded. With the deepening of globalization, relative gains and absolute gains have evolved as two extremes of IR realities – interdependent actors’ actual considerations are always something in between. As Snidal noted, insufficient relative gains can no longer impede states

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<sup>105</sup> Oran R. Young, "Political Leadership and Regime Formation: On the Development of Institutions in International Society," *International Organization* 45, no. 3 (1991).

<sup>106</sup> Alexander Ovodenko and Robert O. Keohane, "Institutional diffusion in international environmental affairs," *International Affairs* 88, no. 3 (2012).

<sup>107</sup> Markus Kornprobst, "Rhetorical Pragmatism and International Relations," *International Studies Review* 11, no. 3 (2009).p.655

<sup>108</sup> Michael C. Webb and Stephen D. Krasner, "Hegemonic Stability Theory: An Empirical Assessment," *Review of International Studies* 15, no. 2 (1989).p.196

collective actions if the potential absolute gains are conspicuous.<sup>109</sup> In this vein, my work supports a more eclectic way to recalculate the losses and gains from a regime, as advanced by Joseph Grieco:

$$\mu = V - k(W - V) \quad [0 < k < 1]$$

Here  $\mu$ , the dependent variable, is the relative gains. On the right hand of this formula,  $V$  and  $W$  are a state's absolute gains and its partner's absolute gains respectively;  $k$  refers to "the coefficient for a state's sensitivity to gaps in payoffs"<sup>110</sup>, which determines a state's desirability of regime-building, or not. The nearer  $k$  approaches 0, the less sensitive a country cares about its counterpart's power and the stronger the motivations are to initiate an international regime. Take China's FTAs as an example. Under the Sino-Pakistan FTA (CPFTA), Beijing does not care much about Pakistan's power -  $k$  approaches 0. It thus proactively initiated the CPFTA because relative gains were assumed to be large. To the contrary, under the Sino-Japan FTA (CJFTA) case,  $k$  approaches to 1 because of the nearly frozen diplomatic relations between the two parties. Thus even though many economic analyses have shown considerable absolute gains if the two could establish an FTA, Beijing still hesitates to do so since it cares about Japan's power. Put it into Grieco's formula, in China's eyes,  $k$  approaches 1 because Japan is its regional rival. Thus no matter how large the absolute gains can be expected, relative gains from a CJFTA are too small. In this sense, the realist relative gains and liberal absolute gains are not mutually exclusive but depend on each other.

The other fundamental dispute within the rational domain is the realists' stress on the *supply* of international regimes and liberals' emphasis on *demand*. The realist paradigm, which links the rise and fall of regimes to the waxing and waning of a dominant power, provides a convincing vision that a hegemon acts as the supplier of regimes. Krasner even goes to an extreme to argue that regimes have a "self-supply function" – even if power becomes more fragmented, shifting downward the supply

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<sup>109</sup> Duncan Snidal, "Relative Gains and the Pattern of International Cooperation," *The American Political Science Review* 85, no. 3 (1991).

<sup>110</sup> Grieco, "Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism." p. 501

function for regimes, regimes may persist because the demand function has been shifted upward by the informational advantages provided by extant principles, norms, rules and decision-making procedures.<sup>111</sup> This realist argument, however, ignores the fact that disadvantaged states have readily and even intentionally initiated and established regimes without the existence of any superpower. The liberal paradigm on the other hand, posits that as linkages between different issue-areas increase and the organizational costs involved in reconciling distinct objectives rise, so too will the demand for overall institutional frameworks also rise.<sup>112</sup> A frequently criticized mistake of this liberal idea is that it regards regimes as being able to be “supplied” automatically when there is sufficient “demand” for the functions they perform.<sup>113</sup> Since the formation of an international regime requires the convergence of both supply and demand, it is necessary to reconcile both paradigms - liberalism plays a role of solving the theoretical blanks left behind by realism, and *vice versa*.

The analysis discussed above blurs classical boundaries between neo-realism and neo-liberalism. This implies that the two theories are not completely distinct paradigms but mutually-complementary. The combination of rational theories will, in Keohane’s words, “help to correct some of the deficiencies of the theory of hegemonic stability, which derive from its one-sidedness, and will contribute to a more comprehensive interpretation of international regime change”<sup>114</sup>. Recalling that liberals inherited most of realism’s theoretical hypothesis, there is no reason for us to treat the two as antagonistic paradigms.<sup>115</sup>

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<sup>111</sup> Stephen D. Krasner, "Regimes and the Limits of Realism: Regimes as Autonomous Variables," *International Organization* 36, no. 2 (1982).p.504

<sup>112</sup> Robert O. Keohane, "The Demand for International Regimes," *International Organization* 36, no. 2 (1982).p.340

<sup>113</sup> Haggard and Simmons, "Theories of International Regimes."p.507

<sup>114</sup> Keohane, "The Demand for International Regimes." P. 333

<sup>115</sup> In a review article, Keohane reaffirms the value of the realist paradigm which posits that institutions depend on structures of power and interests. Elsewhere, he concedes that factors influencing the demand for international regimes may simultaneously decide their supply – therefore, the pursuit of a definitive theory of international regimes risks one-sidedness. See Robert O. Keohane, "Twenty Years of Institutional Liberalism," *International Relations* 26, no. 2 (2012).and Keohane, "The Demand for International Regimes."

### *Compromises between rationalism and constructivism*

As has been repeatedly borne out, it is unrealistic for an actor to possess “the ultimate capacity for computation and the cost-free access to information that fully rational decision making would require”.<sup>116</sup> Rationality hereby should not be an absolute but a relative concept. In other words, actors obey bounded rationality in international practices.<sup>117</sup> Constructivism, in contrast, has to be placed alongside realism’s elementary argument about the crucial role of anarchy.<sup>118</sup> Constructivists also fail to articulate how core elements, such as norms, sentiments, and dispositions originate and evolve into substantive political process.<sup>119</sup> To address these problems, Alexander Wendt suggests that if analysts only aim at explaining regimes, separating rationalism and constructivism would be understandable, since this can prevent researchers from becoming susceptible to personal bias. But if analysts want to use theories to guide practices (i.e. regime design and negotiation), then rationalism and constructivism “need to talk to each other, because their concerns interact”.<sup>120</sup> To transform this argument into a more workable framework, this section draws upon the two explicit pathways to try to reconcile the two otherwise distinct paradigms, which, in reality, are intertwined and together depict a broader and clearer picture of international regimes.

*Cognitive variables causally preceding rationalist variables:* The first pathway is to address the blind spots of rationalist theories, i.e. what and how much of a payoff do actors perceive from a regime? And, what utilities do actors attribute to each possible cooperating consequence? In rational literature, these questions are either deliberately ignored or resolved *ex post*. It implicitly regards as unproblematic that regimes act as interests-maximisers and thus overestimates the driving force of

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<sup>116</sup> Kurt Weyland, "Toward a New Theory of Institutional Change," *World Politics* 60, no. 2 (2008).p.286

<sup>117</sup> Ibid.p.284

<sup>118</sup> BARRY BUZAN, "The English School: an underexploited resource in IR," *Review of International Studies* 27, no. 03 (2001).

<sup>119</sup> Nayef H. Samhat, "International Regimes as Political Community," *Millennium: Journal of International Studies* 26, no. 2 (1997).p.355

<sup>120</sup> Alexander Wendt, "Driving with the Rearview Mirror: On the Rational Science of Institutional Design," *International Organization* 55, no. 4 (2001).pp.1047-1048

preferences and underestimates the significance of norms and ideas as crucial inputs for change.<sup>121</sup> To compensate for this omission, constructivists point out that norms and ideas are at play in at least two areas: (1) options and payoffs are all perceptions of participants; and (2) the operations of ideas may be adduced to fashion deeper explanations of regime formation and outcomes.<sup>122</sup> Following this constructivist logic, norms and ideas will induce actors to redefine their power status in the international structure, as well as their gains and losses from joining a regime. For example, a country will expect to get more if its partner has a high international reputation, or get less if its partner used to be an age-old rival in other issue-areas. As Katzenstein *et al.* state, "Norms are based on material interests, but they can take on an aura of authority that transcends their initial purpose".<sup>123</sup> What can be inferred from this discussion is that pure rationalism rarely suffices for understanding a country's cost-benefit calculus of a specific regime, unless constructive variables are taken into account.

*Cognitive variables causally succeeding rationalist variables:* The second pathway follows an inverse logic to the first one: here norms and ideas, rather than affecting actors' perceived gains and losses, are employed to solve problems during the process of cooperation. This school of scholars believes that actors' calculations of power and interests are given possessions imposed by an anarchic international society. *Epistemology* makes a difference when actors find that each country's material claims have evolved into irreconcilable conflicts which impede the birth and implementation of regimes. In this situation, no cooperation can be achieved unless new variables, distinct from rational ones, are imposed. Here the involvement of constructivism is quite natural because 'common sense' and collective identities will not only mediate the stubborn deadlocks at the initiating stage, but also escort the regimes to run smoothly. Garrett and Weingast propose that cognitive variables can influence regime outcomes in three ways: (1) they resolve bargaining problems by coordinating actors'

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<sup>121</sup> Weyland, "Toward a New Theory of Institutional Change." p.295

<sup>122</sup> Hasenclever, Mayer, and Rittberger, "Integrating Theories of International Regimes." P. 27

<sup>123</sup> Robert O. Keohane ; Peter J. Katzenstein; Stephen Krasner, "International Organization and the Study of World Politics," in *Exploration and Contestation in the Study of World Politics*, ed. Robert O. Keohane ; Peter J. Katzenstein; Stephen Krasner (Cambridge: MIT Press, 1999).p.41

behaviors in a win-win pattern; (2) they help actors fix on their optimal choices because countries are easily lost in the many possibilities for cooperation; and (3) they play a role of lubricant to adjust regime distributions, without which conflicts will occur if there is only coercive power.<sup>124</sup> In an explicit eclectic way, they state that “both power and ideas can be expected significant to influence the resolution of multiple-equilibrium problems, but the relative explanatory power of each is likely to vary significantly with the context”<sup>125</sup>. It is in this *post hoc* sense that constructivism supplements the missing aspects of rationalism and bears out once again that the two seemingly parallel paradigms are overlapped.

In a nutshell, liberal regime theory only illustrates the severity of IR and the imperative demand –side of international regimes. Hegemonic theory plays a complementary role by explaining the supply-side of a regime. Nevertheless, the hegemon alone cannot always guarantee a regime supply, and this can leave a big theoretical blank if the hegemon declines but its successor is not ready to assume all hegemonic responsibilities. Constructivism is required here, providing supply to meet the demand. As Friedrichs and Kratochwil comment, “the beauty of this eclectic approach lies in its ability not only to assess the relative strength of causal hypotheses but also to identify the particular ways by which explanatory factors interact to generate the outcome”.<sup>126</sup>

On the basis of the above, it is clear that AE is necessary in studying Chinese FTAs. Domestically, China’s explicit thirst for external material supplies and the rapid ascent of economic security in its overall security considerations are perfectly congruent with post-classical realists’ arguments about resource-driven FTAs. Yet the establishment of FTAs with countries poor in natural resources, such as Singapore and Costa Rica, casts the realist explanation into doubt. Liberalism takes its place, correctly referring to Beijing’s aspiration to internationalize domestic reform pressures, but it lacks

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<sup>124</sup> Geoffrey Garrett and Barry R. Weingast, "Ideas, Interests, and Institutions; Constructing the European Community's Internal Market," in *Ideas and Foreign Policy: Beliefs, Institutions and Political Change*, ed. Judith and Keohane Goldstein, Robert. O. (Ithaca: Cornell University Press, 1993).pp.173-206

<sup>125</sup> *ibid.* p. 186

<sup>126</sup> Jörg Friedrichs and Friedrich Kratochwil, "On Acting and Knowing: How Pragmatism Can Advance International Relations Research and Methodology," *International Organization* 63, no. 4 (2009).p.63

explanatory power in discerning why it is FTAs rather than deeper institutionalized economic regimes (such as the WTO), that are seemingly more effective in upgrading the industrial structure. Constructivism is right in detecting Beijing's determination to be recognized as a member of international society, however it does not adequately explain why similar external pressures (i.e. human rights, intellectual property protection and environmental protection) elicit such distinct responses.

Internationally, as China's FTAs emerged out of significantly different preferences toward partners with highly disparate levels of material power and economic development, they become easy cases for power-based analysis. For example, it is commonplace for realist analysts to view the Trans Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP) in the context of possible contention between the US and China.<sup>127</sup> But other analysts contend that China is still a partial power, which has to accept and abide by rules and norms set by Western powers.<sup>128</sup> Liberals therefore emphasize the interest-based analysis of free trade, (which, in the era of globalization, has produced considerable common-interests among states) rather than seeing FTAs as tools to compete with each other. Nevertheless, neither realism nor liberalism explains the FTA partner selection mysteries - why, for example, there is still no FTA between China and its major economic partner Japan, and why the China-Pakistan FTA was negotiated in a speedy fashion since Pakistan is by no means an ideal FTA partner. To explain these mysteries, constructive studies could be helpful in exploring more intrinsic aspects of human society, such as norm convergence/divergence and habitual amity/enmity. In this context, it is very hard for any research paradigm to provide a universal rationale in the analysis of Beijing's FTA diplomacy.

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<sup>127</sup> See Mark Thomson, "The Partnership Competition: TPP vs RCEP," (The Strategist, April, 2013); Beginda Pakpahan, "Will RCEP Compete With the TPP?," (East Asia Forum, November, 2012); Zhao Hong, "China's Evolving Views on the TPP and the RCEP," (Singapore's Institute of Southeast Asian Studies, May, 2014).

<sup>128</sup> Barry Buzan and George Lawson, "Capitalism and the Emergent World Order," *International Affairs* 90, no. 1 (2014); Buzan, "The Tributary System as International Society in Theory and Practice."; Shambaugh David, *China Goes Global: The Partial Power* (New York: Oxford University Press, 2012).p.75



Moreover, Kenneth Waltz's the "second image" logic (that international system is the consequence of domestic politics<sup>129</sup>) and Peter Gourevitch's the "second image reversed" (that domestic system is the consequence of international politics<sup>130</sup>) are normally treated as two separate dimensions in traditional IR research. Waltz once stated: "The prescriptions directly derived from a single image are incomplete because they are based upon partial analyses".<sup>131</sup> Likewise, Katzenstein warns that: "A selective focus on either the primacy of foreign policy or the 'internalization' of international effects or on the primacy of domestic politics and the 'externalization of domestic condition' is mistaken".<sup>132</sup> The case of Chinese FTAs, however, provides rich ground for reconciling these two "images". To illustrate, binding economic trade activities within FTAs means that Beijing's foreign policy thinking and making will inextricably require promoting institutionalization to regulate domestic eco-political behaviors, and *vice versa*. With the embrace of free trade, the PRC's domestic and international practices have become intermingled to an unprecedented degree, and thus fluctuations in either dimension can readily influence the other. As shown in the next section, this thesis fills this gap by giving equal attention to both images, and provides a theoretical framework for guiding empirical research.

## 2.2 Theoretical Framework

As noted above, there are attempts to integrate domestic factors into theories of international regimes. This trend, together with the paradigmatic triad, makes it very hard to understand the full complexity of regimes theories. To transform the eclectic approach into a workable research program, Robert Putnam's "two-level game" model

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<sup>129</sup> Waltz, *Man, the State, and War: A Theoretical Analysis*.

<sup>130</sup> Peter Gourevitch, "The Second Image Reversed: The International Sources of Domestic Politics," *International Organization* 32, no. 4 (1978). For a more systematic analysis of domestic dimension's impacts on international regimes, see also Jeffrey and Lisa Martin Frieden, "International Political Economy: Global and Domestic Interactions," in *Political Science: The State of the Discipline*, ed. Ira Katznelson and Helen V. Milner (New York: W. W. Norton, 2003).

<sup>131</sup> Waltz, *Man, the State, and War: A Theoretical Analysis*.p.229

<sup>132</sup> Peter J. Katzenstein, "Introduction: Domestic and International Forces and Strategies of Foreign Economic Policy," *International Organization* 31, no. 4 (1977).p.588

serves as the best starting point for this thesis’s theoretical framework.<sup>133</sup> This model envisions that national leaders (chief negotiators), in taking diplomatic initiatives forward, pursue international agreements (second image) and domestic political calculus (second image reversed)<sup>134</sup> simultaneously. Accordingly, the theoretical framework seeks to answer two questions: How do domestic politics shape a participant’s activities in regimes? And how does a regime act as a route to power and influence in international society? Grafting the two logics together with the IR trichotomy yields a 2x3 matrix, which displays six distinct causal links to international regimes (Table 2.1).

**Table 2.1: Approaches to economic regimes’ strategic implications**

	realism	Neo-liberalism	Constructivism
Domestic level (Second image)	<b>Domestic governance structure – Post classical realism</b>	<b>Adjustment of productive structure – Embedded liberalism</b>	<b>Norm localization</b>
International level (Second image reversed)	<b>Patterned behaviors – Structural realism</b>	<b>Less clashes and more cooperation – Neoliberal institutionalism</b>	<b>Modified expectations/preferences</b>

<sup>133</sup> Putnam’s original article exclusively focuses on “bargaining” an international agreement, but my thesis only employs his theoretical metaphor by studying international regimes both internationally and domestically. This is a common practice in IR studies, as noted by Jeffrey Knopf, “the bulk of research following Putnam’s initial suggestions has used the two-level game metaphor as a framework for analysis of empirical cases”. See Robert D. Putnam, "Diplomacy and domestic politics: the logic of two-level games," *International Organization* 42, no. 03 (1988)., and Jeffrey W. Knopf, "Beyond two-level games: domestic–international interaction in the intermediate-range nuclear forces negotiations," *International Organization* 47, no. 04 (1993).p.604

<sup>134</sup> It should be noted here that Putnam’s analysis mainly focused on how domestic factors affect the outcome of the international agreement under negotiation bargaining, but he overlooked the fact that this logic can be turned around, and that the signature and implementation of the agreement would in turn affect domestic political economies. In other words, Putnam only employed half of what Gourevitch called “second image reversed”, which stressed that interactions between the domestic and the global should be two ways, rather on unilateral.

With regards to realism, for example, a country's behavior under an international regime such as an FTA might be explained by its domestic governance structure or its position in the international structure, or both. For liberal institutionalism, an economic regime has the potential to internally affect adjustments in industrial structure, and externally shape the formulation of foreign policy. Finally, for constructivists, economic regimes might be seen as a result of evolving cognitions and identities during the process of interactivities among trading partners. In practice, however, an international regime can hardly be internally and externally separated, nor can we draw a clear line between different research paradigms. The six approaches represented in the different cells therefore need not contradict one another. The remainder of this section explains the six cells one-by-one, and then turns to employ analytical eclecticism to explore *why* and *how* any two or more approaches can generate greater explanatory powers, thereby filling the theoretical gap between economic regimes and their strategic implications.

### **2.2.1 Second Image: the emerging Chinese national capitalism**

*China's economic security – economic regimes as globalization-cushions and resource-supply-anchors*

The increasingly integrated international market has greatly boosted the liquidity of speculative producers and capital. Governments accordingly scale up the proportion of economic security in their overall consideration of national security. Less developed countries, inherently more vulnerable to the external environment, spearhead doing so because of their domestic structural fragility and political underdevelopment.<sup>135</sup> Benjamin Yeung defines economic security as a condition wherein a state's domestic economy is not threatened by international factors, thereby maintaining its lead in global economic competition.<sup>136</sup> To achieve these goals, a government needs to possess efficient control over key economic sectors, and a guaranteed supply of resources necessary for its internal development.<sup>137</sup> This situation opens up the possibility of temporally abnegating the systemic focus of structural realism that leaves

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<sup>135</sup> See Stephen D. Krasner, "Transforming International Regimes: What the Third World Wants and Why," *International Studies Quarterly* 25, no. 1 (1981).p.137

<sup>136</sup> Benjamin Yeung, "China in the era of globalization: the emergence of the discourse on economic security," *Pacific Review* 21, no. 5 (2008).pp.644-645

<sup>137</sup> Ibid.p.645

aside the internal prominences of national-states, and turning to a postclassical realism of regime study, which stresses domestic level analysis and the instrumentalism of international institutions.<sup>138</sup> In what follows, I attempt to elaborate, from the perspective of postclassical realists, how economic regimes might be used in the service of states' domestic objectives.

Structural realists view economic regimes as instruments privileged by big powers, whereas postclassical realists regard them as shields for the weak.<sup>139</sup> Living in an era of intensive globalization, less developed countries have to face both economic pressures from the international economy, and political pressures emanating from the international system.<sup>140</sup> Yielding to any pressure implies exposing fragile sectors to severe international competition ahead of national schedule, and risks them falling into foreign control. The more important these sectors are to the operation of the overall economy and the welfare of the population, the greater the infringement on

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<sup>138</sup> Classical realists, while generally overlooking the role of international regimes, have a tradition of analysing domestic politics. Postclassical realists however believe that when military costs are prohibitive, rational governments will turn to economic regimes. See Michael Mastanduno and David A. Lake and G. John Ikenberry, "Toward a Realist Theory of State Action," *International Studies Quarterly* 33(1989); Stephen G. Brooks, "Dueling Realisms," *International Organization* 51, no. 03 (1997).

<sup>139</sup> Some scholars of other research paradigms also accept this view. According to Krasner, for example, an economic regime can be created by certain big powers and stuffed with their preferred rules and regulations, but to legitimate it is only possible if the regime is given autonomy. This autonomy can then be used by weak members to turn the regime to purposes and principles disdained by powerful countries. As validated by Keohane, the purposes of regimes can change over time, and vary across issue areas, such that they "support, supplement, or supplant a world market economy". The counterattack cannot always succeed, but when and if powers have more imperative demands to induce the weak(s) cooperation, the economic regime at least provides a ready bargaining table. See Krasner, "Transforming International Regimes: What the Third World Wants and Why." p.120-121; and Keohane, "The Analysis of International Regime: Towards a European-American Research Programme." p.44

<sup>140</sup> Political pressures may come directly from certain big state(s) to force a weak state to liberalize some of its domestic sectors ahead of its national schedule, or indirectly from powerful international organizations manipulated by big power clubs. See Robert O. Keohane and Helen Milner, "Internationalization and Domestic Politics: A Conclusion," in *Internationalization and Domestic Politics*, ed. Robert O. Keohane and Helen Milner (New York: Cambridge University Press, 1996). p.255

economic security.<sup>141</sup> Responding to these pressures, postclassical realists posit that economic regimes offer developing states a lever to “mitigate the exposure of developing areas to systemically generated changes”.<sup>142</sup> Their theoretical position is that while power politics still dominate international regimes not even the most powerful countries can coerce small/weak ones to do everything, as exemplified by the breakdown of the July 2008 WTO Doha Round negotiations.<sup>143</sup> Quite the reverse, economic regimes’ inherent “soft legislation” character<sup>144</sup> accommodates developing states with different degrees of readiness for institutionalization. Those competitive entrepreneurs can enter agreements to cater for external expectations; those underprepared can opt for escape clauses, or strive for a gradual phase-in of the entry provisions, or obtain certain market-share restrictions.<sup>145</sup> In this sense, economic regimes act as a *globalization-amortizer*, cushioning the weak from external disruptions whilst avoiding exclusion from the global market altogether.

A stable supply of resources of raw material and energy is a crucial component of economic security. Neo-realism considers states, except for resource-sufficient ones, as either relying on sustaining paying over the odds, or exercising political leverage (i.e. providing military shelter or engaging in conquest). Post-classical realists, however, aver that a state can also enlarge its share of economic resources by cautiously selecting trade patterns and creating economic institutions.<sup>146</sup> As asserted by David Lake and John Ikenberry, an efficient international regime serves to facilitate *external extraction*, which refers to “state efforts to accumulate resources from outside its

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<sup>141</sup> Mark W. Zacher, "Toward a theory of international regimes," *Journal of International Affairs* 44, no. 1 (1990).p.142

<sup>142</sup> Krasner, "Transforming International Regimes: What the Third World Wants and Why."p.137

<sup>143</sup> Robert O. Keohane, "The old IPE and the new," *Review of International Political Economy* 16, no. 1 (2009).p.39

<sup>144</sup> See Kenneth W. Abbott and Duncan Snidal, "Hard and Soft Law in International Governance," *International Organization* 54, no. 3 (2000).

<sup>145</sup> Stephan and Sylvia Maxfield Haggard, "The Political Economy of Financial Internationalization in the Developing World," in *Internationalization and Domestic Polics*, ed. robert O. Keohane and Helen V. Milner (New York: Cambridge University Press, 1996).p.229

<sup>146</sup> According to Brooks, the differences between neo-realism and postclassical-realism are: the former believes that power is the end; but the latter claims that “power is viewed as a mechanism and not an end in itself”. Brooks, "Dueling Realisms."pp.462-463

borders can be used in achieving domestic objectives”.<sup>147</sup> Normally, regimes, either specific ones, such as oil supply agreements, or comprehensive ones encompassing resources clauses, involve explicit consent about quota, price or tariff arrangements. For buyers, successful regimes can secure a large amount of supply at an advantageous price over a considerable period. Moreover, engaging in an economic regime may enable resource-seeking entrepreneurs to purchase operating rights overseas, such as exploring minerals and gases, buying or constructing foreign refineries, etc. In such situations, resource-hunters, even during global downturns, can be immune to “the threat of a sudden halt in supply or a sudden rise in prices”.<sup>148</sup>

Post-classical realists, recognizing the severity of resource-scarcity, admit that transnational regimes are useful, but not sufficient to reduce resource shortages. The odds of a pure economic arrangement will increase if supplemented with military ingredients. As noted by Chen Yong, a Chinese Major General, “economic globalization produces a ‘butterfly effect’ (蝴蝶效应, *hudie xiaoying*) in international security affairs”.<sup>149</sup> In part, if resource-suppliers lapse into domestic chaos, as has occurred repeatedly, a buyer will suffer immeasurable losses. To ensure supply and protect overseas investments, a country needs to project at least a small number of forces in pertinent regions to “show the flag” during periods of instability.<sup>150</sup> In part, the safety of maritime and riverine routes is relevant to all water-borne trade but of particular salience to energy resources. Again, to safeguard an uninterrupted flow of energy trade, it is necessary to set up military bases abroad and develop long-distance naval capabilities. Therefore, whilst structural realists emphasize on the primacy to protect

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<sup>147</sup> A twin conception of the “external extraction” is the “external validation”, which means a government utilizes its status as “authoritative international representatives of the nation-state” to undergird its domestic legitimacy. These conceptions are mutually conditioned – the more successfully a government can achieve external extraction, the more stable its validation, and *vice versa*. Ikenberry, "Toward a Realist Theory of State Action."p.464

<sup>148</sup> Yeung, "China in the era of globalization: the emergence of the discourse on economic security."p.645

<sup>149</sup> M. Taylor Fravel, "Economic Growth, Regime Insecurity, and Military Strategy: Explaining the Rise of Noncombat Operations in China," *Asian Security* 7, no. 3 (2011).p.188

<sup>150</sup> *Ibid.*p.182

homeland security, post-classical realists encourage governments to employ military strategies that enhance non-combat operations overseas.<sup>151</sup>

Since the accession to the WTO, Chinese leaders have taken a strategic view toward economic security. As expressed in Documents of the 16<sup>th</sup> National Congress of the Communist Party of China: "In opening wider to the outside world, we must pay great attention to safeguarding out national economic security".<sup>152</sup> This statement provides compelling evidence buttressing post-classical realism. On the one hand, pursuing bilateral and regional FTAs *per se* is an endeavor to avoid external shock from multilateral trading institutions such as the WTO. The "soft institutionalization" as a pathway forward in FTA practices further reflects Beijing's cautiousness in running the risk of "blighting the prospects for success with respect to the regime at hand".<sup>153</sup> On the other hand, the access of natural resources, particularly energy, has become a paramount part of economic security. As a growing body of literature argues, a stable resource supply not only determines its economic health, but also relates to the CCP's political legitimacy and survival.<sup>154</sup> As FTAs have emerged to enhance economic and political cooperation among participants, they become a convenient vehicle for China to secure access to resource-rich markets.<sup>155</sup>

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<sup>151</sup> This view is similar to mercantile realism, which suggests the imperative to integrate economic and military security into a more comprehensive realist theory. See Eric Heginbotham and Richard J. Samuels, "Mercantile Realism and Japanese Foreign Policy," *International Security* 22, no. 4 (1998).; and Fravel, "Economic Growth, Regime Insecurity, and Military Strategy: Explaining the Rise of Noncombat Operations in China."

<sup>152</sup> Chinese Communist Party, "Documents of the 16th National Congress of the Communist Party of China," (Beijing: People's Press, 2002).p.258

<sup>153</sup> See Oran R. Young, "Institutional Linkages in International Society: Polar Perspectives," *Global Governance* 2, no. 1 (1996).p.14

<sup>154</sup> Hallding Karl, Han Guoyi, and Olsson Marie, "China's Climate- and Energy-security Dilemma: Shaping a New Path of Economic Growth," *Journal of Current Chinese Affairs* 38, no. 3 (2009); Michele Ruta and Anthony J. Venables, "International Trade in Natural Resources: practice and policy," in *World Trade Organization Economic Research and Statistics Division* (Geneva: WTO, 2012); Shujie Yao, Dylan Sutherland, and Jian Chen, "China's Outward FDI and Resource-Seeking Strategy: A Case Study on Chinalco and Rio Tinto," *Asia-Pacific Journal of Accounting & Economics* 17, no. 3 (2010).

<sup>155</sup> Yang, "China's pursuit of free trade agreements: Is China exceptional?."; Juan Andrés Camus; Jane LePham; Roshan Shankar; and Kenny White, "Strictly Business? An Examination of China's Natural-

The post-classical realistic approach to economic regimes represents an attempt to promote a top-down state-led development approach. Such actions can greatly improve the government-business trusteeship whilst increasing the macroeconomic policy efficacy, and subsequently, protect economic security.<sup>156</sup> Sceptics nevertheless argue that a regime can bear unevenly on different domestic win-sets (stakeholders) – some sort of privileged economic elites/economic sectors may benefit, while others become victims of a particular regime. Protectionism-oriented economic regimes may thus shape new policy preferences and coalitions, which endow specific domestic stakeholders' larger political leverage as capital accumulation progresses and more room for corruption and rent-seeking emerges.<sup>157</sup> These conditions are in fact different forms of economic insecurity – postclassical realism therefore falls into a theoretical trap – an infinite loop of 'from insecure to insecure'. Furthermore, the aforementioned realist model has a sectoral-bias (i.e. weak or resource-intensive), which overlooks another crucial character of the economic regime – its sectoral disparities. This cleavage within the regime suggests the necessity for a supplementary account - one based on domestic industrial structures and a country's internal reform agenda.

#### *China's domestic economic reform: embedded-liberalism*

There are many different strains of liberal literature, but most agree that economic regimes, if cautiously manipulated, are positive for national economic growth. On the one hand, an economic regime involves harmonizing international and domestic rules. In world markets, best situated are entrepreneurs who know well how to profit without offending international rules, and those who can make use of international rules to protect their profits. In contrast, those who are unfamiliar with international rules have to "rely on political levers to prop up a tottering economic position".<sup>158</sup>

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Resource Acquisition Strategy in Latin America," in *siepr Policy Brief* (Stanford Institute for Economic Policy Research (SIEPR), April, 2013).

<sup>156</sup> Stephan Haggard, "Politics, Institutions and Globalization: the Aftermath of the Asian Financial Crisis," *American Asian Review* 19, no. 2 (2001).

<sup>157</sup> McNally, "Sino-Capitalism: China's Reemergence and the International Political Economy." p.751

<sup>158</sup> Barrington Moore, *Social Origins of Dictatorship and Democracy* (Boston: Beacon Press, 1966).p.35  
Cited in Charles Lipson, "The transformation of trade: the sources and effects of regime change," in *International Regimes*, ed. Stephen D.Krasner (London: Cronell University Press, 1983).p.237



Economic regimes thus affect a state's capacity to participate in free trade "by serving as a source of influence for states whose policies are consistent with regime rules, or which are advantaged by the regime's decision-making procedures".<sup>159</sup> In this sense, the deeper a country institutionalizes its economic activities within international regimes, the more adaptive and competitive its industries become when facing foreign competitions. Economic regimes facilitate technology diffusion. Any firm seeking a slice of the global market is required to match its foreign competitors in technology, quality, and marketing. For developing countries whose technologies lag behind, economic regimes, normally encompassing both trade and technology clauses, serve as a platform "to develop new expertise that would be unlikely in a closed national market".<sup>160</sup>

In practical politics, however, getting domestic self-interested actors to agree to the rules of economic regimes is much more difficult than theory might have us to believe. In part, *internationalist actors* – those who are competitive in global markets, those who share the norms of international society, or those who have a stake in transnational resources - may actively support free trade<sup>161</sup>; while, in part, *domestic institutional actors* – those who are stakeholders of protectionism, or those basic industries which are outmoded and labor-intensive but crucial for local employment – may fiercely oppose the entry of foreign competitors.<sup>162</sup> Domestic institutional actors can generate powerful pressures for government to "persist with policies that are favored by the constellation of interests that initially supported their ascent to power ... even if this has deleterious consequences for macroeconomic

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<sup>159</sup> Keohane, "The Analysis of International Regime: Towards a European-American Research Programme."p.29

<sup>160</sup> Jeffrey A. Frieden and Ronald Rogowski, "The Impact of the International Economy on National Policies: An Analytical Overview," in *Internationalization and Domestic Politics*, ed. Robert O. Keohane and Helen V. Milner (New York: Cambridge University Press, 1996).p.33

<sup>161</sup> Lisa L. Martin and Beth A. Simmons, "Theories and Empirical Studies of International Institutions," *International Organization* 52, no. 04 (1998).pp.748-749

<sup>162</sup> Lipson, "The transformation of trade: the sources and effects of regime change."

performance”.<sup>163</sup> Unfortunately, neoliberals often overlook this complex reality. Instead, they “assume highly convergent interests and downplay divergent ones”,<sup>164</sup> and “abstract away a great many considerations that are major preoccupations of negotiators under real-world circumstances”.<sup>165</sup> Some IR scholars have recognized this theoretical inadequacy. As Martin and Simmons queried, how can a government achieve equilibrium among sectoral variations and avoid being captured by “preference outliers who hold policy hostage to their demand”?<sup>166</sup>

Charles Lipson answers this query by emphasizing that sectoral variations should not be a theoretical hindrance, rather, a sectoral account of liberalization can help explain the juxtaposition of weakness and strength in modern economic regimes.<sup>167</sup> For domestic liberalization opponents who are opposed to domestic reforms,, rational policy-makers will choose to transfer the policymaking process to the international level,<sup>168</sup> or as Ruggie understood it, “the internationalization of political authority”.<sup>169</sup> Policy-makers choose to do so because locking a sectoral reform policy into a multi-sector economic regime would take the policy initiative away from illiberal domestic sector coalitions and would “dilute any veto power those coalitions might seek to exercise over the final outcome”.<sup>170</sup> For liberalization opponents who are on *the domestic protection list* but have to be liberalized because of international forces, side-payments such as non-tariff restrictions and domestic compensation would be

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<sup>163</sup> Geoffrey Garrett and Peter Lange, "Internationalization, Institutions, and Political Change," in *Internationalization and Domestic Politics*, ed. Robert O. Keohane and Helen V. Milner (New York: Cambridge University Press, 1996).p.54

<sup>164</sup> Haggard and Simmons, "Theories of International Regimes."p.509

<sup>165</sup> Oran R. Young, "The Politics of International Regime Formation: Managing Natural Resources and the Environment," *International Organization* 43, no. 3 (1989).p.358

<sup>166</sup> Lisa L. Martin and Beth A. Simmons, "Theories and Empirical Studies of International Institutions," *International Organization* 52, no. 4 (1998).p.748

<sup>167</sup> Lipson, "The transformation of trade: the sources and effects of regime change."

<sup>168</sup> Martin and Simmons, "Theories and Empirical Studies of International Institutions."p.748

<sup>169</sup> Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order."p.382

<sup>170</sup> Robert Paarlberg, "Agricultural Policy Reform and the Uruguay Round: Synergistic Linkage in a Two-Level Game?," *International Organization* 51, no. 03 (1997).p.420

adopted.<sup>171</sup> By imposing discriminatory safeguards, such as government procurement, customs valuations, subsidies, and countervailing duties,<sup>172</sup> and improving social insurances (i.e. pensions, unemployment benefits, etc.), governments can effectively dampen popular opponents and attract marginal supporters to openness. As Geoffrey Garrett has shown, this type of trade-off has been the case for over two centuries: economic regimes coupling liberalization and domestic compensation remains a robust pathway to solving the problem of “reaping the efficiency benefits of capitalism while mitigating its costs in terms of social dislocations and inequality”.<sup>173</sup>

The task of economic regimes is, as Ruggie sensed, to therefore embed a state’s liberalization efforts into its domestic sectoral structure, a need he called *embedded liberalism*.<sup>174</sup> The essence of his argument is to devise a form of institutionalization that is compatible with the requirements of “legitimate social purposes”.<sup>175</sup> Regimes are thereby assumed to act in response to “the more or less well-articulated preferences of diverse societal agents”.<sup>176</sup> This proposition is consistent with Putnam’s assertion at Level-II (the internal level in the two-level games model) - external pressure can hardly produce accord without domestic resonance, no matter how intellectually persuasive the overall package.<sup>177</sup> From this we can conclude that both liberal and realist theoretical arguments in the domestic dimension basically start from the same premise – protectionism.<sup>178</sup> In contrast to post-classical realists who promote

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<sup>171</sup> Normally, side-payments appear in forms of side agreements, which mean that actors concerned with a specific regime “add provisions designed to mitigate its unintended – ordinarily negative – impacts on other institutional arrangements”. See Young, "Institutional Linkages in International Society: Polar Perspectives."p.19

<sup>172</sup> Lipson, "The transformation of trade: the sources and effects of regime change."p.247

<sup>173</sup> Geoffrey Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?," *International Organization* 52, no. 4 (1998).p.824

<sup>174</sup> For a detailed understanding of the embedded liberalism, see Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order."

<sup>175</sup> Ikenberry, "Toward a Realist Theory of State Action."

<sup>176</sup> Cohen, *International political economy : an intellectual history*.p.149

<sup>177</sup> Robert D. Putnam, "Diplomacy and domestic politics: the logic of two-level games," *International Organization* 42, no. 3 (1988).p.430

<sup>178</sup> In his study of embedded-liberalism, Ruggies states that protection is an integral feature of liberalism. Garrett, on the other hand, prefers to classify liberalism as “interventionism”, which does not have to be

top-down authority-oriented regimes, liberals highlight the significance of bottom-up market-oriented regimes – although they do not rule out the intentional role of governments.<sup>179</sup> By cautiously differentiating private sectors' intents and adaptability, and emphasizing the economic regimes' role in shaping domestic practices, liberals have made more efforts to generate genuinely interactive theories of domestic politics and international economic regimes, specifying the conditions "under which certain actors are likely to prefer that policy be made on the international level".<sup>180</sup>

Beijing's efforts to promote institutionalization "in the context of emphasizing domestic revitalization" are not at odds with the predictions of neo-liberalism.<sup>181</sup> I would argue that Beijing's activities are determined by its socialist market economy with Chinese characteristics. The CCP naturally trusts the western-style market economy less and puts more faith in planning and hierarchy, particularly in the early period of its reform. The reforms have since given local cadres more political space for a variety of ever bolder economic trials, and worse, the autonomy to circumvent central rules restricting market transactions, foreign investment, and local capital accumulation.<sup>182</sup> State Owned Enterprises (SOEs), on the other hand, constitute a challenge to the central government as they are often burdened with heavy debts, social welfare obligations, and many redundant employees.<sup>183</sup> The socialist market economy, or in McNally's words, Sino-capitalism, is therefore a hybrid, constituted by top-down state governance, bottom-up capital accumulation, and global integration.<sup>184</sup> To maintain its legitimacy in an increasingly complex environment, the

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protective, but utilizes a dose of protectionism or the reimposition of capital controls as useful toolkits. See Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order."; and Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?."

<sup>179</sup> Haggard and Simmons, "Theories of International Regimes."p.498

<sup>180</sup> Martin and Simmons, "Theories and Empirical Studies of International Institutions."p.749

<sup>181</sup> Mitsuru Kitano, "China's Foreign Strategy," *Asia-Pacific Review* 18, no. 2 (2011).p.39

<sup>182</sup> McNally, "Sino-Capitalism: China's Reemergence and the International Political Economy."p.752

<sup>183</sup> To-FAR Wang, "China's Economic Development and Its Challenges," in *Rise of China - Beijing's Strategy and Implications for the Asia-Pacific*, ed. Hsin-Huang Michael Hsiao and Cheng-yi Lin (New York: Routledge, 2009).p.116

<sup>184</sup> McNally, "Sino-Capitalism: China's Reemergence and the International Political Economy."p.757

CCP has undertaken painful efforts toward domestic reform - from Deng Xiaoping's "crossing the river by touching stones" to Li Keqiang's, "no matter how deep the water, we have to wade through because we do not have other options – it's our nation's fate and future that are at stake".<sup>185</sup> To be sure, pre-existing domestic institutions may create institutional inertia and obstruct the reform agenda. Nevertheless, the "blocking and freezing effects of domestic institutions" may be challenged after decisive actions to institutionalize domestic authorities at the international level.<sup>186</sup> FTAs, particularly those with advanced economies such as the Singapore, New Zealand, Iceland and Switzerland, reveal such trends. .

*China's international identity – economic regimes as norm-distributors and identity-definers*

As indicated in the previous section, international regimes are subjective objects and shape participants self-perceptions in relation to the 'Others'. Constructivists further argue that through incremental interactions and socialization, regimes will evolve a strong sense of intersubjectivity.<sup>187</sup> This sense rests upon convergent cognitions (mutual expectation, shared convictions, common knowledge, beliefs about appropriateness and inappropriateness, etc.).<sup>188</sup> It means that international regimes can also influence the Others' corresponding understandings in relation to the Self.<sup>189</sup> As we shall see, once countries internalize a particular regime norm, they make it an integral part of their identity; that identity in turn, creates a collective interest in the

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<sup>185</sup> Emma Rowley, "China's New Premier Li Keqiang 'To Cut State Control over Economy'," (The Telegraph, 2013-03-17).

<sup>186</sup> Milner, "Internationalization and Domestic Politics: A Conclusion."p.256

<sup>187</sup> See Amitav Acharya, "Realism, Institutionalism, and the Asian Economic Crisis," *Contemporary Southeast Asia* 21, no. 1 (1999).; Christer Jonsson, "Cognitive Factors in Explaining Regime Dynamics," in *Regime Theory and International Relations*, ed. Volker Rittberger and Peter Mayer (New York: Oxford University Press, 1993).; and Kratochwil and Ruggie, "International Organization: A State of the Art on an Art of the State."

<sup>188</sup> Andreas Hasenclever, *Theories of International Regimes*.p.138

<sup>189</sup> Certainly, there is a big difference between rationalism and constructivism when defining Self and Others. For rationalists, Others are no more than objects to be utilized to maximize the interests of the Self. Constructivists, on the contrary, regard Self and Others as members of the same community, and more importantly, they are mutually constructive. Wendt, "Driving with the Rearview Mirror: On the Rational Science of Institutional Design."p.1046

norm as ends in themselves.<sup>190</sup> It follows that an international regime may evolve from a representative or embodiment of a community which is packed with distinct values and preferences, a community that Peter Haas named an “epistemic community”, one within which conflicts are rare.<sup>191</sup> These constructivist views, in a broad sense, open up a new window for understanding how subjective elements operating at the international level shape states’ behaviors as independent variables.

Let’s assume there is a bilateral economic regime model containing country A and B. Once established, the regime operates as a *norm-distributor*, which affects how country B views country A. Normally the pathway is issue-conditioned - by highlighting cooperation in agreeable fields (e.g. market access) and downplaying intractable issues (e.g. territorial disputes), the regime facilitates country A to export the norms of benevolence and cooperation, allowing B to focus elsewhere, and relax vigilance. As long as B is loath to revert to its previous perception about A, the regime, acting as a communicative platform, allows country A to advance rationales and justifications for behaviors in controversial issues, together with pleas for tolerance and understanding, or admissions of guilt.<sup>192</sup> With each iteration, intents can be commanded and asymmetric information between the two countries can be balanced. Gradually, country B’s skewed perceptions can be rectified, and positive perceptions about A will grow. Ultimately, after B internalizes the growing positive perceptions, it may reciprocate “restrained political and military behaviors” over previously intractable issues, rather than assuming tit-for-tat policies against A.<sup>193</sup>

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<sup>190</sup> Ibid.p.1025

<sup>191</sup> Petter M. Haas, "Epistemic Community and the Dynamics of International Environmental Co-Operation," in *Regime Theory and International Relations*, ed. Volker Rittberger and Peter Mayer (New York: Oxford University Press, 1993).

<sup>192</sup> Kratochwil and Ruggie, "International Organization: A State of the Art on an Art of the State."p.768

<sup>193</sup> Amitav Acharya, "Ideas, identity, and institution-building: From the ‘ASEAN way’ to the ‘Asia-Pacific way’?," *The Pacific Review* 10, no. 3 (1997).p.332 To be sure, states are by no means the sole actors, nor are they unitary actors. As long as an international regime can affect country B’s major political elites, then it has the potential to help country A to redefine its identity. See Cohen, *International political economy : an intellectual history*.p.119 and Ethan Nadelmann, "Global Prohibition Regimes: The Evolution of Norms in Internatioal Society," *International Organization* 44, no. 4 (1990).

Regimes sometimes act as *identity-definers*, shaping the way states behave as occupants of the identities to which they are assigned.<sup>194</sup> Each country has a basic identity based on its unique culture, language, history, belief, etc. Joining an international regime is to announce that all participants agree to interlock “I-intentions” toward this group,<sup>195</sup> and to behave in accordance with specific rules and regulations of the regime. Meanwhile, this interlocking implies greater responsibilities and obligations and increasing affiliation to this regime. Marc Levy and his colleagues have posed this issue well: “actors regularly take on new roles under the terms of institutional arrangements, even when their basic identities are well established prior to the emergence of the rules in question”.<sup>196</sup> It follows that others will view, judge and contact this country according to the benchmarks of the regime to which it belongs, rather than the country itself. Take China’s accession to the WTO in 2001 for example. Before joining the WTO, the PRC’s self-identity had long been “a developing country in the Third World camp”,<sup>197</sup> one passively accepting international rules set by Western countries.<sup>198</sup> After its admission to the WTO, the People’s Daily commented that Beijing’s participation in a new round of international negotiations would render it possible to change the balance of force between “North and South”, and would boost the developing countries’ collective negotiating capability.<sup>199</sup> Through these comments, Beijing tries to redefine its new identity as, first, proclaiming its support of the Western-set WTO rules and norms; and, second, trying to be one of the rule-makers

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<sup>194</sup> Oran R. Young and Michael Zürn Marc A. Levy, "The Study of International Regimes," *European Journal of International Relations* 1, no. 3 (1995).

<sup>195</sup> I-intentions refer to an actor’s diplomatic intentions in international relations. See Alexander Wendt, "The State as Person in International Theory," *Review of International Studies* 30, no. 2 (2004).p.299

<sup>196</sup> Marc A. Levy, "The Study of International Regimes."p.306

<sup>197</sup> WTO Secretariat, "Participation of Developing Countries in World Trade: Overview of Major Trends and Underlying Factors," (World Trade Organization, August, 1996).

<sup>198</sup> Liu Jie, *Regimenazation (sci): The Strategic Choice In the Course of China's Peaceful Rise [机制化生存: 中国和平崛起的战略选择 jizhigua shengcun: zhongguo heping jueqi de zhanlue xuanze]* [Regime-style Survival: the Strategy Choice in the Course of China’s Peaceful rise] (Beijing: Shishi Press [时事出版社], 2004).

<sup>199</sup> Cited in Mohammad Tanzimuddin Khan, "China, WTO and Developing Countries – A Constructivist Analysis," (Center For Strategic Studies, Turkish Ministry of Foreign Affairs, 2004).p.14

rather than rule-taker. Third, it no longer regards itself as a purely developing country but a bridge between the developing and developed camps.

As indicated above, non-material variables like norms and identities give economic regimes utilities well beyond their power and interests, such as being able to legitimate or delegitimise particular ideas and practices, and to promote intersubjective understandings, etc.<sup>200</sup> These uses, although trivial on conventional measures (such as military means), are invaluable for contemporary China, which has been annoyed about being sandwiched between contrasting perceptions of it being a promising great power, and the largest developing country. Through norm-distribution and identity-redefinition, international regimes thus acquire a “laundering function”. This function enables activities that once might have been viewed as unacceptable in their original state-to-state form, to become acceptable when ‘run through’ regimes. In Beijing’s eyes, joining/establishing regimes thereby serves as a powerful tool to promote the idea that its rise is not a threat but an opportunity.<sup>201</sup> As will be elaborated in the subsequent empirical chapters, the evidence of the Sino-ASEAN FTA suggests that China wants to convey the notion of a “peaceful rise” to Southeast Asian countries, and the evidence of the Sino-LAC FTAs goes some way to prove that China has no intention of challenging the liberal world order.

### **2.2.2 Second Image Reversed: China’s Great Power Posture**

Any international regime is both embedded in *and* shapes International Relations, this is the so-called “reversed second-image”. Generally speaking, international regimes can be interpreted from two distinctive logics. The first, broadly accepted by rationalists, posit that regimes follow *the logic of anticipated consequences and prior preferences*, whereby governments choose among alternatives by trading off possible risk-returns and evaluating the likely consequences of different strategies.<sup>202</sup> Holding a purely instrumental attitude, this logic does not value regimes *per se*, but treats them

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<sup>200</sup> Keneth Abouott and Duncan Snidal, "Why States Act Through Formal International Organizations," *The Journal of Conflict Resolution* 42, no. 1 (1998).p.8

<sup>201</sup> Ibid.p.18

<sup>202</sup> James March and Johan Olsen, "The Institutional Dynamics of International Political Order," *International Organization* 52, no. 4 (1998).p.949



“as means to attain exogenously defined goals”.<sup>203</sup> Constructivists point out that *the logic of appropriateness and senses of identity* better account for regime modalities within which actors automatically match their international obligations of the ‘normatively appropriate’ identity or role to a specific situation.<sup>204</sup> The two logics are not entirely separate but the following interpretation will firstly explore their individual values, and then explain when and how to combine them.

### *China’s hegemonic aspiration – economic regimes as war-assistants*

Realists have an inherently worst-case perspective because their theoretical starting point is Morgenthau’s assertion that actors are intrinsically aggressive and that security is the first priority for surviving in the anarchy that is international relations.<sup>205</sup> Mearsheimer once argued that “states operate in both an international political environment and an international economic environment, and the former dominates the latter in cases where the two come into conflict”.<sup>206</sup> But emphasizing politics by no means implies that realist thinkers pay less attention to economic regimes. Why? Wealthy powers arising from economic regimes “create and reproduce political power” via the process of power-distribution.<sup>207</sup> If so, How? To begin with, economic powers arising from institutionalization provide the foundation for national development, and military potential in particular.<sup>208</sup> Moreover, deepening market interdependence enhances the utility of economic pressures, by which states force their partners to

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<sup>203</sup> Mathias Koenig-Archibugi, "Explaining Government Preferences for Institutional Change in EU Foreign and Security Policy," *International Organization* 58, no. 1 (2004).p.142

<sup>204</sup> Olsen, "The Institutional Dynamics of International Political Order."pp.951

<sup>205</sup> Brooks, "Dueling Realisms."p.449

<sup>206</sup> John J. Mearsheimer, "Disorder Restored," in *Rethinking America's Security: Beyond Cold War to New World Order*, ed. Graham Allison and Gregory F. Treverton (New York: W. W. Norton, 1992).p.222

<sup>207</sup> Wendt, "Driving with the Rearview Mirror: On the Rational Science of Institutional Design."p.1035

<sup>208</sup> As stated by Joanne Gowa, an economic regime is critical to a state’s military capabilities, which she defines as “security externality”. In her words, “These externalities arise because the source of gains from trade is the increased efficiency with which domestic resources can be employed. As a consequence, trade frees economic resources for military uses”. Similarly, Michael Mastanduno points out that a strong economic base is critical to military power and political influence, particularly in times of war. See Joanne Gowa, *Allies, Adversaries, and International Trade* (Princeton: Princeton University Press, 1994).p.6; and Michael Mastanduno, "Economics and Security in Statecraft and Scholarship," *International Organization* 52, no. 4 (1998).p.830

make concessions on specific diplomatic issues.<sup>209</sup> In addition, a country is inclined to establish economic regimes with its allies to strengthen the alliance as a whole and at the same time to increase its adversary's institutionalization costs.<sup>210</sup> Hence, as discussed more fully below, states fight over economic regimes to enhance political externalities.

The realpolitik of international economics originally inspired the '*hegemonic stability theory*' (HST),<sup>211</sup> which assimilates regimes to public goods<sup>212</sup> provided by one

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<sup>209</sup> In a two-countries model that established close economic ties for instance, country A (leading power) may threaten to reduce foreign aid, or increase tariffs, or place an embargo on merchandise imported from country B (subordinate country), in order to barter with the latter for strategic resources (such as energies and rare metals) or strengthening military presence within the confines of country B.

<sup>210</sup> A stronger alliance can pressure allies who are agreed on precise obligations to impose more powerful sanctions against adversaries, such as economic blockades and arms embargoes. As verified by Lisa Martin, Britain's victory in the Falkland Islands conflict to a great extent relied on levers provided within the European Economic Community. See Lisa L. Martin, "Institutions and Cooperation: Sanctions During the Falkland Islands Conflict," *International Security* 16, no. 4 (1992).

<sup>211</sup> For a view of hegemonic stability see Robert Gilpin, "The Theory of Hegemonic War," *The Journal of Interdisciplinary History* 18, no. 4 (1988). Haggard and Simmons, "Theories of International Regimes."; David A. Lake, "Leadership, hegemony, and the international economy: Naked emperor or tattered monarch with," *International Studies Quarterly* 37, no. 4 (1993).; and Andrew Hurrell, "Hegemony, liberalism and global order: what space for would-be great powers?," *International Affairs* 82, no. 1 (2006). Historically, the relationship between the HST and the analysis of international regimes has been closely intertwined, and the HST laid solid groundwork for later regime studies. One of the most influential works is *After Hegemony*, in which Keohane rejects the crude version of the HST to highlight the autonomous significance of regimes per se. See O.Keohane, *After Hegemony -- Cooperation and Discord in the World Political Economy*.

<sup>212</sup> Olson's Public goods theory provides the theoretical basis of the realist-style regime analysis. Hasenclever, Mayer and Rittberger define 'public goods' and states that "the exclusion of any member of the group from the consumption of the good is not economically feasible". Assuming that no country can be excluded from enjoying the collective goods, particularly considering that weak states can hardly change the status quo, weak states normally have a systematic tendency for exploitation of the great. In an anarchic world, the larger the size of a country, the higher demand for it to pursue public goods such as establishing international regimes; the smaller actors will choose to take free-rides if necessary. See Mancur Olson, Jr, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge: Cambridge University Press, 1965).; and Andreas Hasenclever, *Theories of International Regimes*.pp.85-

dominant actor, which happened to have selfish vested interests.<sup>213</sup> The ultimate vested interest, in the eyes of realists, is security. Economic regimes therefore serve as a means to ensure the hegemon's security, which also serves "collectively desirable outcomes for all states in the international system".<sup>214</sup> As long as the dominant actor perceives no great security threat, others can count on a relatively stable international order. In other words, theorists of HST equate the hegemon's security with the world's security. Following this logic, subordinate countries make greater concessions in economic regimes in return for military protection. Markets might be forced open, exports/imports might be monopolized, and prices might be screwed down -- all to meet the strategic needs of the most powerful country. As a result, economic regimes always enable the hegemon to end up being stronger, and the rest weaker.<sup>215</sup>

As countries develop at asymmetrical rates, the international system will change either *revolutionarily* or *evolutionarily*, and so does the power structure.<sup>216</sup> When and if *revolutionary* changes occur, prevailing regimes to the advantage of prior hegemon fall into jeopardy. Here the *power transition theory* (PTT) comes into play.<sup>217</sup> Power

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<sup>213</sup> In a study of the HST, Duncan Snidal further divided the hegemon into two categories: *the coercive leadership* of the centralized model and the *benevolent leadership* of the decentralized model. In the former model, material capabilities to force followers to share the costs of public goods is common, and these capabilities rests on the superpower's relative size; in the latter model, absolute size is essential, and a hegemon may not always exploit others if there is no adequate gains. Hence the HST might follow two distinct logics in different economic regimes: (1) material capabilities – economic interests – power-distribution; and (2) economic gains – material powers – redistribution of powers. See Duncan Snidal, "The Limits of Hegemonic Stability Theory," *International Organization* 39, no. 4 (1985).

<sup>214</sup> Ibid.p.579

<sup>215</sup> Stephen D. Krasner, "Realist Views of International Law," *Proceedings of the Annual Meeting (American Society of International Law)* 96(2002).p.266

<sup>216</sup> Matthew S. Adams, "Kropotkin: evolution, revolutionary change and the end of history," *Anarchist Studies* 19, no. 1 (2011); Andrew Gavin Marshall, "Global Power and Global Government: Evolution and Revolution of the Central Banking System," in *Global Economy* (Center for Research on Globalization, July, 2009); George Lawson, "Negotiated Revolutions: the Prospects for Radical Change in Contemporary World Politics," *Review of International Studies* 31, no. 3 (2005).

<sup>217</sup> Noting that the international system is dynamic and a hegemon cannot last forever, Organski and Kugler developed the PTT, and satisfactorily explained the changes of regime-structures after the decline of prior superpower. This theory assumes that a potential challenger may be increasingly dissatisfied with the *status quo* – over time, accumulating dissatisfaction would provide motive for

transition ushers in regime transformation whereby, “the hegemon is no longer able to control the pay-off matrix or influence the strategies of the weak”,<sup>218</sup> and ascending challengers adjust existing regimes and dominate new regimes favoring their own interests. In extreme cases, the advantaged and disadvantaged transpose with one another,, a shift that is always accomplished by a ‘hegemonic war’,<sup>219</sup> and then “a new cycle begins with regime change contingent upon power change”.<sup>220</sup> However, in most cases, *evolutionary* change is more frequently observed. Ian Clark’s ‘*power succession theory*’ emphasizes that the future hegemon will be shaped by “the potential to develop an institution of hegemony” via the creation of a distinctive and acceptable pattern of international order.<sup>221</sup> Clark proposes that key issues, such as international legitimacy and hegemonic order, other than conventional material powers to exercise dominant power within a bilateral context, announce the coming of a new supremacy.<sup>222</sup>

The international power structure, however, cannot transition from one hegemon to another instantaneously. Instead, this is a process involving challenger(s)’ long-lasting endeavours. Schweller and Pu fill in this gap by bringing in new ideas on *how* a subordinate state contests the incumbent hegemon and eventually establishes its preferred international order. Employing the notion of ‘delegitimation’, Schweller and Pu argue that rising powers in a unipolar system can shape the extant power-structure by both a cost-free delegitimizing rhetoric (the discourse of resistance) and cost-

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revolutionary change. See Jacek Kugler A.F.K. Organski, *The War Ledger* (Chicago: University of Chicago Press, 1980). The PTT is now widely used in analysing the rising China and the downfall of American hegemon. See also Aaron L. Friedberg, *A contest for supremacy : China, America, and the struggle for mastery in Asia* (New York: W.W.Norton & Co., 2011).; Steve Chan, *China, the U.S., and the power-transition theory : a critique* (London: Routledge, 2008).

<sup>218</sup> Krasner, "Regimes and the Limits of Realism: Regimes as Autonomous Variables."

<sup>219</sup> Gilpin defines a hegemonic war as “the ultimate test of change in the relative standings of the powers in the existing system”. See Robert Gilpin, *War and Change in World Politics* (Cambridge: Cambridge University Press, 1981).p.198

<sup>220</sup> Donald J. Puchala and Raymond F. Hopkins, "International Regimes: Lessons from Inductive Analysis," *International Organization* 36, no. 2 (1982).pp.249-250

<sup>221</sup> Ian Clark, "China and the United States: A Succession of Hegemonies?," *International Affairs* 87, no. 1 (2011).pp.24, 28

<sup>222</sup> *Ibid.*p.23

imposing strategies that fall short of full-fledged balancing of power behavior (the practice of resistance).<sup>223</sup> In studying supremacy rivalries between the US and China, they point out that Chinese leaderships are well aware of the essential need to delegitimize the American hegemon. In terms of discourse, although China takes an ambiguous attitude toward a 'Beijing Consensus' to counterbalance the *Pax Americana* order underpinned by the Washington Consensus, what is clear is that it is "thinking beyond the order".<sup>224</sup> The so-called Beijing Model, the much-touted New Great Power Relationship, together with progressively institutionalized economic relations and the emerging Chinese FTA network, are rapidly gaining popularity in some parts of the world.<sup>225</sup> In terms of practice, China seeks not only short-term economic benefits from international regimes but also "a seat at the bargaining table to influence the rules of the game".<sup>226</sup> Apart from expanding Except for culminating its own FTA network, Beijing's efforts to secure a higher international position can be observed in multilateral intuitions. In the WTO platform, for instance, an increasing number of Chinese intellectuals call on the government to "improve the WTO rules" to counterbalance alleged discriminatory measures against China,<sup>227</sup> China hereby turned to the WTO to block the US punitive import tariffs on 22 Chinese exports on May 22<sup>nd</sup>, 2012.<sup>228</sup> In the international financial arena, China strived to expand its influence in the

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<sup>223</sup> Randall L. Schweller and Xiaoyu Pu, "After Unipolarity: China's visions of International Order in an Era of U.S. Decline," *International Security* 36, no. 1 (2011).p.44 .This is similar to the notion of relational power behaviour and meta-power behaviour, which is put forward by Krasner. According to him, a relational power accepts and abides by extant international regimes, but attempts to impair the leader's public credit in the process of decision-making; a meta-power tries to alter current regimes (such as the manipulation of institutional arrangements, norms and values) or build new regimes to build up its own authority. See Krasner, "Transforming International Regimes: What the Third World Wants and Why."

<sup>224</sup> Pu, "After Unipolarity: China's visions of International Order in an Era of U.S. Decline."p.52

<sup>225</sup> Jie, *Regimenazation (sci): The Strategic Choice In the Course of China's Peaceful Rise [机制化生存: 中国和平崛起的战略选择 jizhijhua shengcun: zhongguo heping jueqi de zhanlue xuanze]*.

<sup>226</sup> Pu, "After Unipolarity: China's visions of International Order in an Era of U.S. Decline."p.52

<sup>227</sup> WTO is becoming an important economic regime for Chinese government to improve international status and counterbalance the old irrational international order. Tu Xinquan, "China Must Strive to Improve WTO rules," *China Daily* 2013-01-10.

<sup>228</sup> Steven Mufson, "China Asks WTO to Block U.S. Tariffs," *The Washington Post* 2012-05-25.

IMF by elevating its quota and voting share from No. 8 in 2001 to No. 6 in 2012, and it has proposed a further climb to No 3.<sup>229</sup>

In short, realism presumes that politics dominate economics. In Gilpin's words, "politics determines the framework of economic activity and channels it in directions which tend to serve ... political objectives".<sup>230</sup> The anticipated consequence of establishing economic regimes is thereby clear-cut: to find "structures favorable to their individual objectives"<sup>231</sup>. To meet the target goal, intentions are paid not to Pareto improvements, but to the strategic practices of *ad hoc* state-clubs. In peacetime, national wealth originating from economic regimes will be translated into power to enhance security and advance relative positions (i.e. the weighted voting structures of the World Bank, the role of G8 in administrating global economic issues and beyond<sup>232</sup>). In wartime, economic regimes are often directly held hostages to the war effort.<sup>233</sup> Furthermore, as suggested by Andrew Hurrell, "institutions are sites of power", and only powerful actors can join the game of 'institutionalized hierarchy'.<sup>234</sup> The theoretical logic of realism is thus endless loops from-hegemon-to-hegemon - the ultimate ending is either the prior hierarchic world order running more steadily, or a new hierarchic international system dominated by a successor(s).<sup>235</sup>

The above realist viewpoint can readily explain Beijing's institutionalization moves, including striving for a bigger say in multilateral regimes such as the WTO and the IMF, as well as the culminating FTA network with itself sitting in the center. For realists, to delegitimize the present hegemon involves two phases: the discourse of resistance (a cost-free delegitimizing rhetoric) and the practice of resistance (cost-imposing

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<sup>229</sup> Rebecca M. Nelson and Martin A. Weiss, "IMF Reforms: Issues for Congress," in *CRS Report* (Congressional Research Service, March, 2014).

<sup>230</sup> Robert Gilpin, "The Politics of Transnational Economic Relations," *International Organization* 25, no. 3 (1971). p.54

<sup>231</sup> Olsen, "The Institutional Dynamics of International Political Order."p.951

<sup>232</sup> Hurrell, "Hegemony, liberalism and global order: what space for would-be great powers?."p.10

<sup>233</sup> Gowa, *Allies, Adversaries, and International Trade*.p.6

<sup>234</sup> Hurrell, "Hegemony, liberalism and global order: what space for would-be great powers?."p.10

<sup>235</sup> Stephen D. Krasner, "Structural Causes and Regime Consequences: Regimes as Intervening Variables," *International Organization* 36, no. 2 (1982).p.16

strategies that fall short of full-fledged balancing behaviors).<sup>236</sup> This logic perfectly coincides with what Shi Yinhong, a leading Chinese scholar at Renmin University of China, claims as a two-stage national strategy:

First, bandwagoning, defined as cooperating with the 'first-rate great power and the international regimes supported by it, and thereby obtaining its support and protection and other possible benefits, though at the cost of one's own freedom of action reduced by some degree'; but second, over the medium to long term, 'transcending' this accommodation by contributing to the peaceful transformation of international society from one dominated or controlled by western great powers to one in which the West, and especially the United States, accepts the need to coexist in an equal and reasonable manner with newly rising non-western states.<sup>237</sup>

The FTA diplomacy indicates that China is still in the "bandwagoning"/rhetoric resistance stage and selects its preferred international regimes to accumulate powers. But the coincidence between the above two logics suggests the robustness of the realist explanation of Beijing's hegemonic ambition. It also reveals the Chinese leadership's new cognition that the future hegemonic war is less determined by transitions in material power, and depends more on "the potential to develop an institution of hegemony resting upon widespread international consent".<sup>238</sup>

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<sup>236</sup> Pu, "After Unipolarity: China's visions of International Order in an Era of U.S. Decline."p.44

<sup>237</sup> See Shi Yinhong, "The Rising China: Essential Disposition, Secular Grand Strategy, and Current Prime Problems," in *Asian Voices: Promoting Dialogue between the US and Asia* (Sasakawa Peace Foundation (USA) programme, 2002). Cited in Rosemary Foot, "Chinese strategies in a US-hegemonic global order: accommodating and hedging," *International Affairs* 82, no. 1 (2006).p.91

<sup>238</sup> Clark, "China and the United States: A Succession of Hegemonies?."p.28 This new cognition can refer to a series of publications by leading Chinese scholars. See Jie, *Regimenazation (sci): The Strategic Choice In the Course of China's Peaceful Rise* [机制化生存: 中国和平崛起的战略选择 *jizhijhua shengcun: zhongguo heping jueqi de zhanlue xuanze*]; Wang Guoxing and Cheng Jing, "G20 Mechanization and Global Governance Reform [G20 机制化与全球经济治理改革, *G20 jizhijhua yu quanjiu jingji zhili gaige*]," *Gobal Outlook* [全球展望, *quanqiu zhanwang*], no. 3 (2010); Wang Yiwei, "The Sino-US Relationship Enters into the Institutionalization Era: From Economic Strategic Dialogue to Establishing Military Hotline [中美关系步入机制化时代: 对从经济战略对话到建立军事热线的理解, *zhongmei guanxi buru jizhijhua shidai: dui cong jingji zhanlue duihua dao jianli junshi rexian de lijie*]," *Outpost Comments* [前哨评论, *qianshao pinglun*] 7(2007).

*China's peripheral security – economic regimes as war-extinguishers*

Far from leading to the realist conclusion that economic regimes are war-facilitators, the 'distribution conflict' argument has led liberals to explore yet another pathway – interests distribution – through which regimes substantially promote not conflicts but cooperation.<sup>239</sup> Emphasizing that absolute gains are the core benchmark in the course of regime-design, institutionalists assume that the only goal of actors in mixed-interest interactions is to achieve utility maximization.<sup>240</sup> Hence, collective actions can be expected as long as perceived gains outweigh transaction-costs.<sup>241</sup> The "individualistic payoff maximization",<sup>242</sup> together with asymmetric interests-distribution, may however, render regimes an impediment to cooperation. To overcome this cooperation dilemma, liberals propose a notion of issue-linkages.<sup>243</sup> Despite the power-structure as proposed by realists, liberals suggest that an issue-structure also exists in international relations. Within the issue-structure, as Martin and Simmons

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<sup>239</sup> Robert O. Keohane and Lisa L. Martin, "The Promise of Institutionalist Theory," *International Security* 20, no. 1 (1995).pp.45-46

<sup>240</sup> Robert O.Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press, 1984).p.27

<sup>241</sup> In general, transaction costs include negotiation costs, contracting and drafting costs, approving and ratifying costs, domestic legislating costs, monitoring and enforcement costs, and so forth. States will forgo cooperation if transaction costs are too high to bear, or negligible because the expected value of institutions is sufficiently small. Cooperation most likely happens when the costs of a cooperative transaction falls between these two extremes. See Gilligan Michael, "The Transactions Costs Approach to Understanding International Institutions," in *Power, Interdependence and Non-State Actors in World Politics: Research Frontiers*, ed. Helen V. Milner and Andrew Moravcsik (Princeton: Princeton University Press).

<sup>242</sup> Charles Lipson, "International Cooperation in Economic and Security Affairs," *World Politics* 37, no. 1 (1984).

<sup>243</sup> In *Power and Interdependence*, Keohane and Nye advanced an "issue-structural" model. Under this model, issue-specific regimes are increasingly likely to impinge on each other, and states can achieve individual purposes by consciously manipulating different issue-linkages. Similarly, Keohane claims that international regimes provide the lever of side-payments "among states within issue-areas covered by comprehensive regimes". Lisa Martin, too, suggests that regimes promote cooperation "by establishing credible issue-linkages in situations with heterogeneous actors". See Robert O.Keohane and Joseph S. Nye, *Power and interdependence* (New York: Longman, 2001).; Keohane, "The Demand for International Regimes."p.340; and Lisa L. Martin, "Credibility, Costs, and Institutions: Cooperation on Economic Sanctions," *World Politics* 45, no. 3 (1993).p.407



pointed out, institutions “lock in a particular equilibrium, providing stability”.<sup>244</sup> Insofar as international regimes compensate institutional imperfections in world politics along both dimensions -- decreasing *transaction-costs* and creating *issue-linkages* – they serve as capable tools for a state that wishes to achieve its strategic purposes while reducing the probability of war.<sup>245</sup>

Gilligan defines a transaction as “a specific, agreed-upon change in the policies in one country in exchange for specific agreed-upon changes in policies in another country or countries”.<sup>246</sup> Regimes under the transaction-cost frameworks are arrangements of how to govern transactions – as long as gains exceed costs. Joining an economic institution will therefore lead to “fluctuations in the economic opportunity cost of an assertive foreign policy stance and affect whether or not states can most cost-effectively influence other states through informal economic, as opposed to formal military means”.<sup>247</sup> This function is particularly visible in international relations involving political conflicts, such as territorial disputes. By setting clear-cut injunctions, a regime not only assists states to gain from being able to more reliably judge its partner(s)’ intentions, but also gains from improving the transparency of its own activities and clarifying its commitments and sincerity in cooperation.<sup>248</sup> Take an FTA for instance - the degree of tariff-cut, the scope of market access, and the extent of custom/fiscal policy coordination, all signal a member country’s determination to bind itself with its partners over a long period. By enforcing commitments and reducing uncertainties, hostile activities can thus be effectively forestalled. Moreover, regimes

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<sup>244</sup> Martin and Simmons, "Theories and Empirical Studies of International Institutions." p.105

<sup>245</sup> In most liberal literature, the two independent variables are not mutually exclusive but instead reciprocally endogenous. Nevertheless, this view contradicts some earlier studies. Robert Tollison and Thomas Willett, for instance, argue that dense issue-linkages may lead to higher, rather than lower transaction-costs. This thesis goes along with the former view that transaction-costs and issue-linkages work together to affect international relations, but divide them into separate spheres for better understanding. See Robert D. Tollison, and Thomas D. Willett, "An Economic Theory of Mutually Advantageous Issue Linkages in International Negotiations," *International Organization* 33, no. 4 (1979).

<sup>246</sup> Michael, "The Transactions Costs Approach to Understanding International Institutions." p.14

<sup>247</sup> Brooks, "Dueling Realisms." p.456

<sup>248</sup> See Cohen, *International political economy : an intellectual history*; Keohane, "International Institutions: Can Interdependence Work?."

shape the reputations of participants. States with reputations for trustworthiness and generosity in economic regimes are more easily accepted as sensible partners in resolving political conflicts.<sup>249</sup> Economic institutions thus serve as an IR stabilizer, through the imposition of reputation-costs that “deny governments the use of certain instruments to which they might otherwise resort”.<sup>250</sup>

The other liberal variable to promote cooperation is issue-linkage. Lisa Martin, introducing the notion of heterogeneity among international actors, argues that heterogeneous preferences are likely to exist in many issue-areas, such as trading fields including strategic-resource supply and high-tech collaboration.<sup>251</sup> If so, tactical issue-linkages are “central to successful resolution of some of the most pressing issues facing states today”.<sup>252</sup> In a two-countries model with an asymmetric structure for example, issue-linkages function best if one player is strongly interested in cooperation on one issue, but not in another when the other player has the opposite preference structure.<sup>253</sup> In this vein, economic regimes are normally easier to achieve when and if strategic gains happened to be present. For instance, when conflicts emerged over a crucial security ally, which is at the same time a recalcitrant trading partner, “security

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<sup>249</sup> Members, particularly big powers, will deliberately vindicate their honours in regimes to avoid forfeiting potential future gains from further collaborative ventures. Small countries to the contrary, pay less attention to international reputations than big powers. Conybeare provides such a case in studying the politics of international trade. According to him, in a trade regime involving a small and a big country, when and if the small one finds its obedience costs in the regime exceed gains, it will threaten to damage the big one’s welfare with a retaliatory tariff, even though such retaliation would make the small one worse off. The small one would also pay a price in terms of international reputation. See Robert Axelrod and Robert O. Keohane, "Achieving Cooperation under Anarchy: Strategies and Institutions," *World Politics* 38, no. 1 (1985).; and Conybeare John, "Public Goods, Prisoners' Dilemmas and the International Political Economy," *International Studies Quarterly* 28(1984).

<sup>250</sup> Robert O. Keohane, "International Agencies and the Art of the Possible: The Case of the IEA," *Journal of Policy Analysis and Management* 1, no. 4 (1982).pp.469-470

<sup>251</sup> According to Martin, heterogeneity refers to “asymmetries of power and of preference intensities on different issues”. Lisa L. Martin, "Heterogeneity, Linkage and Commons Problems," *Journal of Theoretical Politics* 6, no. 4 (1994).

<sup>252</sup> Martin, "Credibility, Costs, and Institutions: Cooperation on Economic Sanctions."p.431

<sup>253</sup> Eric Neumayer, "How Regime Theory and the Economic Theory of International Environmental Cooperation Can Learn from Each Other," *Global Environmental Politics* 1, no. 1 (2001).p.138

concerns still tended to prevail".<sup>254</sup> An apt case is the Israel-United States FTA, by which America asymmetrically opened its markets and tolerated discrimination from Israel within the institutional framework in exchange for the latter's geo-political support in the Middle East. In other cases in point, as we shall see in empirical study chapters, China has tactically linked the Sino-ASEAN FTA with its territorial claims in the South China Sea, and the Sino-Costa Rica FTA with its sovereignty claims in isolating Taiwan.

It is possible to point to several mechanisms based on issue-linkages. One mechanism relates to complex linkages developed amongst substantive issues, as illustrated by the operations of Hassian neofunctionalist *spillovers*.<sup>255</sup> For example, reducing industrial tariffs without damaging one's own welfare may rely on tariff reduction from partner(s); and the category of products sold to one state may be more or less advantageous depending on the buyer(s)' industrial structural reform schemes. As such linkages evolve, the organizational costs involved in reconciling divergent objectives will rise, and demands for overall frameworks to cover certain clusters of issues will increase.<sup>256</sup> Market issues thus spill over into the political domain, and consequently economic regimes can have strong strategic ramifications. Another potential mechanism is institutional diffusion, also named regime contagion, defined by Ovodenko and Keohane as "the adoption in new or reformed institutions of institutional features already operating in other institutions".<sup>257</sup> This diffusion stems

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<sup>254</sup> Mastanduno, "Economics and Security in Statecraft and Scholarship."p.843

<sup>255</sup> The notion of "spill over" was developed by Ernst Haas in his pioneering study of how the pure economic European Coal and Steel Community developed into the Economic Community, both forerunners of the all-embracing European Union. See Ernst B. Haas, *The Uniting of Europe* (Stanford: Stanford University Press, 1958).; and Ernst B. Haas, "Why Collaborate?: Issue-Linkage and International Regimes," *World Politics* 32, no. 3 (1980).

<sup>256</sup> Young shares the same idea that, over time, the necessity to merge regimes and create a single more comprehensive regime covering two or more intersecting issues will increase. See Keohane, "The Demand for International Regimes."p.340; and Young, "Institutional Linkages in International Society: Polar Perspectives."p.19

<sup>257</sup>This view has an evidently path-dependence character. "Path dependence" is a notion that appears frequently in historical institutionalism. Fioretos defines it as a process in which the structure that prevails after a critical juncture shapes "the subsequent trajectory in ways that make alternative institutional designs substantially less likely to triumph, including those that would be more efficient

mainly from a regime's "self-reinforcing" nature when it develops complementary relationships in other issue-areas and thus "enhance[s] the value associated with specific designs".<sup>258</sup> It should be noted that institutional spillover/diffusion functions might not always be successful. The analytic results of the Sino-New Zealand FTA, as shown in Chapter 4, suggest that whilst the CNZFTA successfully influences the Trans Pacific Partnership (TPP) discussion, in which New Zealand holds a firm anti-containment China stance, but it has failed to encourage Australia to emulate New Zealand by signing a similar deal with China.

Put simply, liberals believe that economics dominate politics.<sup>259</sup> Their anticipated consequences are therefore grounded in calculated consequential advantage<sup>260</sup> and a purely instrumental attitude<sup>261</sup> - if transaction-costs are sufficiently concentrated, even hostile countries are willing to lock themselves into economic regimes as an alternative to war, because they expect that military confrontation would cost them too much.<sup>262</sup> They also believe that any prior pay-out will be amortized in future transactions. If heterogeneity takes the form of differing preference intensities on different issues, it will lead to the potential for reciprocal issue-linkages, thus enhancing the chances of successful cooperation.<sup>263</sup> Liberals also suggest the following logic: as long as economic regimes work as either issue-linkers or regime diffusers, or side-paymasters, decreased costs would encourage more regimes to spread over issue-structures, and *vice versa*. If stress or strain hinders intra-structural cooperation marked by political conflicts, economic regimes will sooner or later adjust and re-equilibrate to ensure the

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according to a standard expected utility model". See Ovodenko and Keohane, "Institutional diffusion in international environmental affairs."p.524; and Orfeo Fioretos, "Historical Institutionalism in International Relations," *International Organization* 65, no. 02 (2011).

<sup>258</sup> O. Fioretos, "Historical Institutionalism in International Relations," *International Organization* 65, no. 2 (2011).p.377

<sup>259</sup> Cohen, *International political economy : an intellectual history*.p.34

<sup>260</sup> March and Olsen, "The Institutional Dynamics of International Political Orders."p.950

<sup>261</sup> Koenig-Archibugi, "Explaining Government Preferences for Institutional Change in EU Foreign and Security Policy."p.142

<sup>262</sup> Martin, "Institutions and Cooperation: Sanctions During the Falkland Islands Conflict."p.159

<sup>263</sup> Martin, "Heterogeneity, Linkage and Commons Problems."p.490

international system's continued smooth operation.<sup>264</sup>The theoretical consequence of liberalism is therefore a more stable world.

*China's self-identity: economic regimes as norm-recipient and self-identity-definer*

In contrast to rationalists' claim that states are value-free and common-rational, Alexander Wendt, in his notable book *Social Theory of International Politics*, proposed a pioneering argument that "states are people too".<sup>265</sup> Accordingly, a state can be treated as a person as long as it is an intentional actor and consciously making policies.<sup>266</sup> This suggests that states have subjectivity, experiencing the world from a first-person perspective, rather than a third-person perspective of modern science.<sup>267</sup> Wendt's ideational assertion has influenced constructivists' studies of international regimes considerably and they now argue that *regimes themselves are also subjective*.<sup>268</sup> It is then necessary to introduce two key variables in this paradigm – norm and identity – both are highly personified because regimes "do not come out of the blue but are designed by people".<sup>269</sup> Norm, a vehicle of manifesting and exporting intentionality, refers to "standards of behavior defined in terms of rights and obligations", or in other words, "what I will do" and "how I expect Others to reciprocate". Identity, nothing but insulating collective consciousnesses from dissent, is what determines and discerns "who I am" and "who are Others". Following this line of analysis, the remainder of this section will explore how economic regimes shape a country's self-understandings in relation to others.

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<sup>264</sup> Weyland, "Toward a New Theory of Institutional Change."p.285

<sup>265</sup> Alexander Wendt, *Social Theory of International Politics* (New York: Cambridge University Press, 1999).pp.215-240

<sup>266</sup> Wendt, "The State as Person in International Theory."

<sup>267</sup> Ibid.pp.311-312

<sup>268</sup> As will be elaborated more fully in following section, Kratochwil and Ruggie argue that international regimes are ontologically subjective, but epistemologically positivistic-oriented. They thereby suggest a more interpretive approach rather than the simple objective description. See Kratochwil and Ruggie, "International Organization: A State of the Art on an Art of the State."

<sup>269</sup> Here "people" is a paronomasia, which refers to both central policy-makers and those on behalf of them sitting around a negotiating table, and "state personhood". Wendt, "Driving with the Rearview Mirror: On the Rational Science of Institutional Design."p.1033

Regimes sometimes operate as a *norm-localizer*, because joining a regime does not mean accepting all its norms. Norm localization, as defined by Amitav Acharya, is a course that initially starts with a reinterpretation and re-representation of the outside norm, which then becomes congruent with a pre-existing local normative order.<sup>270</sup> This line of constructivist analysis is historically conditioned. At time *t*, a set of collectively accepted norms under a particular regime is codified, while others are artificially omitted. At time *t*+1, the quantity of shared norms among regime partners becomes higher. Over time, these shared norms will lead to “an expansion of the number of topics viewed as appropriate for discussion and the development of common definitions of problems and appropriate actions”.<sup>271</sup> To better account for this process, Acharya proposed the concept of norm subsidiarity, concerning how local actors offer normative resistance to central actors.<sup>272</sup> In this sense, the success of norm-localization rests upon the amount of new norms brought by a regime, and the extent to which the willingness of local agents provides opportunities.

Another constructive mechanism accounting for how economic regimes shape international relations is *self-identity-definer*, which influences a state’s perception of itself to be part of a distinctive country-group. *Corporate identities*, according to Wendt, are “the intrinsic, self-organizing qualities that constitute actors individually”.<sup>273</sup> By choosing to engage in an economic regime, a country implicitly abandons some of its prior corporate identities and takes on a “collective identity” consistent with the new situation.<sup>274</sup> Asking “what am I supposed to do now?”,<sup>275</sup> the

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<sup>270</sup> Amitav Acharya, "How Ideas Spread: Whose Norms Matter? Norm Localization and Institutional Change in Asian Regionalism," *International Organization* 58, no. 2 (2004).p.244

<sup>271</sup> See Barry Buzan, "From international system to international society: structural realism and regime theory meet the English school," *International Organization* 47, no. 03 (1993).p.334; March and Olsen, "The Institutional Dynamics of International Political Orders."pp.963-964; and Drezner, "Is Historical Institutionalism Bunk?."p.794

<sup>272</sup> Amitav Acharya, "Norm Subsidiarity and Regional Orders: Sovereignty, Regionalism, and Rule-Making in the Third World," *International Studies Quarterly* 55(2011).

<sup>273</sup> Alexander Wendt, "Collective Identity Formation and the International State," *The American Political Science Review* 88, no. 2 (1994).p.385

<sup>274</sup>This logic may also apply to international regimes in other issue-areas, including security regimes. However, the costs of establishing an economic regime is smaller than a security one, since the latter

country will behave at least “as if” he cares for his partners. When and if such behaviours are recognized and appreciated, and even reciprocated, this country’s tentative new identity will be further defined and strengthened. In Ruggie’s words, a sense of “we-feeling” will emerge.<sup>276</sup> This implies a stronger sense of belonging, more responsibility, collective honors, changed willingness to cooperate, etc. These subjective experiences will lead to thicker and broader cooperative ventures, and eventually, an internalization of a genuine collective identity on both sides.<sup>277</sup> This process, to quote Wendt, is “identification” – a continuum from egoistic to solidaristic loyalties, from perceiving the other as anathema to the self, to perceiving it as an extension of the self.<sup>278</sup>

Institutions have been depicted as vehicles to prove that China has been socialized into specific norms and identities. An apt example, as indicated by Katzenstein and Okawara, is the CAFTA whereby China “replicates” three core ASEAN norms: informal diplomacy, personal contacts, and respect for the principle of non-intervention.<sup>279</sup> More significantly, these norms have been internalized as an integrated part of China’s diplomacy toward other regional and developing states, as the cases of Sino-Singapore and Sino-Latin America FTAs demonstrate. In this regard Chinese FTAs can be regarded as “high quality”, since theorists posit that regimes that develop norms internalized by participants will be in greater demand and will be valued more than regimes failing to develop such norms.<sup>280</sup> It is exactly during the process of localizing exogenous norms that China gradually defines itself as a responsible great power. As indicated by

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involves highly sensitive issues such as military coordination and sovereignty surrogation. Moreover, “globalization” at the present stage is mainly marked with “economic globalization”, and anyone who fails to jump on this bandwagon would risk marginalizing or eliminating itself from the world market. Countries therefore more readily give up prior corporate identities to pursue economic regimes.

<sup>275</sup> Martha Finnemore and Kathryn Sikkink, "International Norm Dynamics and Political Change," *International Organization* 52, no. 4 (1998).

<sup>276</sup> John Gerard Ruggie, "What Makes the World Hang Together? Neo-Utilitarianism and the Social Constructivist Challenge," *International Organization* 52, no. 4 (1998).

<sup>277</sup> Wendt, *Social Theory of International Politics* p.346

<sup>278</sup> Wendt, "Collective Identity Formation and the International State."p.386

<sup>279</sup> Katzenstein and Okawara, "Japan, Asian-Pacific Security, and the Case for Analytical Eclecticism."p.173

<sup>280</sup> Keohane, "The Demand for International Regimes."p.350

Chengqiu Wu, "having undergone in recent years an identity change from a defensive power of bitterness and insecurity to a rising power aspiring to take more responsibility, China is more concerned about its national image and more receptive to international norms", which has led to the changes in its response to international issues.<sup>281</sup>

### 2.3 Conclusion

This chapter constructs a theoretical framework that captures the various ways of using economic regimes to produce diplomatic outcomes. With the analytically eclectic toolkit in place, the ensuing analysis will explore how the Chinese government uses FTAs to pursue its diplomatic goals. In each case study, I will provide evidence to show whether and to what extent FTAs underpin Beijing's diplomatic objectives, and how. It may be due to considerations of economic security, or to push domestic reform, or toward a transformation of China's world outlook. Similarly, it may be due to big power rivalries, or the desirability to solve political disputes beyond conservative means, or to cultivate and impose a friendly image in the international society. More frequently, it may be due to a random combination, changing with the dynamic of different contexts. The next chapter therefore switches to an empirical study of the Sino-ASEAN FTA to shed new light on both China's regional and international relations.

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<sup>281</sup> Chengqiu Wu, "Sovereignty, Human Rights, and Responsibility: Changes in China's Response to International Humanitarian Crises," *Journal of Chinese Political Science* 15, no. 1 (2010).



## **Chapter 3 The China-ASEAN Free Trade Agreement (CAFTA)**

### **3.1 Introduction**

The China-ASEAN Free Trade Agreement took effect in January 2010. The idea of this pattern of cooperation was initiated by Zhu Rongji in 2000. In November 2002, leaders of both parties consented to sign the Framework Agreement on Comprehensive Economic Cooperation (FACEC), kicking off the long march toward the realization of a final CAFTA. The Framework Agreement instituted a preferential tariff arrangement on certain agricultural products, the Early Harvest Program (EHP), ahead of schedule, supposedly so the parties could enjoy the early benefits of the FTA from January 2004. The two parties then signed the Agreement on Trade in Goods (TIG) in November 2004, the Agreement in Services (TIS) in January 2007 and the Agreement on Investment in August 2009. On 1<sup>st</sup> January 2010, the CAFTA – an FTA involving the largest population and the third largest in terms of nominal GDP - formally took effect. It is China's first free trade agreement, and in particular, with a union of states; and ASEAN's first free trade deal with an outside country as a state union. .

This chapter starts by analyzing the CAFTA's economic effects. It shows that since the signing of the Framework Agreement, the two parties' economic ties have grown ever deeper. A hub-and-spoke economic model, within which China is the hub and ASEAN countries the spokes, is emerging. China today is a primary engine of regional growth, and its investment and imports are becoming increasingly indispensable to ASEAN states. This economic architecture gives rise to three region-wide concerns. Will China replace ASEAN to take a lead role in the process of regional economic integration? Will Beijing manipulate the trade deal as a leverage to realize its territorial claims in the South China Sea (SCS)? Lastly, will the economic dominance encourage the PRC to draw back from its "peaceful development" promise and switch to aggressive policies, as China Threat theorists believe? The following endeavors to answer these queries.

The CAFTA was born out of a context in which ASEAN expressed an explicit intent to lead Asian economic affairs as a unitary actor. Intriguingly, the CAFTA process has been paralleled with the emergence of several free trade blocks - – the China-preferred East Asia Free Trade Agreement (EAFTA), the Japan-proposed Comprehensive

Economic Partnership for East Asia (CEPEA), as well as the US-led Trans Pacific Partnership (TPP). In the third section of this chapter, I explore the correlations between the CAFTA and these trading blocs by embedding them into a larger strategic context of big power rivalries. I conclude that the CAFTA and other trading blocks in the Asia Pacific are mutually conditioning. Specifically, CAFTA plays a role as an anchor in underpinning China's preferences in FTA competitions with Japan and America. Conversely, big power rivalries have greatly dented ASEAN's centrality, which may in turn undercut its potential to lead Asian integration.

The third section delves into the linkages between the CAFTA and the Sino-ASEAN territorial disputes in the SCS. Liberal and realist theorists introduce very different descriptions of the roles economic regimes play in solving high-politic problems – the former believes it a war-extinguisher but the latter treats it a war-facilitator. This section, analyzing the CAFTA-SCS case by both approaches, provides two findings. Empirically, it finds that Beijing is keen on embedding the SCS affairs into the CAFTA, and that this strategy has given it an upper hand in achieving its own territorial objectives. Theoretically, this section advances an eclectic perspective that liberalism and realism are indeed two sides of the one coin: for economic-disadvantaged ASEAN states, the CAFTA serves as a war-extinguisher, mainly due to their economic affiliation with China; for economic-advantaged China, the CAFTA is a war-facilitator, and has emboldened its assertiveness in the SCS.

Outsiders have joined long-lasting debates about whether China is a threat or not. The fifth section of this chapter however suggests that these inconclusive debates are essentially not very illuminating for resolving practical IR problems. A more fruitful approach is to ask whether China cares about being viewed as a threat. Focusing on Beijing's moves in the CAFTA and relevant trading blocks, I answer it by grouping different countries: Beijing is reluctant to be perceived as a menace in Southeast Asia, but shows no evident willingness to “correct” its threatening image in Japan and the US. As a consequence, the CAFTA was endowed with a dual function - a means to appease ASEAN, as well as a lever to counterbalance the Japan-proposed CEPEA and the US-led TPP. This conclusion is in contrast to consequence speaks against the taken-for-granted conjecture that Beijing responds to all countries equally regarding “China Threat” rhetoric.

In the conclusion, I summarize my main findings that the CAFTA is part of a larger strategy for China to participate in regional economic integration, to resolve the SCS disputes, and to advance its “peaceful rise” pitch. This covers a wide spectrum of IR factors – power, interests and history. The absence of any one factor would result in a biased and incomplete explanation of the CAFTA, as outlined in case made for an eclectic rubric laid out in the previous chapter.

### **3.2 Agreement Analysis and Economic Results**

#### *The Framework Agreement and the Early Harvest Program (EHP)*

ASEAN, a union of states characterized by various economic priorities and development levels, is keen to be treated as a single market on the one hand, and keen to be granted special treatment according to individual members’ requirements, on the other. The frequency with which the phrase “different states of economic development among ASEAN member states and the need for flexibility” appears within the six A4 pages length Framework Agreement is a testament to Beijing’s apprehension towards ASEAN’s paradoxical mindset.<sup>282</sup> For example, three members (Vietnam, Laos and Cambodia) did not belong to the WTO when the Framework Agreement was signed. In order to show “flexibility”, China made a considerable concession by pledging to “accord Most Favored Nation (MFN) Treatment consistent with WTO rules and disciplines to all the non-WTO ASEAN member states upon the date of signature of this agreement”. China also comprised by giving the four new member states (ASEAN-4: Myanmar, Vietnam, Laos and Cambodia) five years longer to liberalize than the six old members (ASEAN-6: Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei).

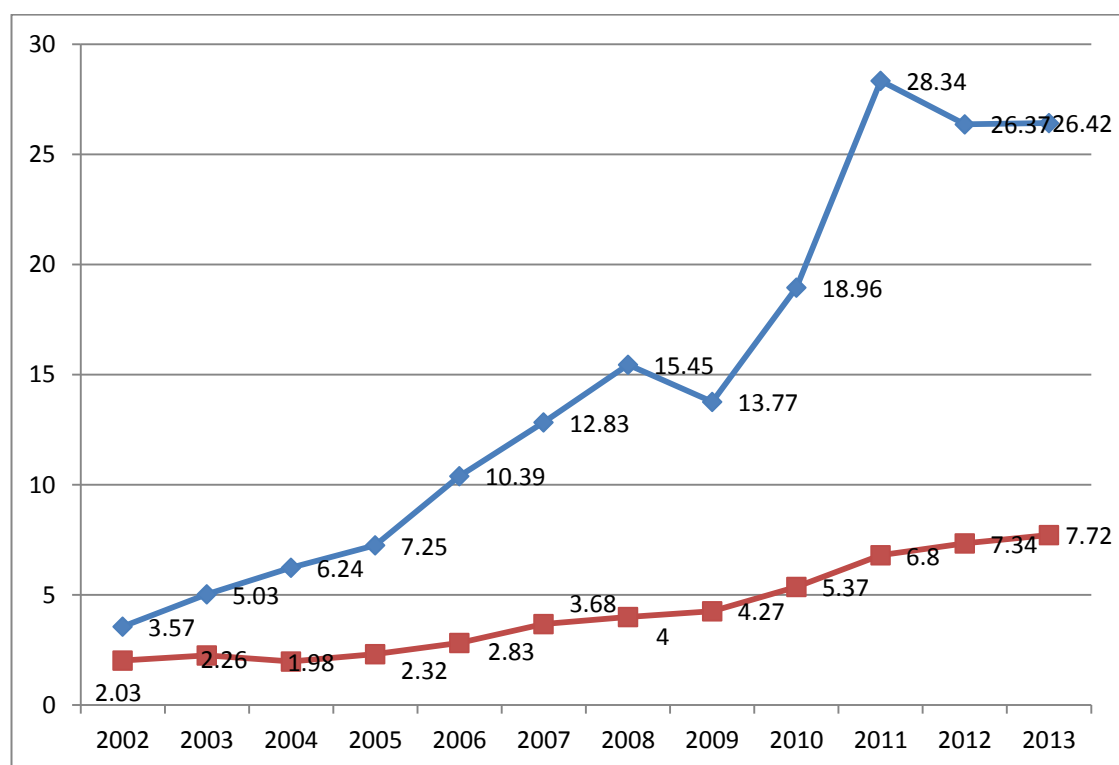
As a testing ground, China and ASEAN envisioned an EHP plan under the Framework Agreement, aiming to remove tariffs on approximately 600 agricultural products ahead of the set schedule. The EHP is a very flexible arrangement, by which parties decide whether to, or when to join. The Philippines, for instance, did not clinch any deal with China under this program until May 2005. Moreover, the EHP permitted an Exclusion List whereby a participator could remit certain products from the program’s coverage. For instance, Vietnam proposed 15 products on its Sensitive list, including meat and

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<sup>282</sup> Wang Liqin, "Competitive or complementary? China's role in trade cooperation with ASEAN in the 1990s and 2000s," *China: An International Journal* 10(2012).p.68

edible offal, birds eggs and citrus fruit, etc.; 30 products were excluded from Cambodia's EHP plan, comprising vegetables (garlic, cauliflowers, etc.), fruit (pineapples, oranges, etc.); and meat (chicken wings, etc.). China did not exempt any product in the Exclusion List, making the EHP an "almost entirely one-sided" concession to ASEAN. Since its inception, two-way agricultural trade has experienced significant growth. (See Figure 3.1 and Appendix 3.1) From 2002 to 2013, the agricultural trade gap widened from US\$1.54 million to US\$18.70 with China in deficit. In 2010, China accounted for more than 16.37% of ASEAN's overall agricultural exports.<sup>283</sup> These concrete benefits laid a firm foundation for later negotiations on Agreements on Trade in Goods.

**Figure 3.1: Agricultural products flows from ASEAN to China and the world (US\$ billion)**



\*The blue line refers to ASEAN's exports to China, and the red line indicates ASEAN's imports from China.

Source: WTO database and author's calculation, available at <http://stat.wto.org/StatisticalProgram/WSDBViewData.aspx?Language>

<sup>283</sup> Another significant role of the trade deficit with ASEAN is that it has largely offset China's trade surplus with developed countries such as the US and EU, which helps to maintain a balance of international payments in terms of China's overall current account position. See Kim Song Tan and Hoe Ee Khor, "China's Changing Economic Structure and Implications for Regional Patterns of Trade, Production and Integration," *China & World Economy* 14, no. 6 (2006), p.3

### *The Agreement on Trade in Goods (TIG)*

The Agreement on TIG was signed in November 2004 and took effect in July 2005. It followed the flexible nature of the EHP, which categorized traded goods into a normal track and a sensitive track.<sup>284</sup> For China and ASEAN-6, tariffs on normal goods should be eliminated before the first day of 2012; tariffs on sensitive goods should be reduced to 0-5% in 2018. For ASEAN-4, the due date for abolishing tariffs on all normal goods was postponed until 2018, and sensitive goods until 2020. In the beginning of the 21st century, neither party was important to the other. This situation has dramatically changed since the implementation of the TIG. In 2005, tariffs on over 7000 products were lower than in the pre-TIG era, serving as a prelude to more substantial tariff cutting. Bilateral trade volume peaked at \$115.7 billion in the same year. In 2010, two-way merchandise trade flows hit \$242.6 billion, with both parties exceeding the threshold of \$100 billion for the first time. China overtook EU-27 as ASEAN's largest trade partner in 2008 and this dominance has been maintained since.<sup>285</sup> ASEAN replaced Japan as China's third-largest trade partner in 2011. In 2013, trade between the two parties increased 10.9% to \$444 billion, eclipsing the 7.6% growth in China's total foreign trade.<sup>286</sup> Now the two sides have set a new joint trade target of \$500 billion by the end of 2015.

As shown in following Figure 3.2 (and Appendix 3.2), after the signature of the CAFTA, the overall ASEAN trade deficit with China increased from US\$9.68 billion in 2005 to

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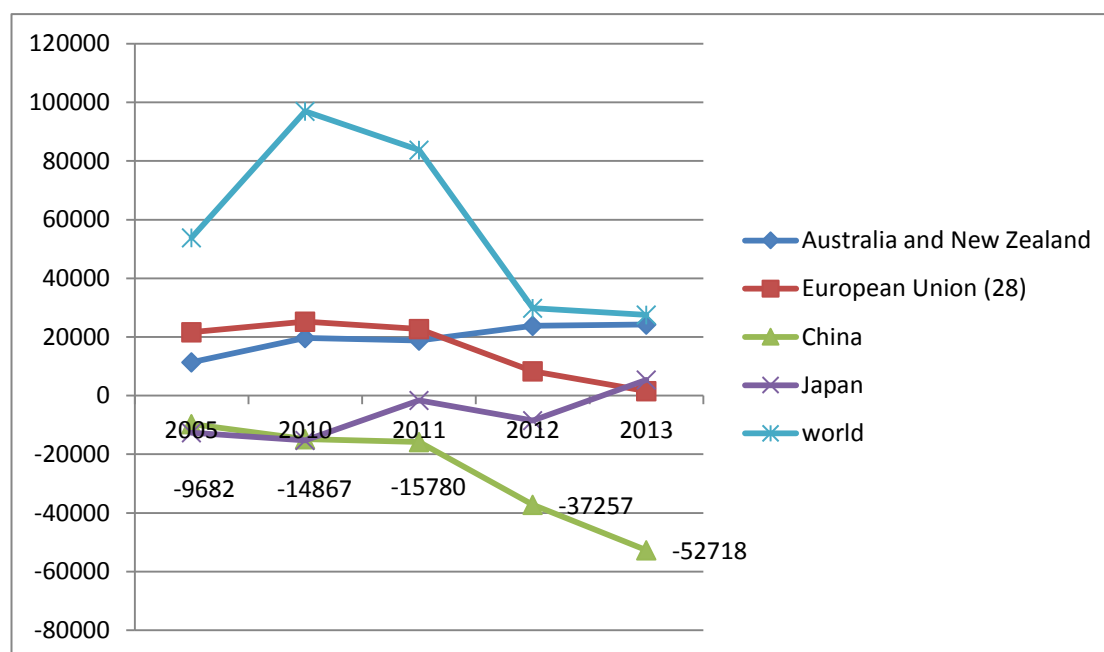
<sup>284</sup> Normal track goods shall suffer tariff reduction and elimination in accordance with Annex 1, and sensitive track goods shall reduce and eliminate tariffs according to Annex 2. The two parties also itemized a "highly sensitive list" in Appendix 2 of TIG. The numbers of categories of such goods proposed by the participants are as follows: Brunei (34), Cambodia (150), China (100), Indonesia (50), Laos (30), Malaysia (96), Philippines (77), Thailand (100), Singapore (1) and Myanmar (Nil). Notably, ASEAN members are inclined to enjoy the economic convenience brought by CAFTA while keeping China out of its cornerstone industries. For example, Thailand has taken a prominent position in Asian automotive industries, but it is reluctant to open its automotive market in China, even though its comparative advantage is quite obvious. Besides, products such as cylinders from 50cc to 3000cc, brake links, clutches and parts thereof were all itemized in Thailand's highly sensitive lists. In a nutshell, CAFTA is one of the few flexible FTAs that involved the exclusion of a large number of products for tariff reduction and elimination.

<sup>285</sup> The ASEAN Secretariat, "ASEAN Community in Figures 2011," (Jakarta: The ASEAN Secretariat, 2011).p.13

<sup>286</sup> Jhon, "China trade facts & figures 2013," (China-Europe Focus, January, 2014).

US\$52.72 billion in 2012, making China the largest contributor to ASEAN's deficit. According to the *2014 CAFTA First Quarter Report*, of the ten ASEAN members, Malaysia and Thailand enjoyed a surplus with China, whilst the remaining eight members recorded deficits. The trade surplus between Malaysia and China was the highest (\$14.21 billion). On the other hand, the trade deficit between Vietnam and China was recorded as the biggest (\$31.70 billion).<sup>287</sup>

**Figure 3.2: ASEAN's Trade Balance with Selected Trade Partners (US\$ million)**



Source: WTO database and author's calculation, available at <http://stat.wto.org/StatisticalProgram/WSDBViewData.aspx?Language=>

By contrasting the two economies' ten major traded commodities in 2007 and 2012, I find that there are three main features of the two-way trade performance. First, trade of intermediate goods plays a central role, indicating a deepened industrial linkage between China and ASEAN. In 2012, ASEAN's top export commodity to China was electrical machinery and equipment and parts thereof, televisions, sound recorders and reproducers, and parts and accessories of such articles (HS85), which together accounted for 25.3% of ASEAN's overall export to China. Similarly, commodities under HS85 accounted for 30.2% of China's total imports from ASEAN in 2012.<sup>288</sup> Second, China's export structure to ASEAN is being gradually reshaped by a shift to

<sup>287</sup> "China-ASEAN Free Trade Area Quarterly Report (The first quarter)," (China-ASEAN Business Council, 2014).

<sup>288</sup> See ASEAN Statistical Yearbook (2013), available at [http://www.asean.org/images/resources/Statistics/2014/StatisticalPublications/asean%20statistical%20yearbook%202013%20\(publication\).pdf](http://www.asean.org/images/resources/Statistics/2014/StatisticalPublications/asean%20statistical%20yearbook%202013%20(publication).pdf)

technology-concentrated goods. For example, in 2007, vehicles trade was out of the top ten traded commodities. In 2012, vehicles climbed to 9th place amongst ASEAN imports from China, valued at \$3,161 million. Third, ASEAN remains one of the PRC's significant resource suppliers. For instance, from 2007 to 2010, the proportion of products under HS27 (mineral fuels, mineral oil and products of their distillation, bitumen substances and mineral wax) that China imported from ASEAN increased from 10.6% to 15.2%.<sup>289</sup> (See Appendix 3.4) Taking these three features together, the TIG contributes a lot to a closely interdependent Sino-ASEAN trade relationship, with China climbing fast in the regional industry chain.<sup>290</sup>

### *The Agreement on Services (TIS)*

The second component of the CAFTA is an agreement on trade in services, which involves complex interwoven problems such as employment rates, social stability and diverse vested interest groups. This makes the service sectors one of the thorniest fields to liberalize, particularly in developing countries. China and ASEAN (except for Singapore) are no exemption. Both of them lack competitiveness in the international service market. As can be seen in Figure 3.3 (and Appendix 3.3), China has the highest share in the international service market, reaching its highest level of 4.41% in 2013. Singapore ranks second, its market share steadily increasing from approximately 2.21% in 2005 to above 2.63% in 2013. Other ASEAN-6 performances in service exporting are barely satisfactory, with Thailand and Malaysia hovering around 0.78-1.26%, and Indonesia's market share declining from 0.18% in 2005 to 0.47% in 2013. ASEAN-4 service exports are almost negligible, with Vietnam the best forerunner amongst them (0.17-0.22%).<sup>291</sup>

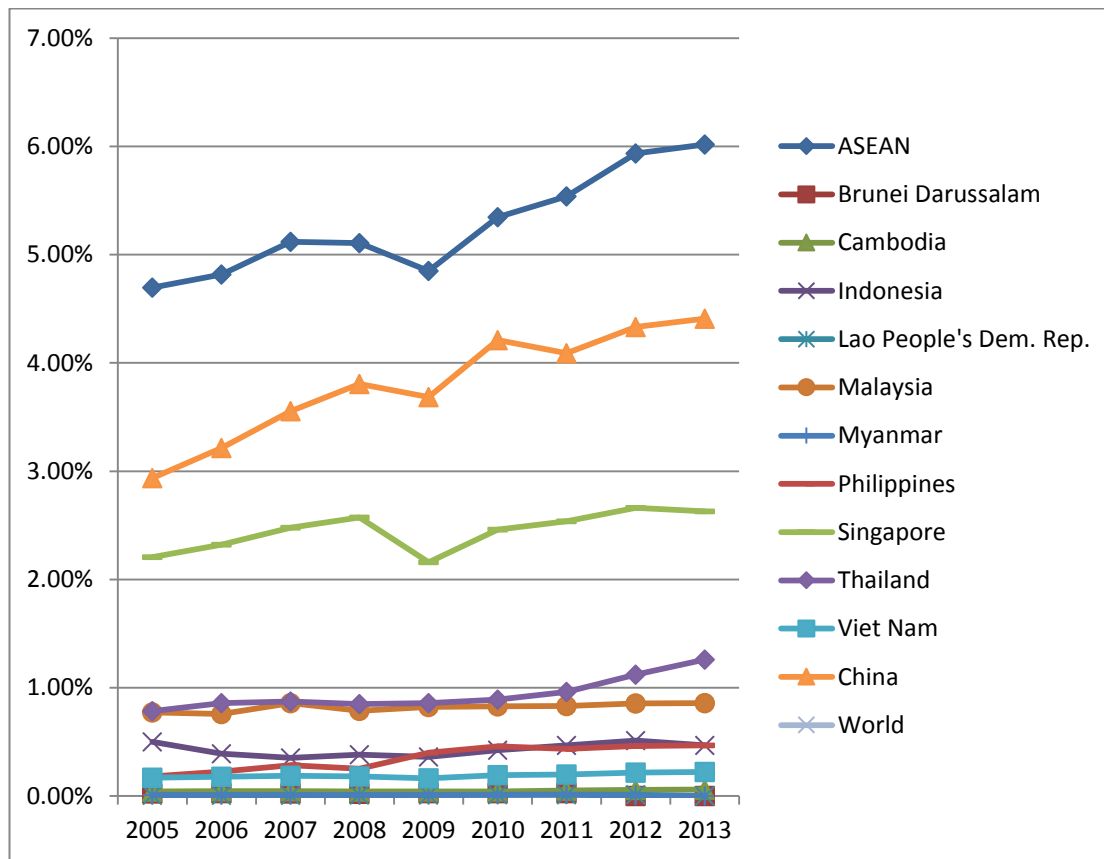
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<sup>289</sup> See ASEAN Statistical Yearbook (2007), available at <http://www.asean.org/images/archive/publications/aseanstats08.pdf>

<sup>290</sup> This finding also supports the "China centric model", in which China is the hub and ASEAN is the spokes. See Gary Clyde Hufbauer and Yee Wong, "Prospects for Regional Free Trade in Asia," in *Institute for International Economics Working Paper* (Institute for International Economics 2005); Tan and Khor, "China's Changing Economic Structure and Implications for Regional Patterns of Trade, Production and Integration." p.7

<sup>291</sup> Data from WTO Statistics Database (Service Trade Profile), available at <http://stat.wto.org/ServiceProfile/WSDBServicePFHome.aspx?Language=E>

**Figure 3.3: China and ASEAN Countries' Share of the International Service Market**



Source: Source: WTO database and author's calculation, available at <http://stat.wto.org/StatisticalProgram/WSDBViewData.aspx?Language=E>

Against this background, the “flexibility” endorsed by the Framework Agreement is extended to the TIS. For example, it takes into account that special and differential treatment shall be given to Cambodia, Laos, Myanmar and Vietnam, allowing them to open fewer sectors and liberalize fewer transactions.<sup>292</sup> Both parties explicitly consented to a “progressive liberalization” approach by introducing a package structure – the first package was signed in January 2007, followed by the second in November 2011.<sup>293</sup> These arrangements, although remaining limited, revealed the two economies’ efforts to diversify each other’s supply and distribution of services, as well as efforts to optimize the allocation of natural and human resources.

<sup>292</sup>Mireya Solís, "TPP and RCEP: Competing or Complementary Models of Economic Integration?," (Brookings Institute, 2014).p.14

<sup>293</sup> This “package structure” arrangement originated in the ASEAN- FTA (AFTA), which was signed in 1995. Under the framework of AFTA, ASEAN countries have five phased packages to liberalize their intra-trade in services. See Yoshifumi Fukunaga and Hikari Ishido, "Assessing the Progress of Services Liberalization in the ASEAN-China Free Trade Area (ACFTA)," in *ERIA Discussion Paper* (Economic Research Institute for ASEAN and East Asia (ERIA), 2013).p.1



In the first package, China's commitments covered twenty-six branches of five service areas on the basis of its WTO commitments, including construction, environmental protection, transportation, sports and commerce. For ASEAN-6, WTO-plus promises were made encompassing commercial services, construction, finance, medical treatment, transportation, tourism, etc. It is worth noting that although their openness varied in depth and width, a shared character was that they all agreed to give China a "first mover" advantage over other WTO members in construction and transportation sectors. This advantage allowed China to increase direct investment and build infrastructure in the region. Among ASEAN-4 states, the commitments of Vietnam, Cambodia and Myanmar were maintained on the WTO level, while Laos's liberalization concentrated on banking and insurance. As noted by the China-ASEAN Business Council, the Sino-ASEAN TIS's opening level is currently lower than the ASEAN-Korea FTA and the ASEAN-Australia-New Zealand FTA. Hence vigorously deepening liberalization of trade in services has been raised to the top priority in the upgraded version of the CAFTA, initiated by the Chinese Premier Li Keqiang in September 2013.<sup>294</sup>

#### *The Agreement on Investment*

In August 2009, China and ASEAN inked the Agreement on Investment, amidst the world economic recession resulting from the subprime mortgage crisis. In 2009, total FDI inflows to South, East and Southeast Asia dropped by 17% to \$223 billion. In 2010, the figure further decreased by 31% to \$153 billion. Against this downward trend, China's outbound direct investment (ODI) in ASEAN increased to \$4.4 billion in 2010, 63.2% higher than a year before. By the end of 2010, Chinese investors had established about 2300 enterprises in ASEAN, and employed 72,000 local employees.<sup>295</sup> According to data released by the Chinese Ministry of Commerce, China-ASEAN two-way investment reached \$14.09 billion in 2013. The top three ASEAN countries enjoying the largest volume of Chinese FDI were Singapore (\$2.4 billion), Laos (\$800 million) and Indonesia (\$760 million); the top three countries that invested most heavily in China were Singapore (\$7.327 billion), Thailand (\$480 million) and Malaysia (\$280

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<sup>294</sup> Michael Richardson, "The Rush Toward Asia-Pacific FTAs," *The Japan Times* July 17, 2013.

<sup>295</sup> The composition of ODI in ASEAN in 2010 was as follows: \$1.079 billion in financial sector, accounted for 24.5%, mainly in Thailand, Singapore, Malaysia, etc.; \$0.898 billion in mining industry, accounted for 20.4%; \$0.791 billion in production and supply of electricity, gas and water, accounted for 18%; manufacturing industry accounted for 11%, mainly in Viet Nam, Singapore, Malaysia, etc.

million).<sup>296</sup> Superficially, China enjoys an investment surplus of \$2.61 billion. It should be noted that Singapore alone accounted for 87.7% of ASEAN's overall FDI in China. When Singapore is removed, Chinese investment in the remaining nine ASEAN countries is three times higher than the reverse.

China's ODI in ASEAN reflects its intention to secure resource supply. (See Table 3.1) In 2010, the energy sector including electricity, gas and water accounted for 19.3% of the ODI stock, mining for 12.8% and agricultural products for 3.7%. Collectively, the share of natural resources constituted 35.8% of China's overall investment in ASEAN. (See table 3.2) This trend became more explicit after four years' of implementation of the Agreement on Investment, particularly in resource-rich states. According to data released by the Heritage Foundation, by August 2014, almost 100% of China's investment in Brunei was concentrated in the energy sector; in Indonesia, more than 42% in energy and 26% in mining; in Vietnam, approximately 70% in energy and higher than 10% in mining; in the Philippines, 77.6% in energy and 20% in mining.<sup>297</sup> For resource-poor ASEAN countries such as Vietnam, Chinese investments mainly concentrate in the textile sector and in Singapore in service sectors including real estate and construction.

**Table 3.1: China's ODI in selected- ASEAN Countries (Quantity: USD, millions)**

Year	Month	Investor	Quantity	Share	Partner	Sector	Subsector	Country
2009	September	CNPC	1.16	96%	Singapore Petroleum	Energy	Oil	Singapore
2009	October	Shanghai Electric	1.38		Electricite de Vietnam	Power		Vietnam
2010	February	Chinalco	0.35	35%	GIIG	Metals	Aluminium	Malaysia
2010	March	Dongfang Electric	1.40		Vietnam Electricity Group	Power	Coal	Vietnam
2010	July	Huadian	1.99		Tan Tao	Power	Coal	Vietnam
2010	December	Sinopec	0.68	18%	Chevron	Energy	Gas	Indonesia

<sup>296</sup> "China-ASEAN Free Trade Area Quarterly Report (The first quarter)."

<sup>297</sup> See the China Global Investment Tracker, created by the Heritage Foundation, available at <http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map>

2011	April	Chinalco	0.80		Smelter Asia	Metals	Aluminium	Malaysia
2011	April	Sinohydro	2.01			Power	Hydro	Laos
2011	August	CIC	0.36	19%	AES and POSCO	Energy	Coal	Vietnam
2011	October	China Nickel Resources	0.27	80%	PT Yiwang Mining	Metal		Indonesia
2011	November	Shougang Group	0.24	40%	Hiap Teck Venture Berhad	Metals	Steel	Malaysia
2012	June	China Nickel Resource	1.26	61%	PT Jhonlinto	Metals	Steel	Indonesia
2012	July	China South Locomotive	0.13			Transport	Rail	Malaysia
2012	August	Dafeng Port	0.60			Metal	Steel	Indonesia
2012	August	Huadian	0.64			Energy	Coal	Indonesia
2012	August	Shenwu Group	0.18			Metals	Steel	Indonesia
2013	May	Shenzhou International	0.12			Others	Textiles	Vietnam
2013	July	Texhong Textile	0.30			Others	Textiles	Vietnam
2013	October	CIC	1.30		Bumi Resources Minerals	Energy	Coal	Indonesia
2013	October	Hongqiao	0.60	60%	Winning Investment	Metals	Aluminium	Indonesia
2014	February	Bank of China, China Life and Hopu Investment	0.16	2%	Global Logistics Properties	Real Estate	Property	Singapore

2014	May	Alibaba	0.25	10%	Singapore Post	Others		Singapore
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Source: The Heritage Foundation, China Global Investment Tracker Dataset, updated July 2010, available at <http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map>

**Table 3.2: China's ODI in ASEAN in 2010 -- Selective Sectors (10 thousand dollars)**

Sectors	FDI Inflows	Share (%)	FDI Stock	Share (%)
production and supply of electricity, gas and water	0.079	18.0	0.278	19.3
Wholesale and retail	0.017	3.9	0.188	13.1
Manufacturing Industry	0.049	11.0	0.190	13.3
Leasing and Business Service	0.016	3.5	0.117	8.2
Mining	0.090	20.4	0.184	12.8
Construction Industry	0.035	7.9	0.116	8.1
Transportation and Warehousing	0.008	1.9	0.084	5.9
Financial sector	0.108	24.5	0.176	12.3
Agricultural	0.017	3.8	0.053	3.7
Others	0.001	0.2	0.002	4.0
Total	0.441	100.0	1.44	100.0

Source: 2010 Statistical Bulletin of China's Outward Foreign Direct Investment<sup>298</sup>

After Xi Jinping's 2013 21st-century Maritime Silk Road (MSR) scheme, China's overwhelming appetite for natural resources investment in Southeast Asia was partially diverted to highway, port, and dam projects. (See Picture 3.1) This move is expected to strengthen the "infrastructure connectivity", which, as the CAFTA Business Council suggests, "remains the urgent need for both China and ASEAN countries in pursuing

<sup>298</sup> "2010 Statistical Bulletin of China's Outward Foreign Direct Investment," ed. Ministry of Commerce of People's Republic of China and National Bureau of Statistics of People's Republic of China and State Administration of Foreign Exchange (2010).

development, and is also the foundation for the establishment of the CAFTA”.<sup>299</sup> Considering that infrastructure construction requires a huge amount of capital resources, in October 2013, Beijing proposed building an Asian Infrastructure Investment Bank (AIIB) to provide specific funds, with itself the biggest shareholder in the bank, with a stake of 50%.<sup>300</sup>

**Picture 3.1 China’s Maritime Silk Road and Silk Road Economic Belt**



Source: The 4<sup>th</sup> Media, available at <http://www.4thmedia.org/2014/06/geo-cultural-strategy-for-eurasia-a-paradigm-for-the-new-silk-road/>

Both the MSR and the AIIB are envisioned as important catalysts for upgrading the CAFTA, which not only facilitates China-ASEAN investment, but also nourishes the two parties’ economic relations as a whole. More importantly, when these regimes begin to bear fruit, Beijing will have a more in-depth engagement in Southeast Asia. Noting that regional economic cooperation is primarily political results, and that the economic consequences are always side effects of the political payoff,<sup>301</sup> the remainder of this chapter now turns to analyze the political dimension of the CAFTA. I will explore China’s strategic considerations behind its regional FTA approach from the following perspectives: (1) to underpin FTA rivalries with other great powers; (2) to relieve political pressure on Beijing over the South China Sea issue; and (3) to appease Southeast Asia’s prevailing anxiousness that China is a revisionist set to challenge the regional strategic *status quo*.

<sup>299</sup> Richardson, "The Rush Toward Asia-Pacific FTAs."

<sup>300</sup> Sanchita Basu Das, "The Trans-Pacific Partnership as a Tool to Contain China: Myth or Reality?," (The Institute of Southeast Asian Studies, 2013).

<sup>301</sup> World Bank, *Trade Blocs* (Oxford: Oxford University Press for the World Bank, 2000).p.11

### 3.3 The CAFTA and China's Big Power Rivalry

In the contemporary Asia Pacific, bilateral FTA building is paralleled with regional free trade block construction. This section argues that these trading blocs essentially compete with each other and have evolved into a new form of big power rivalry. China, as we shall see, prefers the "ASEAN+3" based EAFTA to the "ASEAN+6" based RCEP, mainly due to competition with Japan. But when the US-led TPP presented an imminent threat, it did a U-turn and supported the RCEP. In both cases, the CAFTA plays a central role for China winning over supporters and entrenching preferences. This section is organized as follows: the first part explores the EAFTA vs. CEPEA rivalry by embedding it into the Sino-ASEAN-Japan strategic triangle; the second part studies the RCEP vs. TPP rivalry by contextualizing it in the Sino-US-Japan strategic triangle. Here, strong evidence will show that *realpolitik* still dominates China's big power diplomacy. This chapter concludes with the flip side of these rivalries: ASEAN is split into different trading groups harmful to the Association's solidarity and it needs to keep unitary if it is to lead regional integration.

#### 3.3.1 CAFTA, EAFTA, and CEPEA – the Sino-ASEAN-Japan triangle

China's rapid ascension has greatly shaped Asia's politico-economic landscape. Many pundits are keen to draw parallels between the current regional order and the ancient imperial Chinese tribute system, within which China was the central country whilst peripheral states were tributaries.<sup>302</sup> Such a system would represent a big threat to Southeast Asian countries, since many of them used to belong to the tribute system. As a result, they choose to stay under the shield of ASEAN, which was designed to unify and institutionalize small-middle states' claims to maintain autonomy with "one voice". On the other side, a rising China poses no less a challenge to a Japan wary of "being edged out of its position as the dominant East Asian state and leader of regional integration efforts".<sup>303</sup> In this context, the trilateral relationship between China, ASEAN and Japan represents what Lowell Dittmer called a "Romantic Triangle", consisting of a

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<sup>302</sup> See Ho Khai Leong and Samuel C Y Ku, ed. *China and Southeast Asia: Global Changes and Regional Challenges* (Singapore: Institute of Southeast Asian Studies, 2005); Michael Ewing Chow, "ASEAN-China FTA: Trade or Tribute?," *Singapore Year Book of International Law* (2006); Yan Li, "China-Japan-ASEAN Relations and Eastern Asia's Integration " (Aalborg University, Denmark & University of International Relations, China, 2013).

<sup>303</sup> Christopher W. Hughes, "Japan's response to China's rise: regional engagement, global containment, dangers of collision," *International Affairs* 85, no. 4 (2009).p.840

better relationship between the ‘pivot’ (ASEAN) and two ‘wing’ players’ (China and Japan) than either has with the other.<sup>304</sup> Here ASEAN plays the role of ‘broker,’ taming the excesses of the big powers, leaving Beijing and Tokyo painstakingly courting ASEAN to create relatively asymmetrical trilateral relations to their own advantage. The Sino-Japan FTA membership competition, as we shall see in the following analysis, is telling evidence of this Sino-ASEAN-Japan *Romantic Triangle*.

China’s long journey toward the EAFTA started from 29 November 2004, when it signed the Agreement on Trade in Goods with ASEAN in the 8<sup>th</sup> “10+3” Summit held in Vientiane, Laos. On the same day, former Chinese Premier Wen Jiabao announced that China would take the initiative to set up a Joint Expert Group (JEP) to conduct a feasibility study on an FTA encompassing all “10+3” members – the EAFTA. On 22 July 2006, the JEP submitted its Phase I study report, asserting that the EAFTA would generate positive economic effects for all thirteen participants. It also recommended a feasible pathway toward the EAFTA through individual “10+1” FTAs - China, Japan and Korea to establish an FTA with ASEAN separately and then consolidate the three together.<sup>305</sup> This pathway is supposed to grant Beijing a privileged position under the EAFTA framework, anchored, since the inception of the CAFTA, by burgeoning Sino-ASEAN economic cooperation. Moreover, given that South Korea’s market potential and political influence are much less than that of China’s, and that Japan prefers to cooperate with ASEAN on a bilateral basis, the CAFTA will enable China to acquire a stronger bargaining position when negotiating the EAFTA.<sup>306</sup>

Beijing places a great premium on the CAFTA and EAFTA, as they form the basis for its broader ambition of reshaping regional orders. Regime theorists posit that states advantaged within one institution will find themselves at an advantage in other regional institutional agendas, because transaction costs of concluding agreements outside of an

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<sup>304</sup> Dittmer, "Sino-Australian Relations: A Triangular Perspective." pp.664-665

<sup>305</sup> The report also suggested two other pathways: (1) China, Japan and Korea achieve a trilateral FTA (CJKFTA) first and then combine with the ASEAN FTA; and (2) using the existing “10+3” framework and establishing the EAFTA in a one-off effort. But they were regarded as more difficult than combining the three “10+1”. See Joint Expert Group for Feasibility Study on EAFTA, "Towards an East Asia FTA: Modality and Road Map," (July, 2006). The EAFTA’s phase II study was initiated and led by South Korea, for details see EAFTA Joint Expert Group, *Final report on EAFTA Phase II Study: desirable and feasible option for an East Asia FTA* (Joint Expert Group on EAFTA Phase II Study, 2009).

<sup>306</sup> Cai, "Chinese Changing Perspective on the Development of an East Asian Free Trade Area." p.590

established institution are high.<sup>307</sup> A CAFTA, underpinning a strong Sino-ASEAN axis, is well qualified for the task. For example, except for the CAFTA-centered EAFTA, some Asia-watchers pointed out that the CAFTA “will be a cornerstone for the proposed East Asian Economic Community (EAEC)”,<sup>308</sup> making China a competitive candidate for driving regional integration. Although Beijing has repeatedly indicated that it has no such intention, Men Honghua, a leading Chinese scholar at the CCP Central Party School, tells a different story. Men suggests that China’s self-defined role in East Asia should change from a participator to a leader. The CAFTA, to quote Men, is “the most creative Chinese proposal and strategic action for creating new multilateral economic order”.<sup>309</sup> He also notes the political impact of the trade deal, “although it is an economic agreement, it has shifted the decision center for East Asian regional affairs northwards to China. It provides China with major opportunities to reshape the East Asian order”.<sup>310</sup>

Beijing’s advantaged position in the EAFTA placed Tokyo under considerable peer pressure. Thus, two months after the EAFTA Phase I feasibility study finished, Japan proposed a plan named Comprehensive Economic Partnership for East Asia, aiming to enlarge the regional-scale FTA membership from thirteen (ASEAN+3) to sixteen countries by encompassing Australia, New Zealand and India (ASEAN+6). At the second East Asia Summit (EAS) held in 2007, leaders of all members agreed to launch a feasibility study on the CEPEA, with Japan taking the initiative.<sup>311</sup> The Japanese government touted the CEPEA as superior to the EAFTA: qualitatively, it contains “a

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<sup>307</sup> Robert O. Keohane, "International Institutions: Two Approaches," *International Studies Quarterly* 32, no. 4 (1988).p.387

<sup>308</sup> Chow, "ASEAN-China FTA: Trade or Tribute?."p.252

<sup>309</sup> Men Honghua, *Gou jian Zhongguo da zhanlüe di kuang jia (Defining Parameters for the Chinese Grand Strategy)* (Beijing: Beijing Daxue Chubanshe (Beijing University Press), 2005).pp.274-275, cited in Zhang Baohui, "Chinese Foreign Policy in Transition: Trends and Implications," *Journal of Current Chinese Affairs* 39, no. 2 (2010).p.51

<sup>310</sup> Honghua, *Gou jian Zhongguo da zhanlüe di kuang jia (Defining Parameters for the Chinese Grand Strategy)*. Cited in Baohui, "Chinese Foreign Policy in Transition: Trends and Implications."p.51

<sup>311</sup> Moreover, Japan regards the US as a trump card in FTA competition with China. To maintain America’s presence in Asia, it has lobbied heavily for the US’s EAS membership on the one hand, and joined the US-led TPP on the other (I will discuss this in the second part of this section). In 2011, the US, together with Russia, formally joined the EAS, which further reduced the hope for Beijing to lead regional integration.



full package of long-term and legally binding developmental benefits”;<sup>312</sup> quantitatively, the benefit of CEPEA is larger for ASEAN+3 states as well, with 2.05% of GDP increase in case of CEPEA and 1.93% in case of EAFTA.<sup>313</sup>

The CEPEA, despite its economic superiority, is supposed to function geopolitically because under the EAFTA “there was no potential counterbalance to China’s physical size and projected growth”.<sup>314</sup> But the situation may change after the access of new entrants - India for many years has viewed China as its “No 1 enemy”, and it may work against Beijing’s interests in the forum; Australia and New Zealand, so-called developed democratic countries, are also supposed to line up with Japan due to similar levels of development, and ideology commonalities.<sup>315</sup> Even if new-comers choose to keep neutral, their economic size is big enough to at least dilute China’s economic dominance. Some ASEAN countries, such as Singapore and Indonesia, also welcome the CEPEA as a “non-American balance” to counterbalance China’s influence.<sup>316</sup> Thus the CEPEA initiative, or what Christopher Hughes called a “blocking strategy”, enables Tokyo to “gang up” with like-minded countries and to impede Beijing from fully exerting its economic clout and political influence.<sup>317</sup>

Many scholars in China are skeptical about Tokyo’s intentions regarding the CEPEA. Nor do they think Beijing should give up the dominant position provided by the EAFTA and CAFTA. In this context, they recommend a more pragmatic approach to follow a dual-track, in which the EAFTA is the fast-track, whilst ASEAN+6 countries continue their collaboration under the CEPEA on a steady-track.<sup>318</sup> For example, Zhang Yunling,

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<sup>312</sup> Hughes, "Japan's response to China's rise: regional engagement, global containment, dangers of collision."p.847

<sup>313</sup> The Track Two Study Group on CEPEA, "Report of the Track Two Study Group on Comprehensive Economic Partnership in East Asia (CEPEA)," (June, 2008).

<sup>314</sup> Yang Jian, "Great Powers and the Regional Architecture in Asia Pacific," in *Vietnam - NZ Track II Dialogue: Managing Change in the Asian region* (Asia New Zealand Foundation, 2010).

<sup>315</sup> Reiji Yoshida, "Abe Secured Only Half of KEy Goals at Meeting," *The Japan Times* April 24, 2014.

<sup>316</sup> Thomas Lum; Wayne M. Morrison; Bruce Vaughn, "China's "Soft Power" in Southeast Asia," in *China's Foreign Policy and Soft Power Influence*, ed. Alice V. Monroe (New York: Nova Science Publishers, 2010).p.30

<sup>317</sup> Hughes, "Japan's response to China's rise: regional engagement, global containment, dangers of collision.", p.847

<sup>318</sup> Bin Sheng, "A New Direction for Regional Cooperation in the Asia Pacific: A Perspective of Competitiveness Configuration [yatai quyu hezuo de xin dongxiang: laizi jingzhengli gouxiang de

China's chief FTA negotiator and a leading scholar from the Chinese Academy of Social Science, argues that a more feasible approach of achieving the CEPEA is to begin with "10+3" through a negotiation based on three "10+1" FTAs, and then to extend it to other "10+6" members as a whole.<sup>319</sup> He further suggests that "it is desirable for CEPEA to initiate a facilitation agreement starting with a single window ... which may be considered as an EAFTA early harvest program".<sup>320</sup> Recalling Beijing's generosity to ASEAN under the CAFTA's EHP arrangement with major concessions in the agriculture sector, many observers point out that Tokyo cannot afford to do the same, at least in the short-term.<sup>321</sup> This suggestion makes clear the intent to draw ASEAN closer whilst pushing Tokyo aside.

The Sino-Japan FTA-membership competition accords with geo-economic realists' expectation that governments are sensitive to relative costs, and that powerful states will "organize their relations with their weaker neighbors in order to enhance their position in great power economic competition".<sup>322</sup> Beijing knows full well, as the economic literature has eloquently shown that the CEPEA works better than the EAFTA in enhancing participants' economic welfare.<sup>323</sup> To endorse the CEPEA indicates larger market access beyond ASEAN and Northeast Asia. It can also rescue Beijing from the frustrations of finalizing bilateral FTAs with Japan and Australia. The former's huge market potential and the latter's rich mineral resources will be two anchors helping secure China's economic growth. Nevertheless, these foreseeable benefits are less attractive to Beijing since Tokyo is supposed to gain more by rallying up "allies". "To the extent that gains resulting from collective action are likely to affect these

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dongcha]," *International Economy Review [guoji jingji pinglun]* 3(2010); Yang Yong and Hu Yuan, "New Trend of Regional Integration in the Asia Pacific: China's Strategic Choices [yatai quyue jingji yitihua fazhan qushi yu zhongguo de celue xuanze]," *Asia Pacific Economy [yatai jingji]* 6(2011).

<sup>319</sup> CEPEA Track Two Study Group, "Phase II Report of the Track Two Study Group on Comprehensive Economic Partnership in East Asia (CEPEA)," (2009).

<sup>320</sup> Ibid.

<sup>321</sup> Japanese government has been tried to avoid the sensitive agricultural sector in FTAs if possible, such as the Japan-Thailand FTA. See Mark S. Manger, "Vertical Trade Specialization and the Formation of North-South PTAs," *World Politics* 64, no. 04 (2012).p.640

<sup>322</sup> Michael Mastanduno, "A Realist View: Three Images of the Coming International Order.," Vaughn, "China's "Soft Power" in Southeast Asia."p.24

<sup>323</sup> Masahiro Kawai and Ganeshan Wignaraja, "EAFTA or CEPEA: Which Way Forward?," *ASEAN Economic Bulletin* 25, no. 2 (2008).; Dent, "Bilateral Free Trade Agreements: Boon or Bane for Regionalism in East Asia and the Asia-pacific?."

capabilities [safeguarding survival and independence]”, as Andreas Hasenclever *et al.* suggests, “states, when contemplating cooperation in a given issue-area, must take into account not only the size of the absolute gains they are likely to achieve, but also the size of the absolute gains that are enjoyed by their partners”.<sup>324</sup> To be more specific, the uneven growth of power among states is the means to achieve higher status in a given international structure, or at least maintaining the *de facto* state-status. To prevent Japan from winning the positional contest, Beijing chose to sacrifice considerable economic gains – a main rationale for why it responded negatively to the CEPEA. Due to similar realist logic, Japan’s persistence in enlarging the scale of regional FTAs is not without costs. Both Australia and New Zealand are agriculturally advanced states – finalizing free trade agreements with them would pose great challenges to Japan’s agricultural sector. Besides, the three new entrants, with different priorities and sensitivities, will greatly complicate and delay a final agreement and impede Japan from benefiting from regional integration, thus jeopardizing its own development.

The Sino-Japan membership rivalry broke up ASEAN into different camps to potentially weaken its pivot position in the Romantic Triangle. Singapore is the steadiest proponent of the CEPEA. But given its close economic ties with China and its status as the only ASEAN member that has signed a bilateral FTA with China under the framework of CAFTA, it keeps neutral by supporting both countries’ initiatives. Other members, such as Thailand, Myanmar and Cambodia are also neutral because they want to both placate China, their biggest trading partner, whilst not incensing Japan, their major patron and important economic partner. One factor that appears to be in China’s favor is increased regional advocates for a ‘more Asia-oriented grouping’, spearheaded by Malaysia.<sup>325</sup> Indonesia, which used to support Japan, changed its stance and complained that the CEPEA “may be seen as serving the geopolitical interests of a few players, to little economic effect. Then it will not be ‘the economy, stupid’, but just politics as usual”.<sup>326</sup>

Noting that ASEAN countries were somewhat aloof about its CEPEA initiative, Japan was passive in Northeast Asian FTA talks crucial to the EAFTA. Hughes raised doubts about Japan’s ability to exercise influence over ASEAN, since its behavior under the

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<sup>324</sup> Andreas Hasenclever, *Theories of International Regimes*.p.116

<sup>325</sup> Vaughn, "China's "Soft Power" in Southeast Asia."p.30

<sup>326</sup> Jayant Menon, "Will Aisa's Largest FTA Make a Difference?," (The Jakarta Post, 2013-07-01).

CEPEA indicates that it lacks a clear idea of how to bring the sixteen countries together, nor has it shown any willingness to make substantial commitments to agricultural trade. Further:

Japan's desire to block wider efforts to forge a more coherent East Asia-centered region, seen from its foot-dragging on concluding an FTA with China, which is a key step in completing a genuine region-wide FTA, may rebound, as it finds itself potentially isolated from regional integration efforts.<sup>327</sup>

To stop big power rivalry from further denting ASEAN's cohesion, the Association proactively assumed its brokerage role. In August 2011, East Asia Summit Economic Ministers welcomed a Chinese and Japanese joint "Initiative on Speeding up the Establishment of EAFTA and CEPEA".<sup>328</sup> Then in November 2011, at the 19th ASEAN Summit in Bali, ASEAN proposed its own model for an ASEAN centric regional-FTA – the RCEP.<sup>329</sup> It was a compromise between Japan and China: on the one hand, the RCEP endorsed Japan's insistence on the "10+6" formula. On the other hand, ASEAN reaffirmed the "10+3" formula as the main vehicle to achieve the long-term goal of building an East Asian Community and recognized the mutually reinforcing complementary roles of the ASEAN+3 process and regional forums such as the EAS and the ASEAN Regional Forum (ARF).<sup>330</sup> In doing so, ASEAN hopes the RCEP can pave a way to "play out its central role and enable it to bypass the deadlock of China-Japan strategic rivalry,"<sup>331</sup> and bring the derailed regional economic integration back on track.

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<sup>327</sup> Hughes, "Japan's response to China's rise: regional engagement, global containment, dangers of collision."p.21

<sup>328</sup> Department of Foreign Affairs and Trade, "Background to the Regional Comprehensive Economic Partnership (RCEP) Initiative," (Australian Government, Department of Foreign Affairs and Trade, December, 2012).

<sup>329</sup> Sanchita Basu Das, "The political economy of the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP) agreements: an ASEAN perspective," in *Trends in Southeast Asia* (Institute of Southeast Asian Studies, 2004).p.43

<sup>330</sup> Min Gyo Koo, "The ASEAN+'X' Framework and its Implications for the Economic-Security Nexus in East Asia," in *Linking Trade and Security: Evolving Institutions and Strategies in Asia, Europe, and the United States*, ed. Vinod K. Aggarwal and Kristi Govella (New York: Springer, 2012).p.101 and House Committee on Foreign Affairs, *The Trans-Pacific Partnership: Outlook and Opportunities*, August 1, 2013 August 2013.

<sup>331</sup> BBC, "TPP: What's at stake with the trade deal?," in *Business* (BBC News, April 22, 2014).p.7

Beijing did well to seize on this ASEAN overture. Officials and media outlets overwhelmingly welcomed the new idea of RCEP and supported ASEAN in leading the upcoming negotiations. This was a smart move to woo Southeast Asian countries, allowing Beijing to outperform Tokyo, which invites non-Asian powers to ensure its own regional dominance. At present, the “ASEAN leadership” pitch is gradually evolving into a convenient shield to contend with Japan. For example, the *China Daily* published an article titled “Beijing-Tokyo Dispute Affects ASEAN”, calling for ASEAN to be tougher and more decisive in leading regional affairs:

Gone are the days when ASEAN served as a fulcrum for major powers to converge on the region because they could not do it on their own. ASEAN’s strength has always been its policy of “enemy to none but friend to all”. Of late, the growing tension and polarization in East Asia has gradually narrowed the once impeccable niche diplomatic space of ASEAN. What ASEAN policymakers decide now will determine the grouping’s future playing field vis-a-vis their powerful dialogue partners that is China and Japan.<sup>332</sup>

For now, EAFTA and RCEP are seen as parallel pathways toward Asian integration, and the CAFTA remains a centerpiece in both of them. Although Beijing remains suspicious about the RCEP, it has ostensibly accepted it on the basis of the “open, inclusive regionalism”, formally endorsed by ASEAN. Yet this left a potential risk: since Beijing and Tokyo view each other through the view of realpolitik, it would render any regional cooperation, whatever its membership and leadership, being susceptible to a downturn in relations between the two, who may freeze dialogue or even result in war, should they believe it necessary. ASEAN’s split verifies the fact that China’s efforts to promote the CAFTA-based regional economic integration are neither successful nor in vein. Rather, it is a half-won battle. It still has a lot riding on the success of regional integration. For Japan though, the outlook for maintaining its regional leadership is very murky. As a result, as we shall see in the following analysis, it turned to more firmly embrace the TPP.

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<sup>332</sup> Basu Das, "The political economy of the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP) agreements: an ASEAN perspective."

### 3.3.2 RCEP vs. TPP – the Sino-Japan-US strategic triangle

The TPP is the most ambitious free trade agreement currently under negotiation and grew out of a 2005 FTA initiative among four Pacific countries, namely Brunei, Chile, New Zealand and Singapore (also called P-4). It was then enlarged with the US, Australia, Peru, and Vietnam joining in negotiations in 2008, Malaysia in 2010, Canada and Mexico in 2012 and Japan in 2013.

Japan's accession to the TPP forum profoundly changed the FTA landscape in the Asia Pacific - there are some overlaps in membership between RCEP and TPP, but Japan is the only very large economy belonging to both. There are also many differences between the two arrangements, but the biggest one is that Japan's no. 1 rival China belongs to the RCEP but not the TPP, whilst Japan's no. 1 ally America belongs to the TPP but not the RCEP. Already, the "RCEP vs TPP" debate had been touted as a tussle between Beijing and Washington.<sup>333</sup> In the context of this section, I argue that it is in fact a tussle among China, the US, as well as Japan, which fits the "Stable Marriage" triangle as proposed by Dittmer – relationships between Washington and Tokyo are better than either with the third, the 'pariah, Beijing'.<sup>334</sup> China currently feels very uncomfortable in this triangle. As stated by Zhu Feng, a pioneering Chinese scholar of international affairs, "The US feels for the Emperor of China's challenge to the alarms in the Asia Pacific will likely imperil ... the American's credibility and interest in Eastern Pacific. So then China also see US particularly just take the side always just siding with Japan and leaving China alone [*sic*]"<sup>335</sup> In Beijing's eyes, then, America joined the TPP to curb its rise, and China's exclusion is the biggest selling point of the TPP for Japan.<sup>336</sup> Going further, since the US does not participate in the RCEP and Japan has no capacity to lead the RCEP, in the two countries' strategic calculate that the ASEAN-sponsored regional trading block is at best a 'pariah', if not a stumbling stone to realizing the TPP. For Beijing though, the RCEP has become the very rare regional institution it can count on to break through this perceived containment.

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<sup>333</sup> Kevin Gallagher, "Pacific Partners Should Push Back Against TPP Untile U.S. Shows Respects for Financial Reforms," *The Japan Times* May 5, 2014. In the words of David Pilling, a leading columnist for the Financial Times, the TPP reflects the US's aim of building an "Anyone-But-China club". See David Pilling, "It Won't Be Easy to Build An 'Anyone But China' Club," (Financial Times, May, 2013).

<sup>334</sup> Dittmer, "Sino-Australian Relations: A Triangular Perspective." pp.664-665

<sup>335</sup> Clint Richards, "US Voices Exasperation Over Japan-ROK Disputes " (The Diplomat, August 21, 2014),p.5

<sup>336</sup> Yoshida, "Abe Secured Only Half of KEy Goals at Meeting."

Three main lines of responses to the TPP in China can be detected. First, knowing that maintaining a cordial economic relationship with ASEAN is an anchor in assisting China's regional preferences, the CAFTA construction has moved to be the first priority in its FTA diplomacy. In September 2013, at the 10<sup>th</sup> China-ASEAN Expo and the China-ASEAN Business and Investment Summit, Premier Li Keqiang initiated an upgrade of CAFTA, and set an ambitious goal of expanding bilateral trade volume to \$1 trillion by 2020.<sup>337</sup> Two months later, the Third Plenum of the 18<sup>th</sup> Chinese Communist Party Congress designated the neighboring states as "priority direction" for China's diplomacy and called for "accelerating the FTA strategy on the basis of periphery countries".<sup>338</sup> The directive has induced a series of CAFTA related economic cooperation initiatives, including the Bangladesh-India-Myanmar-China economic corridor, the Great Mekong Sub-region Economic Zone, and the 21-century Maritime Silk Road referred to above.

Moreover, Beijing knows that FTAs in Northeast Asia are a crucial "missing link" in the regional proliferation of trade agreements, which can lay a solid foundation to counter or hedge the TPP. As a result, it has made a conciliatory gesture toward Japan. In early 2014, Commerce Ministry spokesman Shen Danyang stated that China would give priority to free trade negotiations with East Asia neighbors, including the trilateral Sino-Korea-Japan FTA (CKJFTA) and the Sino-Korea FTA (CKFTA). On 17<sup>th</sup> March and 26<sup>th</sup> May 2014, Beijing and Seoul kicked off two consecutive rounds (the 10<sup>th</sup> and 11<sup>th</sup>) of bilateral negotiations, and set a deadline of achieving a final agreement at the end of 2014. Most interestingly, China, Japan and South Korea launched the fourth round of FTA talks on May 05, 2014, two weeks after Abe visited the Yasukuni Shrine. This was a very rare move by Beijing, which normally stops all high level official talks and ceases governmental cooperation after such acts that it regards as provocations. On 1<sup>st</sup> September 2014, the fifth round of trilateral talks was held in Beijing, and the Chinese Ministry said that it "earnestly anticipates finalizing the talking as soon as

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<sup>337</sup> Kazuhiko Togo, "Obama Visit Fails to Strengthen US-Japan Trust," (East Asia Forum, 2014).

<sup>338</sup> Timothy Stratford and Managing Partner, "China's Economic Reforms: Current Policy Trends and Debate - Prepared for the European Commission Directorate-General for Trade," (Covington & Burling LLP, 2014).

possible”.<sup>339</sup> These ice-breaking negotiations indicated that China was very serious about establishing an Asian-only FTA to counter the TPP.

Should the CJKFTA succeed, it will give the RCEP negotiation a very strong support because the three Northeast Asian states account for over 2/3 of the GDP of RCEP members.<sup>340</sup> Alternatively, if the CKJFTA goes slowly, the CKFTA may “serve as a catalyst for the CKJFTA since Japan would worry it may pay the cost if only China and ROK sign the agreement”.<sup>341</sup> This Prediction soon came true. On 13<sup>th</sup> November 2014, after 14 rounds of negotiation, the CKFTA formally came to its end (it was then officially inked on 1<sup>st</sup> June 2015). It only took three years for the two signatories to finish this deal, reflecting their highly competitive trade structure. Economically, China is already South Korea’s largest trading partner, and the CSFTA is China’s largest such deal in terms of the trade volume affected. Tokyo will feel the pressure from the FTA between its two close neighbors – in 2014, bilateral trade volume between China and Korea was \$290.5 billion, quickly catching up with China-Japan bilateral trade. Geopolitically, this is an important lever for Beijing to draw its neighbor closer into its own economic circle. Given the fact that the Soul is considering to play a bigger role in the burgeoning “One Belt, One Road” scheme and the AIIB, whilst Tokyo remains suspicious about these China-initiated plans, Northeast Asian relationship is getting more and more imbalance.

In fact, the CKFTA was deemed by many observers as having an uncertain fortune when it was kicked out in 2012, mainly because Seoul’s status as one of Washington’s close military ally in East Asia and its high possibility of joining the US-led TPP. The tender situation in the Korea Peninsular was also regarded as another stumbling stone in finishing the bilateral deal. Nevertheless, the CKFTA concluded in quite a fast speed. More importantly, it represents the highest level in terms of economic liberalization among all Chinese FTAs. According to a Chinese media, the CKFTA signifies that China’s FTA strategy has entered into “version 3.0” – 1.0 mainly involves merchantal trade, 2.0 focuses on market access, and 3.0 means signatories emphasize on rule-

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<sup>339</sup> China Ministry of Commerce Media Office, "The Fifth Round of Sion-Japan-Korea FTA is Held in Beijing," (China FTA Network, September 01, 2014).

<sup>340</sup> Zhang Yunling and Shen Minghui, "FTAs in the Asia-Pacific: a Chinese Perspective," (The Japan Institute of International Affairs, 2013).p.9

<sup>341</sup> Ibid.p.12



making.<sup>342</sup> For example, this is the first time that “Financial Services” and “Telecommunications” are set up as two independent chapters in a Chinese FTA. Besides, the CKFTA involves regulations on some “21<sup>st</sup> Century Trade issues”, such as e-commerce etc. These set-ups would give China and Korea a first mover advantage. As Global Times commented, “If Japan keeps hesitating, China and South Korea will soon become trade centers of East Asia and Japan’s economic clout in the region will be impaired”.<sup>343</sup>

In the meantime, Beijing strengthened cooperation with three new entrants to the RCEP. New Zealand and Australia have dual memberships in both RCEP and TPP. Thanks to the benign implementation of the Sino-New Zealand FTA and burgeoning economic cooperation, the New Zealand government has explicitly vowed opposition to the TPP if it is in any way an instrument to contain China. Beijing also managed to conclude FTA negotiation with Australia in November 2014. Although Australia’s stance between the RCEP and TPP is still ambiguous, it is expected to change after the signature of the CAUFTA. The third new-comer India joins- the RCEP only. As with China, the TPP’s “high quality” poses a huge barrier for India to surmount. Therefore for New Delhi, concentrating on the RCEP is the only option to avoid being marginalized by the TPP. Noting this common aversion, Beijing has been keen to normalize its relationship with New Delhi, moving away “from the troubling April 2013 border stand-off and other issues”.<sup>344</sup> As Xi Jinping told India PM Modi: “if China and India speak in one voice, the whole world will listen; and if China and India join hands in cooperation, the whole world will watch. Whether from a bilateral, regional or global perspective, China and India are long-term strategic cooperative partners instead of competing adversaries [*sic*”].<sup>345</sup>

It should be noted that Beijing’s embrace of the RCEP does not mean that it has given up the EAFTA claim. To the contrary, the Sino-Japan “10+X” rivalry has spilled over into the TPP platform. In a seminar debating the TPP and RCEP, held in February 2014

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<sup>342</sup> “The Chinese-South Korea FTA Determines Rules of Cooperative Game (中韩自贸协定制定合作游戏规则)”, (China Business Daily (中国商报), 11<sup>th</sup>, June, 2015).

<sup>343</sup> Editorial, “China-S. Korea FTA Sets Positive Precedent”, (Global Times, 1<sup>st</sup> June, 2014).

<sup>344</sup> Ankit Panda, “How India Can ‘Balance’ Relations with Japan and China,” (The Diplomat, September 04, 2014).

<sup>345</sup> “Xi Jinping Meets with Prime Minister Narendra Modi of India,” (Ministry of Foreign Affairs of the People's Republic of China, July, 2014).

by the Brookings Institute, Kenichiro Sasae, the Japanese ambassador to the US, suggested that China's insistence on the "10+3" was as a way to dilute US influence; but now "ASEAN+3 is already gone, and it has been submerged into ASEAN+6 one way or another". He also complained that the "10+6"-based RCEP is of low-quality, indicating that Japan's priority had already shifted to the TPP. Similarly, the US representative, Charles Barfield, said that "I am skeptical about the ability to pull all this together (the Asian Economic Community) in an ASEAN+6 in any time soon ... Any agreement that has both Indonesia and India in it is not going to go very far, very fast [*sic*]"<sup>346</sup> Other participants also expressed concerns that India's membership in the RCEP would increase negotiation difficulties and decrease the "10+6" group's prominence.<sup>347</sup> Some even queried "why is India participating (the RCEP) in the first place?" Zhang Yunling fired back: "I think probably that should ask Japan because Japan always pushes the way to let India to join, but I think for India in itself it's regional policy worried about exclusion. So already India has 10 plus 1 at ASEAN a very low level He added that China won't abandon India, instead, the RCEP is "open for India participate or not participate in the beginning if, for instance, India really cannot accept. So the guidelines make it clear India can join later".<sup>348</sup> [*Sic*]

Despite accelerating its own efforts to build an Asia-only FTA, China's attitude to the TPP has moderated to the point where some officials and analysts are openly talking about participating in the TPP. This is why Wei Jianguo, China's former Deputy Commerce Minister, declared on 9 April 2013, that Beijing is "considering joining the TPP when necessary". This was only two weeks after Abe officially announced that Japan would join the TPP negotiations.<sup>349</sup> In late May, during the deepest confrontation with Japan over the Diaoyu Islands, and in the run-up to the Xi Jinping-Obama summit, the Chinese Ministry of Commerce officially declared that it would launch studies on the possibility of joining the TPP. In addition, in July 2013, China agreed to re-launch the long-frozen Bilateral Investment Treaty (BIT) with the US. Chinese officials admitted that "if this leads to reduced investment restrictions on both sides, it could

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<sup>346</sup> "TPP and RCEP: Competing or Complementary Models of Economic Integration?," (Brookings Institute, 2014).p.43

<sup>347</sup> *Ibid.*p.20

<sup>348</sup> *Ibid.*p.50

<sup>349</sup> Wei Jianguo, "Proactively Joining in the TPP is Better to China [Zhudong jiaru TPP dui zhongguo geng youli]," (Global Times [Chinese Edition], July 26, 2013).

pave the way for China to join the TPP”.<sup>350</sup> This reflects Beijing’s desire to change its disadvantaged position in the triangle by improving its relationship with the US. Many Chinese leading economists including Lin Yifu and Zhang Yunling also have urged Beijing to join the TPP talks. In their eyes, fitting undergoing domestic reform into the TPP jigsaw is essential to China’s own long-term interests.<sup>351</sup> Regardless of whether outsiders think China is qualified or willing to join the TPP, Beijing is already moving ahead on the assumption that it should not be excluded or isolated. Given China’s ability of carrying out extensive ‘trade-off’ reforms to gain WTO membership, “its membership to the TPP will just be a matter of time”.<sup>352</sup>

Intriguingly, the US-Japan side of the triangle, an erstwhile relationship of disputed amity, began to show some fissures in the form of a series of policy missteps related to some unexpected TPP challenges. In the context of the high-profile US “pivot to Asia Pacific”, the success or failure of the TPP will be taken as a key indicator of the effectiveness of the Obama administration’s foreign policy.<sup>353</sup> To entice Abe into accepting the TPP, Obama issued a brutal warning to China over the Diaoyu Islands, saying that commitments under the US-Japan Security Treaty “extend to all the territories under the administration of Japan, including the Sankaku [Diaoyu] Islands ... the United States opposes any unilateral action that seeks to undermine Japan’s administration of the Sankaku [Diaoyu] Islands”.<sup>354</sup> To many Asia observers, this move is widely regarded as a tradeoff between America’s role as security guarantor in the East China Sea, and Japan’s economic concessions for the TPP.<sup>355</sup> Nevertheless, although last-minute efforts to reach a TPP accord continued until Obama left Tokyo to

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<sup>350</sup> Richardson, "The Rush Toward Asia-Pacific FTAs." Beijing knows that a bilateral investment pack alone cannot facilitate its TPP membership. Therefore, it also seeks to forge bilateral FTAs with other TPP members. In this context, a Sino-Canada FTA is already under consideration. See Minghui, "FTAs in the Asia-Pacific: a Chinese Perspective."p.13

<sup>351</sup> "Justin Yifu Lin Says China Should Join TPP," (WantChinaTimes.com, March 1, 2014).

<sup>352</sup> Basu Das, "The Trans-Pacific Partnership as a Tool to Contain China: Myth or Reality?."p.7

<sup>353</sup> Claude Barfield, "The United States and East Asian Regionalism: Balancing Economics and Security," in *Alliance 21: Trade & Investment* (Sydney: The University of Sydney, 2012).p.16

<sup>354</sup> The White House Office of the Press Secretary, "U.S.-Japan Joint Statement: The United States and Japan: Shaping the Future of the Asia-Pacific and Beyond," (The White House, 2014).

<sup>355</sup> Linda Sieg and Matt Spetalnick, "Obama Wraps Up Japan Visit With Security Pledge But No Trade Deal," (Reuters, April, 2014).

Seoul, his second Asian destination, the two allies did not generate any results, indicating that the traditional “give-and-take” strategy does not always work.<sup>356</sup>

A major reason for the split in the US-Japan alliance is the fact that Tokyo feels that Washington’s “demands” in regard to certain market concessions identified in the TPP, exceed what it is willing to offer.<sup>357</sup> From 2000 to 2010, the US’s share of exports to 15 key East Asian market countries plummeted by 42%.<sup>358</sup> Thus recapturing the Asian market is a main objective underpinning America’s TPP plan, including access to Japan’s auto and agriculture markets. Japan, for its part, knows that without its cooperation, the US’s efforts to expeditiously finalize the TPP will be in vain. A senior official told the *Japan Times* that “I think time sides with Japan. For the US, TPP agreements without Japan would have no meaning ... We don’t need to make any compromises”.<sup>359</sup> Nowadays, Tokyo takes quite a tough stance in TPP talks and refuses to liberalize five key agricultural products (beef, dairy products, pork, rice, wheat and sugar), about which American farmers have placed huge pressure on Washington.<sup>360</sup> What’s more, Japan calls on cooperating regional countries to say no to the US, and asserts that “Until the United States starts to see Asia as a true trading partner, rather than as a region to patronize, it is right to hold out on the TPP”.<sup>361</sup> Taken together, the TPP drives a wedge between the US and Japan. These incidents suggest that the two allies still have much to do to strengthen solidarity.

Abe’s visit to Yasukuni on 22 April 2014, a day before Obama’s visit, also put the Japan-US alliance under pressure. Clearly, Obama does not like Abe stirring up historical issues that undercut Washington’s relations with Beijing and Seoul. As Jake Douglas put it, the Diaoyu Islands “are intrinsically worthless to most US defense planners and certainly to the American public ... Nor does the US wish to unnecessarily

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<sup>356</sup> Jonathan Soble, "Obama and Abe Fail to Reach Trade Deal," (Financial Times, April, 2014).

<sup>357</sup> William Pfaff, "Third Obama Disappointment Seems Imminent," *The Japan Times* May 2, 2014.

<sup>358</sup> *The Trans-Pacific Partnership: Outlook and Opportunities*.p.10

<sup>359</sup> According to a poll by NHK, a Japanese public broadcaster, only 31% of those surveyed supported the Japan joining the TPP. See Yoshida, "Abe Secured Only Half of KEy Goals at Meeting.", and BBC, "TPP: What's at stake with the trade deal?."

<sup>360</sup> William H. Cooper, "U.S.-Japan Economic Relations: Significance, Prospects, and Policy Options," (Congressional Research Service, February, 2014).

<sup>361</sup> Gallagher, "Pacific Partners Should Push Back Against TPP Untile U.S. Shows Respects for Financial Reforms."

provoke China or write a blank check to a Japanese premier who has shown little grasp of his neighbors' national sentiments".<sup>362</sup> As a consequence, as stated by Kazuhiko Togo, Japan's former Netherlands ambassador, "many observed the displeasure on Obama's face" during his journey in Japan and it was evident that the "Yasukuni visit caused a real stir in the alliance".<sup>363</sup> Abe's behavior also strained the US-Korea relationship, which impedes America's 'pivot' initiatives in Asia.<sup>364</sup> To quote Bruce Klingner, a senior research fellow of the Heritage Foundation: "Washington has become frustrated with both our friends. With Japan for its tin-eared, ham fist diplomatic approach toward resolving historic issues, and with South Korea's insistence on seeing every issue through the lens of history".<sup>365</sup> To teach Abe a lesson, when Obama arrived in Seoul, he condemned Japan on the comfort women issue: "this was a terrible, egregious violation of human rights. Those women were violated in ways that, even in the midst of war, was shocking ... I think Prime Minister Abe recognizes, and certainly the Japanese people recognize, that the past is something that has to be recognized honestly and fairly".<sup>366</sup> Nevertheless, his appeasement did not result in a Korea-Japan rapprochement, but an ever closer Korea-China relationship - the two carried out two rounds of FTA talks within one and a half months of Abe's Yasukuni visit.

It is noteworthy that in a manner similar to the RCEP, the TPP also drives a wedge between ASEAN countries by separating them into different trading groups. The Association works on a principle of "all for one and one for all", but as of 2014 only four members have been accepted into the TPP, namely Brunei, Vietnam, Malaysia and Singapore. Although the TPP is framed to be "open and inclusive", it requires a commitment to "high quality", such as deeper liberalization and wider sectorial coverage, to meet the so-called "21<sup>st</sup> century standard". If negotiations hold fast to these requirements, even current member Vietnam risks being barred entry.<sup>367</sup> In this context, for those non-TPP ASEAN members, the only choice left is to more tightly stick to the EAFTA and RCEP; countries which have dual memberships may be less devoted to the RCEP but pro-TPP. – Membership of the TTP is attractive not only because it

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<sup>362</sup> Carl Thayer, "China's Oil Rig Gambit: South China Sea Game-Changer?," (The Diplomat, 2014); Pfaff, "Third Obama Disappointment Seems Imminent."

<sup>363</sup> Togo, "Obama Visit Fails to Strengthen US-Japan Trust."

<sup>364</sup> Richards, "US Voices Exasperation Over Japan-ROK Disputes ".

<sup>365</sup> Ibid.

<sup>366</sup> Jeff Kingston, "Obama's Pivot to Asia: Rebalance and Reassure," *The Japan Times* April 24, 2014.

<sup>367</sup> Khai Nguyen, "Vietnam risks TPP slot on labor reality," (Asia Times Online, March 6, 2014).

represents 40% of the global GDP and 30% of the world trade, but more importantly, it also means being enlisted in the US camp. Another flipside of the TPP is its leadership. Initiated by P-4, the forum used to represent preferences and interests of relatively small countries. After the US and Japan joined, (together accounting for 80% of its economic heft), the center of gravity soon shifted.<sup>368</sup> The US, taking its leading role for granted, was dismissive of demands by others about leadership, and did not seem to mind dividing the divided ASEAN. As Sanchita Basu Das criticized:

It was felt that the US was not interested in promoting regional trade integration with ASEAN countries as a group ... The US has not discussed the possibility of an US-ASEAN FTA. Instead, the US went for bilateral FTAs with Singapore and other selected ASEAN countries under the framework of TPP. This reflects US's interests over high-level FTAs with comprehensive coverage and its view on the lack of preparedness of some ASEAN countries to participate in such FTA.<sup>369</sup>

In short, Japan's membership in TPP was initially set to consolidate the US-Japan alliance but it is tearing them apart in ways that Washington evidently failed to foresee. If economic spats between them exacerbate the relationship in the future, it could trigger tensions that further limit the prospects of the military alliance. Although their consequent disjuncture would not fundamentally change the nature of the Sino-US-Japan *Stable Marriage* triangle, it could provide an opportunity for China to more proactively and pragmatically pursue economic dialogue with the US and Japan respectively. At the same time, as Japan's attention has been largely distracted by the TPP, China has entrenched itself in the process of Asian regionalization with more and more Asian members leaning toward it, particularly non-TPP ASEAN countries and South Korea.

Economic cooperation in Asia Pacific is now developing along several, rather than only one, integrating trajectory. Constrained by a broad spectrum of issues and interests, the real challenge facing regional countries now is not *how* to cooperate, but *whether* to cooperate. Otherwise, regional integration would be further delayed, already lagging far behind the EU and NAFTA. Although the 2010 APEC Leaders' Summit announced that

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<sup>368</sup> Jackie Norhtam, "8-Day Asia Trip Critical to Obama's Regional Strategy," (Brookings Institute, April 22, 2014).

<sup>369</sup> Basu Das, "The political economy of the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP) agreements: an ASEAN perspective." p.43

the EAFTA, RCEP and TPP were parallel trajectories and would ultimately be consolidated into a broader Free Trade Area of the Asia Pacific (FTAAP), this section suggests that they are essentially contradictory, making the future of the FTAAP doubtful rather than bright. Besides, each of the three agreements has several hurdles to jump before completion, an unlikely outcome given that all three contribute to splitting ASEAN. For China, upgrading the CAFTA in substantial terms would be the most efficient way to secure its position in EAFTA and RCEP. For Japan, breaking the bottleneck over agricultural liberalization and achieving some give-and-take compromises with Washington would seem to be the best approach for realizing its aim of building a high-quality free trade deal.

### **3.4 To bind the South China Sea Dispute with the CAFTA**

Securing a stable and friendly peripheral environment is given the highest priority in China's diplomatic strategy. ASEAN holds the key to this because four of its members have maritime disputes with China in the South China Sea (SCS) - the Paracel Islands dispute (China and Vietnam), and the Spratly Islands dispute (China, Vietnam, Malaysia, Brunei and the Philippines). To Beijing, the SCS is its "historical waters", wherein Chinese fishing activities can be traced back the era of the Emperor Qin Shihuang (259BC-210BC).<sup>370</sup> It is the only country that claims *all* the disputed islands in this water region, and its formal sovereignty claims started as early as 1951.<sup>371</sup> It is noticeable that China's massive economic expansion in Southeast Asia, particularly after the inception of the CAFTA, is in tandem with its increasing activism in the SCS, verifying the country's intention to link territorial disputes with economic ties.<sup>372</sup> This section tackles the most volatile but under-theorized SCS issue and its correlations with the security-embedded CAFTA, as well as the relevance of regime theories to the region.

#### **3.4.1 The CAFTA as a war-extinguisher in the SCS – the liberal perspective**

The liberal argument of cross-issue linkage helps to account for the correlation between the CAFTA and the SCS disputes. When "recalcitrant states" are sucked into

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<sup>370</sup> Jianmin Shen, "China's Sovereignty Over the South China Sea Islands: A Historical Perspective," *Chinese Journal of International Law* 1, no. 1 (2002).

<sup>371</sup> See Michael Yahuda, "China's New Assertiveness in The South China Sea," *Journal of Contemporary China* 22, no. 81 (2013).

<sup>372</sup> Some scholars proposed that there is a new trend to embed security into regional economic institutions in Asia. See Koo, "Asia's New Institutional Architecture: Evolving Structures for Managing Trade, Financial, and Security Relations."

cooperation deadlocks, as Lisa Martin suggested, wise governments should resort to “cautious institutional design” to tradeoff counterparts’ concessions by juggling “functional differentiations”.<sup>373</sup> These “differentiations” refer to different countries’ development priorities – some may value imminent economic stability over security, and *vice versa*. Illustrative cases include designing security issues into economic regimes, or *vice versa*. The CAFTA is a case in point. As shown in the previous section, since the signing of the CAFTA, economic ties between China and ASEAN have deepened, making China ASEAN’s biggest trading partner and third biggest investor. Moreover, an obvious asymmetric dependence is emerging, with ASEAN depending much more on China. Liberals may posit that, as CAFTA’s lock-in effects become evident, ASEAN claimants will act prudently in disputed waters to avoid unnecessary economic losses. Even if a conflict emerges, an actor can adopt, or threaten to adopt, economic sanctions to diminish the momentum toward an uncontrollable military confrontation.

There is evidence that the CAFTA is cautiously designed. As Seungjoo Lee observed, Chinese political leaders often prioritize overall strategic and security interests ahead of narrow economic interests.<sup>374</sup> Many Chinese officials also admit that geopolitical considerations trump any economic gains when China is negotiating economic issues with its neighbors.<sup>375</sup> Premier Zhu Rongji warned Chinese CAFTA negotiators to abide by the principle of “giving more and taking less” (*duo yu shao qu*, 多予少取) and “giving first and taking later” (*xian yu hou qu*, 先予后取).<sup>376</sup> Clearly, what the Chinese government wants to “give” is economic benefits, and what it anticipates to “take” is other national interests, including legitimizing its SCS sovereignty. This view is echoed

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<sup>373</sup> See Zhang Yunling, *China and Asian Regionalism* (Singapore: World Scientific, 2010).p.210. For theories, see Martin, "Heterogeneity, Linkage and Commons Problems."p.474; and Martin, "Institutions and Cooperation: Sanctions During the Falkland Islands Conflict."p.153

<sup>374</sup> Seungjoo Lee, "The Economy-Security Nexus in East Asian FTAs," in *Linking Trade and Security: Evolving Institutions and Strategies in Asia, Europe, and the United States*, ed. Vinod K. Aggarwal and Kristi Govella (New York: Springer, 2012).p.142

<sup>375</sup> Wei Liang, "China's FTA Negotiations and Its Regional Implication for Asia," in *China's Quiet Rise: Peace Through Integration*, ed. Baogang Guo and Chung-China Teng (UK: Lexington Book, 2011).p.51

<sup>376</sup> Wang, "China, Economic Regionalism, and East Asian Integration."p.203



by State Councilor Wu Yi, who acknowledged that “building the FTA with ASEAN was important for China’s interests, even if it includes China making sacrifices”.<sup>377</sup>

Few researchers would contest that the intentional “sacrifices” China made under CAFTA have provided Beijing with an upper hand in the SCS disputes. For instance, the Vietnamese media reported no suggestions of escalating tensions around the Paracel Islands while their officials were in the bordering Guangxi province during 12-13 August 2010 negotiating CAFTA.<sup>378</sup> Tensions between China and the Philippines over the Huangyan Island disputes (Huangyan is Chinese Pinyin, which means “黄岩岛”, it also named Scarborough Island in English) provide a similar example. Immediately after the eruption of the Huangyan Island controversy in early April 2012, an article published in *China Daily* titled “Trade Warning to Philippines” warned that if the dispute continued, Philippines’ exports, accounting for a small share of China’s foreign trade but closely related to its own economic growth, would be severely affected.<sup>379</sup> The Chinese General Administration of Quality Supervision then issued an official notice of stricter inspections for harmful organisms in bananas and pineapples imported from the Philippines. Meanwhile, the National Tourism Administration issued a red alert to Chinese nationals visiting the Philippines over safety concerns.<sup>380</sup> As Shi Yinong, a leading IR scholar at Renmin University stated, Manila’s economic losses due to restricted access to the Chinese market could be “as much as that of a real war”.<sup>381</sup> Eventually, the Philippines softened its stance and dispatched a special envoy to Beijing to seek reconciliation – this occurred after thousands of tons of bananas reportedly rotted in Philippine ports due to Beijing’s strict inspections; and a large number of tourist groups from China cancelled their visit after the travel warnings. The latter was particularly damaging as China is the Philippines’ fourth largest tourist market.<sup>382</sup>

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<sup>377</sup> Gregory Chin and Richard Stubbs, "China, regional institution-building and the China–ASEAN Free Trade Area," *Review of International Political Economy* 18, no. 3 (2011).p.285

<sup>378</sup> Emmanuel Yujico, "The Real Story Behind The South China Sea Dispute," (LSE Ideas, 2010).

<sup>379</sup> Li Jiabao, "Trade Warning to Philippines," *China Daily* May 14, 2012.

<sup>380</sup> See China National Tourism Administration Official Website, available at <http://www.cnta.com/html/chts/index.html>

<sup>381</sup> Xinhua, "Tourism Hit As Huangyan Dispute Escalates," *China Daily* 2012-05-16.

<sup>382</sup> John Chan, "Tensions ease temporarily between China and the Philippines," (World Socialist Web Site, May, 2012).

The Vietnamese and Philippines cases suggest that the PRC manipulates economic leverage to resolve SCS problems, a situation congruent with the neo-liberal argument that in a situation of asymmetrical interests, cross-issue linkages can “provide one of the few levers for gaining the cooperation of recalcitrant states”.<sup>383</sup> It also suggests Beijing’s efforts to scale down regional conflicts, since troublesome and uneasy neighborhoods can only be a distraction from its focus on economic development.<sup>384</sup> As envisaged by Klare, without regional institutional arrangements, “the Pacific Rim could be the site of periodic military convulsions in the 21<sup>st</sup> century, as Europe was in the 20<sup>th</sup> century”.<sup>385</sup> The CAFTA is just the beginning of China’s institutional initiatives - in November 2014, when Premier Li Keqiang visited Myanmar, he envisaged a system linking the CAFTA and the 21<sup>st</sup> Century Maritime Silk Road. Supporting facilities include upgrading current CAFTA, establishing new economic zones, the Silk Road Fund, China-ASEAN Currency Exchange Center, as well as the Asian Infrastructure Investment Bank.

Given the fact that some SCS littoral states have expressed strong interests in participating the Maritime Silk Road projects, and that all ASEAN members have signed up to the AIIB, the liberal logic however provides a misleading picture, suggesting that the CSC disputes will be automatically and peacefully be settled with the further integration of markets between China and its Southeast Asian neighbors. As we shall see in the following analysis, a new dispute started on May 2, 2014, when China National Offshore Oil Corporation (CNOOC) deployed an offshore oilrig (HYSY-981) near Xisha Islands in the SCS, both claimed by Beijing and Hanoi. This is but one of many cases to demonstrate that China has never achieved any real peace with SCS claimants. This development seems to run counter to the neo-liberal argument. We now turn to using a realist analysis, one that complements liberalism, and helps explain why the CAFTA failed to act as a basis for resolving regional disputes.

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<sup>383</sup> Martin, "Institutions and Cooperation: Sanctions During the Falkland Islands Conflict." p.153 Similarly, Michael Leifer’s research on ARF also verifies the fact that military force is not the only means to achieve regional peace, rather adroit diplomacy and “institutional locking” can be equally effective. See Michael Leifer, "The Truth About the Balance of Power," in *The Evolving Pacific Power Structure*, ed. Derek DaCunha (Singapore: Institute of Southeast Asian Studies, 1996).

<sup>384</sup> Liang, "China's FTA Negotiations and Its Regional Implication for Asia."p.51

<sup>385</sup> Michael T. Klare, "The Next Great Arms Race," *Foreign Affairs* 72, no. 3 (1993).p.152

### 3.4.2 The CAFTA as a war-facilitator in the SCS – a realist perspective

Like liberals, realists also believe that powerful countries compromise in economic regimes to achieve larger gains from non-economic issue-areas.<sup>386</sup> According to Conybeare, “powerful states may at times be moved by pursuing free trade because the potential for linking free trade to purely political objectives”.<sup>387</sup> Similarly, Gowa points out that a clear-thinking, forward-looking powerful country would reduce tariffs to levels which may not be recommended by standard trade theory, in the interests of maximizing its national power as a whole.<sup>388</sup> Unlike liberals, however, realists view economic regimes as a matter of expediency, rather than an ultimate means to resolve high-politic problems. In other words, territorial and maritime disputes greatly reshape the judgement of many countries, compelling them to disregard even obvious economic advantage.<sup>389</sup> Guided by this logic, liberals regard economic sanctions as a harsh measure, but realists treat them as preliminary “punishment”. When a big power perceives being constrained or challenged, a punishment would be imposed on weaker countries - at its minimum level in terms of economic sanctions but in other conditions, with military action. Normally, the more economic compromises the power made to the weaker party, the more likely the former would appeal to “punishments”.<sup>390</sup> In this sense, the role of economic regimes is a war-facilitator, rather than extinguisher. The remainder of this section is an endeavor to explore CAFTA’s correlations with China’s recent move of deploying the oilrig YHSY-981. It concludes that the trade deal has essentially emboldened China’s growing assertiveness in the SCS, because the territorial claimants’ increasing economic dependency is an effective means of mitigating the costs of Beijing’s provocation.

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<sup>386</sup> See Martin, "Credibility, Costs, and Institutions: Cooperation on Economic Sanctions."; Lisa L. Martin, "The Rational State Choice of Multilateralism," in *Multilateralism Matters: The Theory and Praxis of an Institutional Form*, ed. John Gerard Ruggie (New York: Columbia University Press, 1993); Young, *International Cooperation: Building Regimes for Natural Resources and the Environment*.

<sup>387</sup> Andreas Hasenclever, *Theories of International Regimes*.p.98

<sup>388</sup> Joanne Gowa, "Bipolarity, Multipolarity, and Free Trade," *The American Political Science Review* 83, no. 4 (1989).

<sup>389</sup> Lucio Blanco Pitlo III, "China's 'One Belt, One Road' To Where? (The Diplomat, February 17, 2015)

<sup>390</sup>Some realist analyses indicate that increases in the scale of bilateral trade and degree of economic interdependence is often accompanied by increases in military conflicts. See Min-Hua Huang and Yunhan Chu, "Exploring Theoretical Implications of the Rise of China: A Critique on Mainstream International Relations Perspectives," in *Managing The China Challenge: Global Perspectives*, ed. Quansheng Zhao and Guoli Liu (New York: Routledge, 2009).p.48

To many observers, the deployment of the HYSY-981 points to a tactical shift in China's SCS policy from "reactive" to "proactive". Some Chinese scholars explain Beijing's behaviors in prior SCS conflicts as "reactive assertiveness" – namely being reactive to neighbors' unilateral challenges –however, this new oilrig move is a totally different story. To quote Carl Thayer, "China's move was so unexpected because Vietnam has not undertaken any discernible provocative action that would justify China's unprecedented action".<sup>391</sup> Besides, the Chinese government asserted that the drilling location of the HYSY-981 is purely commercial but to many outside observers, this is indisputable geopolitical activity.<sup>392</sup> Obviously, no commercial company would undertake such a high-profile project, knowing the obvious consequences for China's foreign policy, without first obtaining the central government's backing. The HYSY-981, described by the CNOOC chairman Wang Yilin as "mobile national territory" and a "strategic weapon", reveals Beijing's two-fold intentions.<sup>393</sup> One is to promote the PRC's offshore oil industry. This explains why the oil rig was removed a month earlier than scheduled - after finding that the drilling location did not contain significant hydrocarbon reserves.<sup>394</sup> The other intention, perhaps more crucial, is to assert Chinese jurisdiction over disputed parts of the SCS. On 7 July, China effectively internationalized this dispute by submitting its claim against Vietnam to the UN Secretary General, which successfully made the Secretary General the key to the solution process, rather than Vietnam's preferred UN Permanent Court of Arbitration.<sup>395</sup>

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<sup>391</sup> Thayer, "China's Oil Rig Gambit: South China Sea Game-Changer?."

<sup>392</sup> See Ian Storey, "The South China Sea Dispute: How Geopolitics Impedes Dispute Resolution and Conflict Management," in *Global and Regional Powers in a Changing World* (Buenos Aires, Argentina 2014).

<sup>393</sup> Tom Orlik, "Picking Apart Nationalist Rhetoric Around China's New Oil Rig " in *China Real Time* (The Wall Street Journal, May 11, 2012).

<sup>394</sup> Carl Thayer, "4 Reasons China Removed Oil Rig HYSY-981 Sooner Than Planned," (The Diplomat, 2014).

<sup>395</sup> A day before appealing to the UN Secretary General, the Chinese Ministry of Foreign Affairs made a statement titled "The Operation of the HYSY-981 Drilling Rig: Vietnam's provocation and China's Position", criticizing Vietnam's provocative activities over the drilling area and providing an outline of China's claims to the Parcel Islands. On 7 July, this statement was posted to the official website of the PRC's permanent mission to the UN. In the meantime, Wang Min, China's Deputy Ambassador to the UN, sent the paper to Ban Ki-moon and suggested he circulate it among all members of the UN General Assembly. See Zachary Keck, "China 'Internationalizes' South China Sea Dispute," (The Diplomat, 2014); "The Operation of the HYSY 981 Drilling Rig: Vietnam's Provocation and China's Position," (Ministry of Foreign Affairs of the People's Republic of China, June 8, 2014).

This exercise, as Zachary Keck noted, means that Beijing once again declares in the international arena that the territorial dispute with Hanoi does not exist at all.<sup>396</sup>

China's provocation sparked nation-wide protests-turned-riots in Vietnam. One of the most severe riots on 13 and 14 May in Binh Duong province, led to 21 deaths and extensive property losses – about 400 factories were damaged and 1,100 were shut down.<sup>397</sup> Protests are usually suppressed in Vietnam, and Beijing described them as “the outcome of Hanoi's years of anti-China propaganda”.<sup>398</sup> Consequently, relations between the two communist states sank to their lowest level. But from 18 May onwards, the Vietnamese government reversed its policy by acting heavy-handedly to constrain further anti-China riots. Students in high schools and universities were systematically admonished by their teachers and warned not to participate in “poorly organized” demonstrations.<sup>399</sup> In addition, after Beijing warned that “Vietnam has to offer compensation for the losses incurred to foreign investors ... otherwise Vietnam will pay an additional political price”,<sup>400</sup> police in Binh Duong province arrested more than 1,000 rioters, with at least 700 of them facing trial, and the rest administrative fines.<sup>401</sup> Moreover, Defense Minister Phung Quang Thanh described the oilrig affair as merely a small disagreement between “brothers”.<sup>402</sup>

The extent to which liberalism remains a useful theoretical explanation for Vietnam's softened posture is not difficult to assess. To illustrate, two years after the inception of the Framework Agreement on Free Trade, China became Vietnam's biggest trading partner. This position was maintained to 2013, with total trade turnover reaching \$50.2 billion, surging 22% compared with the previous year. Noting Vietnam's over-reliance on China, Pham Quang Vinh, Vietnam's Deputy Foreign Minister, claimed that “Economic force should not be applied in the case of settlement of territorial disputes”. He also recalled the Sino-Japan dispute in the East China Sea in 2012, which resulted in

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<sup>396</sup> Keck, "China 'Internationalizes' South China Sea Dispute."

<sup>397</sup> The numbers of protesters are respectively 19,000 and 30,000, according to Vietnamese and Chinese media. See "Burning nationalism cornering Hanoi," (Global Times, May 15, 2014).

<sup>398</sup> Ibid.

<sup>399</sup> William Frasure, "Vietnam Steers Between China's Threat and Public's Anger," (The Diplomat, 2014).

<sup>400</sup> "Burning nationalism cornering Hanoi."

<sup>401</sup> "Over 1,000 Arrested For Rioting in Vietnam," (Thanh Nien News May, 2014).

<sup>402</sup> Brian Benedictus, "US and Vietnam Should Tread Carefully on Relations," (The Diplomat, 2014).

a 12% decrease of Japan's exports to China.<sup>403</sup> But this time, bilateral trade between Vietnam and China suffered an even more severe setback. Immediately after the riots, China cooled economic cooperation with Vietnam. According to China's General Administration of Customs, in July, trade volume with Vietnam was RMB 3825 million, down 44% from April. (See Table 3.3) This downward trend represented a sharp contrast with the two parties' upward trade growth trend after the inception of the CAFTA. (See Figure 3.4 and Appendix 3.5) Tourism is one of the key drivers of Vietnam's development, contributing 5.8% of its total GDP in 2011.<sup>404</sup> Its close neighbor China is the No. 1 source of international tourists in 2013, accounting for 25.2% of all visitors.<sup>405</sup> After the riots, the PRC warned Chinese citizens against visiting Vietnam via the website of the Tourism Administration. The notice was upgraded from "caution" on 14 May, to "try to avoid" on 15 May, and then "temporarily banned" on 16 May.<sup>406</sup> According to data released by the Vietnam's General Statistics Office, in May, 194,000 Chinese people traveled to Vietnam, a decline of 10.4% from the previous month. In June, the number declined further to 136,700, down 29.5% from May.<sup>407</sup> In terms of investment, as reported by *the South China Morning Post*, the Ministry of Commerce has temporarily barred State-owned companies from bidding for fresh contracts in Vietnam.<sup>408</sup> This move would be very detrimental to the Vietnamese economy, since Chinese entrepreneurs account for approximately 90% of construction, engineering, and procurement contracts in Vietnam's various domestic industrial zones.<sup>409</sup> These are all signs of Beijing using economics as a weapon, and confirmation of the rational that Vietnam would not want to jeopardize its substantial economic gains over disputed water of minimal potential oil and gas reserves.

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<sup>403</sup> "China Should Not Use Trade as Weapon: Vietnam," *The Sydney Morning Herald* December 3, 2012.

<sup>404</sup> Ha Van Sieu, "Country Presentation: Vietnam Tourism Master Plan to 2020."

<sup>405</sup> See the official website of the General Statistic Office of Vietnam, available at [http://www.gso.gov.vn/default\\_en.aspx?tabid=472&idmid=3](http://www.gso.gov.vn/default_en.aspx?tabid=472&idmid=3)

<sup>406</sup> See China National Tourism Administration Official Website, available at <http://www.cnta.com/html/chts/index.html>

<sup>407</sup> See General Statistics Office of Vietnam Database, available at [http://www.gso.gov.vn/default\\_en.aspx?tabid=472&idmid=3&ItemID=14595](http://www.gso.gov.vn/default_en.aspx?tabid=472&idmid=3&ItemID=14595)

<sup>408</sup> Keira Lu Huang, "State Firms Barred From Vietnam Contract Bids," *South China Morning Post* August 17, 2014.

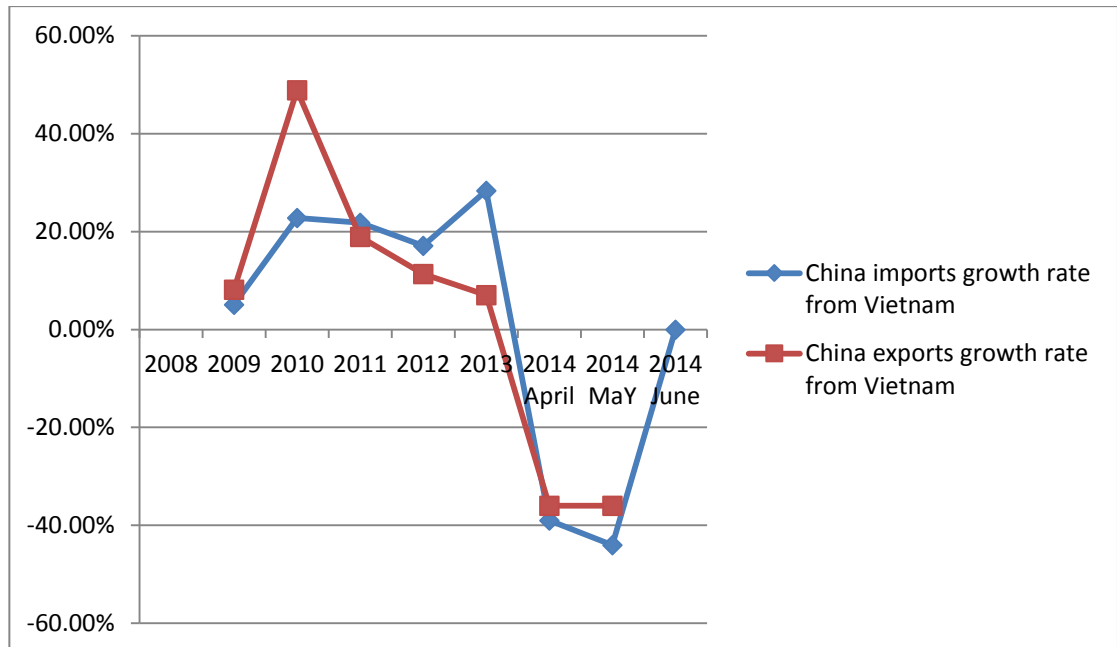
<sup>409</sup> Benedictus, "US and Vietnam Should Tread Carefully on Relations."

**Table 3.3: China’s exports and imports from Vietnam (from April-July 2014, RMB billions)**

	Overall	Rate	China’s Export	Rate	China’s Import	Rate
April	6.79	—	5.24	—	1.55	—
May	4.15	-39%	3.17	-40%	0.99	-36%
June	3.83	-44%	2.84	-46%	0.98	-36%

*Resource:* The Statistical Database of the General Administration of Customs of the People’s Republic of China, available at <http://english.customs.gov.cn/tabid/47819/Default.aspx>

**Figure 3.4: Trade growth rate change between China and Vietnam (2008 to July 2014)**



*Resource:* General Statistics Office of Vietnam and the author’s calculation, data available at [http://www.gso.gov.vn/default\\_en.aspx?tabid=626](http://www.gso.gov.vn/default_en.aspx?tabid=626)

Significantly, the oilrig incident did not cause panic amongst all ASEAN members – this is the main reason China has managed to resolve SCS disputes on a bilateral basis. Of the ten Southeast Asian countries, only the Philippines and Vietnam have pressing territorial problems with China. The other two claimants, Malaysia and Brunei, always take a very low profile. For example, when two People’s Liberation Army Navy (PLAN) warships visited the disputed James Shoal Islands, Vietnam called on its neighbors to collectively criticize China. However, Hishammuddin Hussein, the Malaysian Defense Minister stated “Just because you have enemies, doesn’t mean your enemies are my

enemies”.<sup>410</sup> Noting that China was Malaysia's largest trading partner, the third tourist resource and the fifth largest investor in 2013, Carl Thayer commented that, “Malaysia’s reaction ... gave rise to speculation that Malaysia was breaking ranks with fellow ASEAN members and was pursuing a low-key approach on territorial disputes with China in order to accrue economic benefits”.<sup>411</sup> What’s more, even the four claimants have overlapping territorial claims amongst themselves as well as with China, making themselves “odd bedfellows in the diplomatic melee to keep China out of the South China Sea”.<sup>412</sup>

Those having no territorial claims, such as Singapore and Indonesia, prefer to play mediating roles and keep neutral. Singapore PM Lee Hsien Loong, for example, once suggested that “ASEAN needs to be neutral, but ASEAN cannot stay silent”.<sup>413</sup> But to some observers, “remaining neutral” is in fact taking China’s side – because ASEAN silence is exactly what Beijing has called for all along.<sup>414</sup> For the rest of the ASEAN members, such as Myanmar, Cambodia and Laos, China has long enjoyed good rapprochement and is regarded as an implicit security guarantee even before the signing of the CAFTA.<sup>415</sup> After spending decades carefully crafting the relationship, particularly after the CAFTA was manipulated as a reward to ASEAN?, Beijing has further paralyzed the Association as a unitary body. For instance, it is an especially lucrative partner for Cambodia, arguably its closest ally in the region, which received a promise of nearly \$550 million in aid in 2013. And for Myanmar, the current ASEAN chair, China’s investment accounts for more than 30% of its overall FDI.<sup>416</sup> In this

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<sup>410</sup> Carl Thayer, "Speak Softly and Carry a Big Stick': What is Malaysia Playing At?," (The Diplomat, 2014).

<sup>411</sup> Ibid.

<sup>412</sup> Tyler Roney, "Philippines, Vietnam Reject Xi's Warning Against Military Alliances," (The Diplomat, 2014).

<sup>413</sup> Chris Blake, "Southeast Asia Ministers Urge Self-Restraint On Sea Spat," (Boomberg, May 11, 2014).

<sup>414</sup> Shannon Tiezzi, "How China Won the ASEAN Summit," (The Diplomat, 2014).

<sup>415</sup> See Chen Jie, "Taiwan's Diplomacy in Southeast Asia: Still Going-South?," in *China And Southeast Asia: Global Changes And Regional Challenges*, ed. Khai Leong Ho; Samuel C. y. Ku (Singapore: Institute of Southeast Asian Studies, 2005).p.253; and Vaughn, "China's "Soft Power" in Southeast Asia."p.31; Juliana Chen, "Achieving Supreme Excellence: How China is Using Agreements with Asean to Overcome Obstacles to its Leadership in Asian Regional Economic integration," *Chicago Journal of International Law* 7, no. 2 (2007).p.666

<sup>416</sup> Shannon Tiezzi, "Why China Isn't Interested in a South China Sea Code of Conduct," (The Diplomat, 2014).



context, these countries are more willing to side with, rather than against China. As a consequence, the 24<sup>th</sup> ASEAN Summit, held five days after the YHSH-981 was deployed, failed again in issuing a collective statement that explicitly named China. The summit spokesman, Ye Htut, said that there was a “long” discussion on whether to release a separate statement on the SCS affair, or whether to address it in a sub-paragraph of the original statement - “ASEAN countries have different opinions on the South China Sea. No one will say which country is right or which country is wrong”.<sup>417</sup> Additionally, Indonesia refused to support Vietnam’s call for China to leave the region. Likewise, Thailand’s Foreign Ministry commented that the conflict was a bilateral issue between Vietnam and China.<sup>418</sup>

Noting that ASEAN’s silence could to a great extent be attributed to the CAFTA’s “lock-in effects”, Beijing embarked on a more ambitious initiative: the 21<sup>st</sup> Century Maritime Silk Road, which was envisioned as a catalyst to deepen interdependence.<sup>419</sup> The MSR is expected to substantially improve payoffs from the CAFTA, particularly in terms of ocean trade, as nine out of the ten ASEAN members are maritime countries. According to one version of the blueprint, the MSR starts from Fuzhou in Fujian province, and heads south into territories of ASEAN countries. From the Malacca Strait, it turns west to states along the India Ocean before meeting the land-based New Silk Road via the Red Sea and the Mediterranean. As stated by David Cohen, this project is “an effort to deemphasize territorial difference in favor of trade, inaugurating what Chinese statements describe as a ‘diamond decade’ for China-ASEAN relations including cultural exchanges and goodwill as well as trade”.<sup>420</sup> For instance, the MSR enables Beijing to build on the role played by the Chinese diaspora in Southeast Asia. At present, more than 32 million of the 50 million Chinese who live abroad reside in Southeast Asia. They account for a considerable share of the wealth in a number of

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<sup>417</sup> "ASEAN Statement on Concern Over Tension in South China Sea," (Eleven, May, 2014).

<sup>418</sup> Ben Otto, "China Must Exit Disputed Waters, Asean Leader Says," (The Wall Street Journal, May 16, 2014).

<sup>419</sup> To further strengthen this superior position, a “21<sup>st</sup>-century maritime silk road”, as an important matching measure of the CAFTA, was initiated by Xi Jinping during his visit to Indonesia in October 2013.

<sup>420</sup> David Cohen, "China Pushes “Silk Road” Regional Trade on Two Fronts," *China Brief* 13, no. 20 (2013).

ASEAN countries, and are believed to play key roles in China's economic diplomacy.<sup>421</sup>

To some realist observers, the CAFTA and the MSR respectively belong to Beijing's first-wave and second-wave "charm offensive".<sup>422</sup> Many ASEAN states seem very eager to move forward.<sup>423</sup> For example, after China vowed to inject about \$1.6 billion in upgrading the Kuantan deep water port in Malaysia, others along the MSR, such as Cambodia, immediately expressed demands for investment to develop port infrastructure.<sup>424</sup> Although Beijing insists that its investment in maritime infrastructure is for economic reasons, it still would engender unavoidable strategic ramifications. Unless the Chinese economy suffers a sudden collapse or enters into long-term stagnation, its "economic weapon" over ASEAN will continue to grow as the promotion of free trade zone construction and initiatives such as the Maritime Silk Road begin to bear fruit. These actions of using economic clout to "buy" peace are not at odds with realists' claims that China's will and its wherewithal, sooner or later, would amount to regional hegemony.<sup>425</sup> As stated by David Martin and Lawrence Rowan, "Conflict avoidance plays into China's hegemonic ambition of returning the region to its precolonial order where the mandate of heaven exercised itself over the Nanyang through a tributary arrangement with the various governments of Southeast Asia, maintained through bilateral trade and policy ties".<sup>426</sup> But this strategy is not without costs. Resentment against China for this move has become palpable among ASEAN members since the oilrig deployment, putting at risk its careful cultivation of an "ASEAN-centric" regional diplomacy and the "peaceful rise" pitches.<sup>427</sup> To quote Zachary Keck:

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<sup>421</sup> Yukon Huang, "Can a Chinese 'Maritime Silk Route' Cool Tensions in Asia?," (East Asia Forum, 2014).

<sup>422</sup> Bonnie Glaser and Deep Pal, "Is China's Charm Offensive Dead?," *China Brief* 14, no. 15 (2014).

<sup>423</sup> Huang Jin and Zhang Qian, "ASEAN Welcomes China's New Maritime Silk Road Initiatives " *People's Daily* August 15, 2014.

<sup>424</sup> Siva Sithraputhran and Stuart Grudgings, "China to Invest \$1.6bn in Malaysia Steel, Port," (Reuters, February 05, 2013).

<sup>425</sup> Nah Liang Tuang, "China's Maritime Expansion: Exploiting Regional Weakness?," (The Diplomat, 2014).

<sup>426</sup> David Martin Jones, "Making Process, Not Progress ASEAN and the Evolving East Asian Regional Order," *International Security* 32, no. 1 (2007).p.179

<sup>427</sup> Barfield, "The United States and East Asian Regionalism: Balancing Economics and Security."p.14

These incidents demonstrate that economics won't save us, only good strategy will. While economic ties between China and its neighbors continue to grow, no appreciable positive impact on security relations has followed. Instead, tensions over territorial disputes in the Asia-Pacific are becoming more frequent, with escalating threats and increasingly risky behavior on all sides. The actions of leaders in Manila, Hanoi and Tokyo, as well as in Beijing, continue to demonstrate that the political need to stand tough on territorial disputes sometimes overrides concerns about the economic impact of such policies.<sup>428</sup>

In short, the interwoven economic cooperation and territorial conflicts verify what Keohane stresses that "cooperation ... is not equivalent as harmony. Harmony requires complete identity of interests, but cooperation can only take place in situations that contain a mixture of conflicting and complementary interests".<sup>429</sup> This section suggests that any explanation of economic regime building will be incomplete in the absence of a reference to issue-areas to which the regime pertains.<sup>430</sup> The CAFTA has been heavily shaped by maritime considerations and *vice versa*. It serves as fertile ground for advancing a combination of liberalism and realism: for economic-disadvantaged ASEAN countries, the CAFTA is a war-extinguisher, mainly due to their economic affiliation with China. For economic-advantaged China, the CAFTA is a war-facilitator - as ASEAN's response to its provocation in disputed waters is predictably restrained, why not act more assertively to legitimize as many disputed waters as possible? Taken together, Beijing gambled with confidence that despite the oilrig provocation, Hanoi would not hit back with force, but rhetoric. It turned out as expected. Therefore, liberals and realists' explanations are essentially two-sides of one coin and consistent with the eclectic rubric laid out in this thesis.

On the flip side, what the Xisha standoff demonstrates is that the territorial dispute remains volatile. Despite successive administrations' intensive diplomatic outreaches and economic payoffs, there is still a big goodwill deficit between China and its neighbors. A tough lesson to be drawn is that the CAFTA by itself was unable to bring

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<sup>428</sup> Keck, "China 'Internationalizes' South China Sea Dispute."

<sup>429</sup> Robert and Keohane Axelrod, Robert, "Achieving Cooperation under Anarchy: Strategies and Institutions," in *Cooperation under Anarchy*, ed. Kenneth Oye (Princeton University Press, 1986).p.226

<sup>430</sup> See Martin, "Institutions and Cooperation: Sanctions During the Falkland Islands Conflict."

about loyal submission; it is more frequently an instrument for gaining profit.<sup>431</sup> In fact, some SCS littoral states remain wary and skeptical of real intent behind Beijing's offerings, as well as the possible adverse conditions that may be attached to them. Hence, China risks falling into regional isolation whenever a bigger patron emerges. Worse, it puts the CAFTA, widely viewed as a lynchpin of Beijing's "smile diplomacy" on trial. The following section now turns to another important dimension of this trade deal, and tries to answer a cliché question: is China a threat? To be more specific, is the CAFTA a bane or boon for ASEAN countries?<sup>432</sup>

### 3.5 The CAFTA and the "China threat" Rhetoric

Some may be tempted to see states' efforts to link economic regimes with image-building to show "like-mindedness" as evidence of constructivism.. But Jeffrey Checkel, focusing on the EU, suggests that correlations between international institutions and role-socialization are better captured by an eclectic approach of synthesizing functionalism and constructivism. According to him, agents' (countries) socialization-degree within an international institution can be divided into two types. Type I refers to a condition wherein a member country learns to behave in accordance with others' expectations, no matter whether it likes or agrees with the way it behaves – conscious instrumental calculation is still dominant. Type II means that members accept regime norms as "the right thing to do", with instrumental calculation being supplanted with the logic of appropriateness.<sup>433</sup>Q<sup>434</sup> Later, Beijing found that such rhetoric could be as lethal as a real war – not only did its "peaceful development" discourse risk being swept away, in a worst-case scenario it may eventually ratchet up a Cold-War-like encirclement. Against this background, the CAFTA became an ideal platform to counter anti-China sentiments, since it provides a well-established channel of communication. A three-fold

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<sup>431</sup> Zhang Feng, "How Hierarchical was the Historical East Asian System?," *International Politics* 51, no. 1 (2014).p.17

<sup>432</sup> This question was raised by Jose Tongzon in 2005 in a journal article titled as "ASEAN-China Free Trade Area: A Bane or Boon for ASEAN Countries?". Focusing on an economic perspective, he mainly explored the possible impacts that CAFTA would have on regional production chains. See Tongzon, "ASEAN-China Free Trade Area: A Bane or Boon for ASEAN Countries?."

<sup>433</sup> Jeffrey T. Checkel, "International Institutions and Socialization in Europe: Introduction and Framework," *International Organization* 59, no. 4 (2005).p.804

<sup>434</sup> Yang Jian, "The Rise of China: Chinese Perspective," in *The Rise of China and International Security: America and Asia Respond*, ed. Kevin J. Cooney and Yoichiro Sato (New York: Routledge, 2009).p.22

strategy can be identified, namely threatening ASEAN as a unitary actor, advocating its leading role over regional affairs, and abiding by the “ASEAN way”.<sup>435</sup>

From a constructive perspective, through cautiously initiating, negotiating and implementing institutional affiliations, member countries can both “learn” and “persuade”.<sup>436</sup> In the process of *learning*, knowledge generated from frequent intergovernmental contacts can be transmitted to decision-makers about how to deal with “other settings” in an acceptable way. Based on the CAFTA experience, China learnt that ASEAN was happy to be treated as a unitary actor, as the trade deal was the first time the regional organization was treated so. Similar practices now abound in China’s ASEAN policy: it was among the first countries outside ASEAN to sign the Treaty of Amity and Cooperation in Southeast Asia in 2003; the first to forge a Strategic Partnership for Peace and Prosperity with ASEAN; the first to pledge accession to the protocol to the Treaty on Southeast Asia Nuclear Weapon Free Zone; and the first to sign a “strategic partnership” with ASEAN at the October 2003 Bali Summit.<sup>437</sup> All these acts are appreciated by ASEAN states for it allowed them to “overcome the disadvantage of smallness by pooling resources and combining markets”.<sup>438</sup>

In the process of *persuasion*, a persuader may export and legitimize propositions that are consistent with its own interests. Maintaining ASEAN’s central position in regional

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<sup>435</sup> As yet IR scholars have not agreed on a collective or common definition of the “ASEAN Way”. To quote *The Economist*: the “ASEAN Way” “favours consensus over confrontation, conviviality over candour and process over substance. It is credited with keeping the peace in what was once a strife-torn region. And co-operation within ASEAN not only enhances its economic coherence and attractiveness to outsiders, but also gives it a diplomatic clout its individual members could never attain.” See Banyan, “Getting in The Way: South-East Asia Finds The Decorum of Its Regional Club Rather Rudely Shattered,” (*The Economist*, May, 2014). Regarding the relationship between the “ASEAN Way” and big powers, Katzenstein and Okawara pointed out that ASEAN made China, the US and Japan replicate three of its core norms: informal diplomacy, personal contacts, and respect for the principle of nonintervention. See Katzenstein and Okawara, “Japan, Asian-Pacific Security, and the Case for Analytical Eclecticism.” p.173

<sup>436</sup> Beth A. Simmons and Zachary Elkins, “The Globalization of Liberalization: Policy Diffusion in the International Political Economy,” *The American Political Science Review* 98, no. 1 (2004).p.175

<sup>437</sup> Zhao Hong, “Can a Captive Southeast Asia Ease China-Japan Tensions?,” (*The Institute of Southeast Asian Studies*, 2014).

<sup>438</sup> John Wong and Sarah Chen, “China-ASEAN free Trade Agreement: Shaping Future Economic Relations,” *Asian Survey* 43, no. 3 (2003).pp.507-508

issues has been the stance taken by its ten members since the launch of 10+3 during the 1997 Asian Financial Crisis.<sup>439</sup> Through the CAFTA, ASEAN again imparts a clear will to lead regional integration. Taking a cue from this, the Chinese leadership and media have reiterated their stance regarding a high-profile level of support for ASEAN's leading role.<sup>440</sup> This explains why, when Japan proposed to expand the "10+3" based EAFTA into a "10+6" based CEPEA, Beijing did not hide its strong opposition. Yet when ASEAN took Japan's side to embrace Australia, New Zealand and India, Beijing immediately reversed policy by advocating an "open, inclusive regionalism" - a stance held by ASEAN countries. Apparently, Beijing wants to show that it agrees with ASEAN on regional issues, an endeavor to psychologically evoke ASEAN's empathy and where applicable, to create a positive impression of China. Southeast Asian states know that Beijing's observance of the ASEAN norms is not equivalent to a collective identity, since "identity" is not measured in years, but decades or longer.<sup>441</sup> But at the very least, the PRC can demonstrate to ASEAN that there is a collective identity "in the making".<sup>442</sup>

Moreover, China claims to abide by the "ASEAN way", a norm not only subscribed to consented by the ten ASEAN members but also beneficial to Beijing. To illustrate, the so-called "ASEAN way" is indeed a covert delaying tactic in resolving substantive problems, and is in accordance with what Deng Xiaoping told his successors, "bide their time and hide their capabilities".<sup>443</sup> This norm can create a regional milieu wherein conflicts "either did not arise or could be readily managed and contained", which is consistent with the peripheral environment strategy pursued by Beijing.<sup>444</sup> In this context, complying with the "ASEAN Way" is no longer just an instrument to woo

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<sup>439</sup> Alyssa Greenwald, "Asean-China Free Trade Area (ACFTA): A Legal Response to China's Economic Rise," *Duke Journal of Comparative and International Law* 16(2006),p.198

<sup>440</sup> Ou Yang, "An ASEAN-led Regional Comprehensive Economic Partnership is Emerging [Dongmeng zhudao de quyu quanmian jingji huoban guanxi jijiang dansheng]," (People's Daily.com, November 2012).

<sup>441</sup> Katzenstein and Okawara, "Japan, Asian-Pacific Security, and the Case for Analytical Eclecticism."p.174

<sup>442</sup> Amitav Acharya explicitly distinguished two types of collective identities: "identity in being and identity in making". See Amitav Acharya, "Do norms and identity matter? Community and power in Southeast Asia's regional order," *Pacific Review* 18, no. 1 (2005).

<sup>443</sup> Trefor Moss, "China Tries to Steal a March," (Asia Times Online, 2011-01-14).

<sup>444</sup> Michael Leifer, "The ASEAN Regional Forum," (London: International Institute for Strategic Studies, 1996),p.16

Southeast Asian countries, but a diplomatic norm embedded in China's regional policy-making. When asked about the source of compliance, to quote Checkel, China might answer that "Well, this is the right thing to do even though I didn't think so".<sup>445</sup> Thus there are reasons to believe that China follows this constructivist logic by voluntarily socializing itself into the "ASEAN way" because it posits the "ASEAN way" as appropriate.

As Ann Kent suggests, China constitutes a least-likely case of complying with the norms, principles, and rules of international regimes by virtue of its history, culture, and power.<sup>446</sup> If it nonetheless actively binds itself into norms preferred by its weak neighbors, as demonstrated by the responsibility and generosity it has shown under the CAFTA, people may be led to believe that China has begun to reassess its difficult history with neighboring countries.<sup>447</sup> The expectation here is that "the adoption of common principles for addressing problems will induce behavior change on the part of governments, possibly through a process of socialization and/or governments' fear for their reputations should they be perceived as an unreliable partner because of their failure to comply with commitments".<sup>448</sup> Once this goodwill is appreciated by ASEAN, enmity may decrease and trust may pile up. In so doing, the PRC has earned a degree of trust with its Southeast Asian neighbors. As stated by Evelyn Goh "One of the major reasons for the resilience of the 'ASEAN way' in East Asian institutionalism is that ASEAN has found a major normative ally in Beijing."<sup>449</sup> In retrospect, it is true that although Japan and Korea have also developed individual relationships with ASEAN, neither is as well developed as the ASEAN-China dialogue.<sup>450</sup> Gradually, Beijing's

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<sup>445</sup> Checkel, "International Institutions and Socialization in Europe: Introduction and Framework." p.812

<sup>446</sup> Ann Kent, *Beyond Compliance: China, International Organization and Global Security* (Stanford: Stanford University Press, 2007).p.2

<sup>447</sup> David Shambaugh, "China Engages Asia: Reshaping the Regional Order," *International Security* 29, no. 3 (2004).p.77

<sup>448</sup> John Ravenhill, "Resource insecurity and international institutions in the Asia-Pacific region," *The Pacific Review* 26, no. 1 (2013).p.45

<sup>449</sup> Evelyn Goh, "Institutions and the Great Power Bargain in East Asia: ASEAN's Limited 'Brokerage' Role," *International Relations of the Asia-Pacific* 11, no. 3 (2011).p.388

<sup>450</sup> Vinod K. Aggarwal and Kristi Govella, "The Trade-Security Nexus in the Asia-Pacific," in *Linking Trade and Security: Evolving Institutions and Strategies in Asia, Europe, and the United States*, ed. Vinod K. Aggarwal and Kristi Govella (New York: Springer, 2012).p.15

automatic binding commitments would encourage Tokyo and Seoul to follow suit. To quote Goh:

Insofar as a large measure of the logic of ASEAN-style multilateral institutions relies on the constructive conviction that institutional membership would, over the medium term, create expectations and obligations on the part of the great power, and over time, socialize them into embracing peaceful norms, China's voluntary self-restraint and pursuit of mutual benefits signaled a good start to what was potentially the most dangerous part of the new great power bargain.<sup>451</sup>

### **3.5.2 The SCS standoff – China a threat?**

Although the above analysis proves that constructivism explains some aspects of the CAFTA, Beijing still has been at pains to convince ASEAN that it remains a subscriber to the “good neighbor policy” and that its economic superiority will not be transformed into military menace. The prior two sections reveal that China's attitude to ASEAN is essentially paradoxical – remaining humble and respecting ASEAN's centrality in the economic realm, but becoming assertive and maintaining a bilateral stance over territorial disputes. This paradox, in the eyes of realists, means that a big power portraying itself as the representative of the weaker parties' interests, by making concessions under international regimes, is either pursuing or entrenching its hegemonic position.<sup>452</sup> In this sense, the For realists CAFTA is but a means to “buy” ASEAN's obedience in high political fields, and “threat” rhetoric illustrates that the PRC is using all imaginable means and occasions to achieve its own aims.

While this argument includes several apt points, it would be too early to draw a China threat conclusion. A threat is usually defined as a state that proactively provokes conflicts with others. Yet at least three other criteria are equally important in judging a threat – the reason to behave proactively, the means to resolve conflicts, and the ultimate ends of conflicts. Realists naturally assume that a country with hegemonic ambitions would be expansive and aggressive. The PRC's current SCS claims are all in line with its first formal claim to sovereignty over islands in the region from the 1951 response to the San Francisco Treaty, rather than more recent ones after it became

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<sup>451</sup> Goh, "Institutions and the Great Power Bargain in East Asia: ASEAN's Limited 'Brokerage' Role."pp.382-383

<sup>452</sup> Cox, "Social Forces, States and World Orders: Beyond International Relations Theory."



rich.<sup>453</sup> In other words, the country is not behaving expansively because its claims never go beyond those made when it was very poor and weak.<sup>454</sup> Yet to many observers, China's deployment of the HYSY-981 in the disputed water is provocation. To quote Carl Thayer again, "China's move was so unexpected because Vietnam has not undertaken any discernible provocative action that would justify China's unprecedented action".<sup>455</sup> I agree with Thayer that the action is "unprecedented" because it is the first time China has done so in these waters. But his justification for Vietnam's absolute passiveness has no merit. Beijing, using a historical account, claims that China was the first to discover and exercise jurisdiction over the Xisha Islands, a jurisdiction that is well documented and which can be traced back to the Song Dynasty (AD 96--1126). Prior to 1974, no successive Vietnamese government had ever queried China's ownership of these islands.<sup>456</sup> But now Hanoi claims 215 oil and gas blocks in the South China Sea, covering almost all the islands and reefs in the region.<sup>457</sup>

In this sense, a more justifiable comment on China's recent SCS moves could be to describe them as 'reactions to reactions'. It is understandable for small SCS claimants' provocative reactions to a rising China. As stated by Wu Shicun, National Institute for South China Sea Studies president, "They worry that when China becomes strong one day, and is able to define the nine-dash line as it wishes, they are powerless to do anything about it".<sup>458</sup> This situation is different to the 2012 Huangyan Island crisis

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<sup>453</sup> Yahuda, "China's New Assertiveness in The South China Sea."p.450

<sup>454</sup> The Vietnam government disagrees with China's historic account, and asserts that China had never claimed the disputed water before 1940s. But in fact, even during the 1930s, when China was unprecedentedly weak and was invaded by Japan, the Kuomintang (Guomindang in pinyin) authority still filed protests against the illegal occupation of some of SCS islands by the French colonial administration. See Yingchun Gong, "Vietnam Fooling No One," *China Daily* June 13, 2014; BBC, "Q&A: South China Sea Dispute," (BBC News, May 2014).

<sup>455</sup> Thayer, "China's Oil Rig Gambit: South China Sea Game-Changer?."

<sup>456</sup> For Vietnamese maps recognizing SCS Islands as Chinese territories, see the 1960 map of Vietnam People's Army General Staff at the compilation of the "World Map" and the 1972 World Atlas, surveyed and mapped by Vietnamese government and bureau of Mapping in 1972, etc. It is also recorded my map publications in many other countries, for example, World Atlas of the Earth, published by Germany (in 1954, 1961 and 1970), the Atlas of Encyclopaedia of Great Britain (in 1958) , the Oxford Atlas of Australia published in the Great Britain (1957), the Word Map published by National Geography Institute of France (in 1968), etc.

<sup>457</sup> "The Operation of the HYSY 981 Drilling Rig: Vietnam's Provocation and China's Position."

<sup>458</sup> Goh Sui, "Chinese General vague on Extent of Claims," *The Strats Times* June 2, 2014.

when the Philippines behaved provocatively and China took the opportunity and made use of Philippines' provocation. The HYSY-981 reflects a new idea of "taking and making opportunities maintain the status quo in China's favor" – in response to perceived challenges abroad.<sup>459</sup> Moreover, one should not overlook that China attempts to use economic means and other soft mechanisms to resolve such standoffs. Even at the most hazardous junctures, only water cannon, rather than conventional weapons were used. It should be noted that ideological affiliation and socialist brotherhood are not adequate to ensure a benign relationship, and that security mechanisms, such as the military hotline set up by the two parties in 2011, are not necessarily effective. To the contrary, economic regimes such as the CAFTA and the Great Mekong Sub-region Economic Zone can prove to be a key stabilizer for the two, removing the need to use force to advance their claims. Therefore, although realists may argue that China is flexing its economic muscles to achieve political gains, only liberalism explains why the PRC abstained from using military means.

Realism also nicely explains China's assertiveness over territorial disputes but does not foresee the means and ends of these disputes. For example, most realists correctly point out that territorial disputes are one of the most serious threats to Asian security, but their suggestion that power-balance and alliance strategy are the key to avoid conflict escalation nevertheless does not fit the findings of this chapter. As observed, the disposition of clashes with both the Philippines and Vietnam relied largely on the economic hierarchy within East Asia, rather than third party intervention or alliances with non-regional big powers. These findings are consistent with Benjamin Goldsmith's analysis that there is a liberal peace between China and Southeast Asia, based primarily on economic interdependence.<sup>460</sup> In this sense, realism and liberalism respectively interpret parts of the correlations between free trade agreements and high-politic disagreements, but increasingly, the latter "will explain more of the region's future security orientation".<sup>461</sup> To quote a Brookings Foreign Policy Brief:

The United States should not exaggerate, however, what is going on in the South China Sea and regard it an Asian counterpart to Russian aggression against Ukraine. China's territorial claims in the South China Sea are of long standing. Troops are not moving,

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<sup>459</sup> Pal, "Is China's Charm Offensive Dead?" p.5

<sup>460</sup> Benjamin E. Goldsmith, "A Liberal Peace in Asia?," *Journal of Peace Research* 44, no. 1 (2007).p.22

<sup>461</sup> Sheldon W. Simon, "Realism and neoliberalism: International relations theory and Southeast Asian security," *The Pacific Review* 8, no. 1 (1995).p.7

people are not being killed. Management of claims disputes is important, but occasional assertions of sovereignty by one actor or another are not a fundamental challenge to recognized borders or the integrity of existing states.<sup>462</sup>

The HYSY-981 incident was a little diplomatic episode does not doom the overall Sino-ASEAN relationship, notwithstanding that it is not a positive sign to many China skeptics. The current SCS situation is nowhere near the point where a traditional war is likely. Therefore, in regards to the final resolution of the CSC disputes, should Beijing lean toward realists' expected military means, or remain using economic measures underwritten by liberals, observers need to adopt a more eclectic perspective to avoid misjudgments. The PRC, which is keen to create a benign image in ASEAN, should continue to conduct FTA diplomacy whilst remaining vigilant to behaviors in the SCS that may give rise to anti-China sentiments.

### **3.5.3 China a threat to other big powers?**

The above analysis indicates that Beijing is now building as a new image of a peaceful, open and responsive great power. However it shows no interest in smoothing relationships with Tokyo, which may mar its new image drive. Japan, similarly, regards China as its ancient enemy. To quote Taro Aso, Japanese Deputy Prime Minister, "For the past 1,500 years and more, there has never been a history when our relations with China went extremely smoothly".<sup>463</sup> China's fast rise makes relations even trickier, since the two have never previously been powerful at the same time.<sup>464</sup> An unavoidable consequence is a constant rivalry between them, as well illustrated in the FTA arena. This is why, in contrast to the European Coal and Steel Community (ESCS) and the North America Free Trade Area (NAFTA), FTAs in East Asia have been labeled as stumbling blocks to regional integration. Ravenhill, for example, warns that trade pack negotiations in the region can actually "do lasting damage unless concluded within a reasonable period of time".<sup>465</sup> Therefore, western-oriented rational theories fail to fit Asia's reality. Rather, I suggest that a constructive notion of "the logic of habit" helps us to explore something deeper operating within the region.<sup>466</sup> To quote Ted Hopf:

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<sup>462</sup> Kenneth G. Lieberthal and Michael McDevitt Jeffrey A. Bader, "Keeping the South China Sea in Perspective " in *The Foreign Policy Brief* (Brookings Institute, 2014).p.9

<sup>463</sup> Max Fisher, "The Real Roots of China-Japan Tensions," (Washington Post, 2013-05-13).

<sup>464</sup> Jones, "Making Process, Not Progress ASEAN and the Evolving East Asian Regional Order."p.180

<sup>465</sup> Cited in Koo, "The Past, Present, and Future of Asia's Institutional Architecture.", p.295

<sup>466</sup> See Ted Hopf, "The logic of habit in International Relations," *European Journal of International Relations* 16, no. 4 (2010); Jong Kun Choi and Chung-in Moon, "Understanding Northeast Asian

The logic of habit underpins an enduring rivalry begins with an enduring pattern of hostile interactions not accompanied by a reflective calculation of the costs and benefits of the relationship or reference to some norm specifying what actions are appropriate in such a relationship. Instead, we should see automatic responses to the actions of a rival.<sup>467</sup>

Drawing on this constructivism logic, one key knot that prohibits reconciliation between Beijing and Tokyo is their different perceptions of the Japan's invasion and massacres in China during 1894-1945.<sup>468</sup> Tokyo is angry with the CCP for stirring up anti-Japanese based nationalism, and claims that the major aim of doing so is to back-up its domestic legitimacy.<sup>469</sup> Pro-Japan academicians and media have appealed to China to learn from France's collaboration with Germany after World War II to cooperate with Japan over regional issues. Beijing fires back that the Japanese leaders' persistent indifference toward history is "only in consideration of the upper house election".<sup>470</sup> As for regional issues, Chinese authorities propose that Japan should follow Germany's example of coping with its Nazi past. With such ongoing contention, and emerging problems such as Japanese cabinet members' visit to Yasukuni, it is understandable that China feels sensitive to Tokyo's CEPEA proposal, and instinctively opposes it without looking at whether its opposition represents a threat to Japan or not.

China's paradoxical identity poses another obstacle to normalization of the Sino-Japan relationship. According to Rawi, China's identity can be divided into state identity and national identity – the former is informed by international norms, which is shaped by the international society; the latter is informed by domestic society, which refers to "the

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Regional Dynamics: Inventory Checking and New Discourses on Power, Interest and Identity," *International Relations of the Asia-Pacific* 10(2010).

<sup>467</sup> Hopf, "The logic of habit in International Relations." p.552

<sup>468</sup> See Wikipedia, "Nanjing Massacre," (Wikipedia). Available at [http://en.wikipedia.org/wiki/Nanking\\_Massacre](http://en.wikipedia.org/wiki/Nanking_Massacre)

<sup>469</sup> Erik Beukel, "Popular Nationalism in China and The Sion-Japanese Relationship: The Conflict in The East China Sea and Introductory Study," in *DIIS Report* (Danish Institute for International Studies (DIIS), 2011).

<sup>470</sup> Pu Zhendong, "China and South Korea Criticize Visits to Shrine," *China Daily* 2013-04-23.

population of a state rather than to the state itself".<sup>471</sup> Applying this analysis to the Sino-Japan relationship, what matters is China's two-layered identity - a rising power which is powerful enough to counterbalance and even challenge Japan (state identity), and at the same time a weak and backward country inferior to Japan since the First Sino-Japanese War (national identity). These two identities both stem from China's real experience and national memory. As Katzenstein and Okawara note, "history ... is an open-ended process in which the accumulation of events and experience from one period alters the contours of the next".<sup>472</sup> Hence, although the CCP's patriotic education normally juxtaposes "American imperialists" and "Japanese imperialists", the latter one gets much more public resonance because the US did not launch an invasion of China. Therefore, it is state identity and national identity intertwined that constitutes a major impetus for Chinese nationalism and attitudes toward Japan. Japan's history of aggression provides China with an important lesson – backwardness exposes one to attack [落后就要挨打]. As a result, it does not want to be lag behind Japan in any aspects, including in FTA network building. That is why China anticipates outperforming Tokyo through the CAFTA-based EAFTA, rather than the CEPEA, which risks it living in the shadow of Japan or even being led by Japan again. Its blunt opposition to Tokyo's CEPEA initiative also indicates that the "peaceful rise" rhetoric was not made for Japan, because China believes that being feared by a hostile country is better than being underestimated and dominated.

Compared with the habitual enmity between China and Japan, the Sino-US relationship is less complex, but similarly uneasy. In fact, most famous and faithful advocates of the "China threat" rhetoric are America-based. But few signs suggest that Beijing has ever tried very hard, as it did in Southeast Asia, to convince Washington that it is not a threat. The logic is simple. Generally speaking, there are two reasons that Americans view China as a menace: different domestic regimes and its fast growing economic clout. But that does not mean that the absence of either or both causes can decrease the US's feeling of being threatened. First, if China's political regime persists but the economy falters, it remains a threat by virtue of ideology difference. Second, if China's political

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<sup>471</sup> Rawi Abdelal, "Constructivism as an Approach to International Political Economy," in *Routledge Handbook of International Political Economy (IPE): IPE as a Global Conversation*, ed. Mark Blyth (New York: Routledge, 2008).p.72

<sup>472</sup> Katzenstein and Okawara, "Japan, Asian-Pacific Security, and the Case for Analytical Eclecticism."p.156

regime collapses but the economy continues growing, it would pose a greater threat to the US, since a politically democratic and economic prosperous country can more easily challenge its hegemonic position. Third, if both China's political regime and economy breakdown, then it will continue to be a threat, because it may become another Iraq, Afghanistan or Syria. Taken together, these scenarios mean that there is little room for China to lobby its "peaceful development" discourses in Washington. This situation is consistent with what Hopf describes as a security dilemma: "when a state is certain that another state is an enemy, and so habitually responds to every move that other state makes in the realm security as if it is threatening to its own security".<sup>473</sup> Therefore, looking from a combined perspective of the realist power transition theory and constructivist ideological dyad dogma, Beijing's responses to different countries in the light of "China Threat" rhetoric vary considerably.

In essence, the PRC lacks both the means and willingness to correct its "assertive" image. To the contrary, it has demonstrated a propensity to go tit-for-tat. For example, the SCS standoff has to some extent pushed the US-Vietnam relationship closer. For example, two weeks after the oil rig was set, Hanoi announced that it would participate in the Proliferation Security Initiative (PSI), after more than a decade of hesitation since the initiative was first proposed in 2003. This act revealed a growing level of mutual trust in the two's security cooperation.<sup>474</sup> On the other hand, to prevent Vietnam from being further locked within the Sino-ASEAN free trade zone, the two also concurred on the imperative to enhance cooperation under the TPP framework. Some observers thereby claim that a US-Vietnam alliance is now emerging. As a response, the Chinese Ministry of Foreign Affairs gave up the traditional vague criticism such as "certain countries", but directly named Vietnam as "trying to rope in other parties and put pressure on China".<sup>475</sup> In addition, Xi Jinping, in his keynote speech at the Conference on Interaction and Confidence Building measures in Asia (CICA) called for Asian problems to be "solved by Asians themselves". Specifically, he stated that "we cannot just have security for one or a few countries while leaving the rest insecure. A military alliance which is targeted at a third party is not conducive to common regional

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<sup>473</sup> Hopf, "The logic of habit in International Relations."p.552

<sup>474</sup> Mark E. Manyin, "U.S.-Vietnam Relations in 2014: Current Issues and Implications for U.S. Policy," in *Congressional Research Service Report* (Congressional Research Service, 2014).p.3

<sup>475</sup> Ben Blanchard, "China Says Vietnam Efforts to Rope in Others on Spat Will Fail," (Reuters, May 12, 2014).

security”.<sup>476</sup> Furthermore, when Washington promised to provide \$18 million of aid to the Vietnamese coast guard,<sup>477</sup> the *Global Times* warned that

Third-party interference is increasingly an obstacle that curbs Sino-US relations. Some countries believe they have US support so they do not care about the worsening relations with China; the US is kidnapped by the interests of its allies in this way. If the US continues its strategy of containing China and rebalancing it would not get rid of the dilemma of being used by small allies.<sup>478</sup>

All in all, the “China threat” debate is an inclusive one, but scholars in both realism and constructivism camps may draw an identical conclusion that Beijing hates being treated as a threat. Once ASEAN, Japan and the US are placed in a comparative perspective, nevertheless, the strong evidence in this section suggests a very different answer: to ASEAN, China considers that being loved is better than being feared; to Japan, being feared is better than being underestimated; and to America, either being feared or underestimated or overestimated makes no big difference. As a result, although China tries hard to prevent itself from being perceived as a threat by neighboring countries, it does not try so hard when dealing with Tokyo and Washington. These paradoxical behaviors are not policy confusion. Rather, it is in line with its strategic blueprint for the long term. For the short-medium term, when China is still a ‘partial’ big power, its strategy is to maintain amicable ties with ASEAN both economically and politically, while reaping economic gains from Japan and the US. But securing a friendly peripheral environment is not Beijing’s only goal. For the long term, when China becomes a true global power, its diplomatic center of gravity will shift toward how to share power with other big ones – then ASEAN’s support would serve as a robust bulwark for it to be a bigger shareholder.

I want to finish this section by invoking two caveats. First, as Ravenhil suggests, the CAFTA as a “shallow institution” that is far from being able to overcome “China threat” rhetoric, a rhetoric which is essentially derived from a combination of historical

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<sup>476</sup> Shannon Tiezzi, "At CICA, Xi Calls for New Regional Security Architecture," (The Diplomat, 2014).

<sup>477</sup> Hoang Oanh, "Vietnam’s Deft Diplomatic Footwork on the South China Sea," (East Asia Forum, 2014).

<sup>478</sup> Dong Chunling, "US Should be Blamed for China-Vietnam Row," (People’s Daily Online, June 03, 2014).

disputes, economic order, regional leadership and nationalism.<sup>479</sup> Therefore, Beijing should use all possible tools and occasions, including political and cultural ones, to build a benign image. Economic diplomacy alone would give others an impression that China is overly utilitarian, leaving them thinking twice before embracing its “goodwill”. Some of Beijing’s ASEAN supporters are increasingly reticent toward Chinese proposals. The Cambodian government, for instance, has met strong domestic opposition to the ratification of a hydropower project financed by China since July 2013.<sup>480</sup> This episode should caution Chinese policymakers about how far they can stretch the economic diplomacy. Second, even if Beijing seems not to care about whether Tokyo and Washington view it as a menace or not, maintaining good relationships with both is still very important, and requires a nuanced and forward-looking array of policies.

### 3.6 Conclusion

The CAFTA serves as fertile ground for exploring the shaping of economic architecture in Asia Pacific. In the Sino-ASEAN-Japan strategic triangle, realism offers a compelling answer as to why Beijing and Tokyo employ a tit-for-tat strategy toward each other’s regional FTA preferences. In the Sino-US-Japan strategic triangle, although realists’ power-balance assumptions remain in play, it would be superficial to assume that Tokyo and Washington will collaborate conformably to counter the rising China. Rather, the TPP stalemate exposes considerable underlying contradictions and a growing rift between the two military allies, as revealed in the limitations of the traditional “give-and-take” strategy. This situation provides Beijing some breathing room to more pragmatically pursue economic dialogues with Japan and the US. Besides, Beijing outperformed its big power rivals in wooing ASEAN by respecting its centrality and leading role through the CAFTA and the ASEAN-led RCEP. Through this eclectic lens, this section suggests that *realpolitik* still plays an important, but not the only role in accounting for China’s FTA diplomacy.

The above analysis also indicates that the CAFTA is a security-embedded free trade deal. Liberal and realist theorists provide different arguments about the role that an

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<sup>479</sup> John Ravenhill, "Economics and security in the Asia-Pacific region," *The Pacific Review* 26, no. 1 (2013).p.13

<sup>480</sup> Liu Coco, "China-led Hydropower Project Faces Resistance in Cambodia," (Global Climate Debate, June 10, 2014).



economic regime plays in solving high-politic problems – the former regard it as a war-extinguisher while the latter reckon it to be a war-facilitator. Using an eclectic approach, I have analyzed the CAFTA-SCS case through both lenses. I find that the two seemingly paradoxical paradigms are essentially two sides of one coin. To ASEAN claimants, the CAFTA is a war-extinguisher because it shackles these countries through economic reliance on China. To China, the CAFTA is a war-facilitator, which emboldened its assertiveness in the SCS. Empirically, I suggest that Beijing will more frequently and confidently use FTA leverage to achieve its own territorial objectives

The study of correlations between CAFTA and the “China threat” rhetoric is equally illuminating. At first glance, people might feel tempted to see China’s ascendancy as a purely ‘realist’ affair. The above analysis however speaks against realists’ posit that the PRC seeks to overthrow the existing regional order. Rather, by respecting ASEAN’s centrality in economic areas, China’s behavior is more congruent with constructivists’ argument that regional regimes serve as a platform for small countries to tame big ones, even if in a limited term. Nor do realists righteously predict that the balance-of-power strategy of strengthening military cooperation with the US is the only resort to decrease regional conflicts. In fact, even though the US remains the symbolic security guarantor of East Asia, resolving the SCS standoff mainly depends on regional countries’ growing interdependence and self-restraint, rather than America’ direct military interventions. This is an encouraging sign congruent with liberal and constructivist’s claim of “more trade, less war”. The study of Sino-Japan and Sino-US relations is illuminating too - realism still has a big say, but when studied together with constructivism, we know how important historic and ideological issues shape today’s big power rivalry.

## Chapter 4 The China-New Zealand FTA (CNZFTA)

### 4.1 Introduction

This chapter links the CNZFTA to the central hypothesis that China uses FTAs as a diplomatic tool to achieve political goals. Compared with other Chinese FTAs, the CNZFTA has two main characteristics: it is the first trade deal that China sealed with an agriculturally-advanced country, particularly in the dairy sector; and it is the first bilateral FTA that Beijing achieved with a developed economy. Drawing on these characteristics, this chapter argues that China pursues the CNZFTA with two diplomatic objectives: (1) to facilitate domestic dairy reforms; and (2) to use it as a stepping stone toward more ambitious FTAs with other developed countries.

This chapter is divided into five sections. Section two is an empirical examination of the CNZFTA. It will show that since the signing, the bilateral merchandise trade gap in New Zealand's favor has grown significantly, spearheaded by the country's dairy exports. This section finds that Sino-NZ economic relations are highly asymmetric. In both merchandise and service trades, New Zealand enjoys an obvious surplus, exposing its asymmetric reliance on the Chinese market. But compared to the burgeoning bilateral trade, Chinese investment in New Zealand remains low and faces various resistances, revealing New Zealand's suspicions about investors from China. As we shall see, these economic results have strong implications for the newly conclude China-Australia FTA (CAUFTA), which was announced on 17<sup>th</sup> November 2014 when President Xi Jinping visited Australia.

Section three analyzes the potential impact of the CNZFTA on China's simultaneous efforts to promote nation-wide dairy reforms, which are divided into two distinct phases. I will show that in the initial stage, Beijing seriously considered the CNZFTA as an instrument to improve enterprise efficiency and stimulate domestic market potential. However, when the influx of NZ dairy products began to overshadow its own domestic industry Beijing took a big step backwards in the second reform phase under the banner of "economic security". By this account, this section argues that China's decision to open its dairy trade to New Zealand is less for pro-liberalism than for political expediency, if not a downright hard-nosed calculus of national interest underpinned by realist dogmas.

The fourth section suggests that it would be an incomplete test to focus on the CNZFTA *per se*. The deal was in fact conceived from the very beginning as an overture in Beijing's FTA strategy toward other developed economies. Drawing on the liberal idea of regime diffusion, I will explore (1) why the CNZFTA failed to encourage Australia to emulate New Zealand by signing a similar deal with China in an immediate term; and (2) how the CNZFTA successfully influences the Trans Pacific Partnership (TPP) arena, in which New Zealand holds a firm anti-containment stance toward China. The liberal view invites an unwarranted assumption that since China has locked Australia into a bilateral FTA, then Canberra may follow Wellington's suit in accommodating China over TPP issues.

Drawing on Dittmer's strategic triangle as the analytic tool by triangulating the AU-US-NZ relationship, I argue that the liberal assumption is very unlikely to be realized. Rather, realists favored variables, such as a military alliance's economic externality, are demonstrated to be crucial factors determining AU-NZ divergence on how to get along with China over free trade deals. In addition, constructivist factors such as perceptions of whether China is an economic market, and whether China is a military threat, also loom large in Australia's consideration of whether to follow with New Zealand's stance in the TPP, and whether to finalize the CAUFTA. This section will demonstrate that analytical eclecticism is particularly suited to understand China's initial leap into FTAs with the developed Western world.

The fifth section concludes that China utilizes FTAs to pursue its strategic goals in domestic and international dimensions. Moreover, this case study corroborates the hypotheses laid out in the analytic framework in the theoretical chapter of this thesis. It shows that CNZFTA's strategic connotations are not shaped exclusively by interests, power or perceptions, but by the combination of all these factors.

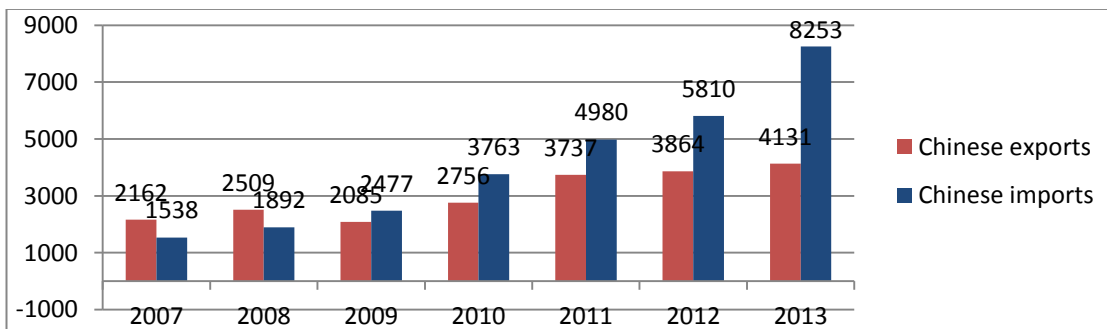
#### **4.2 The Economic analysis of the CNZFTA**

FTA talks between China and New Zealand were officially launched in December 2004. In April 2008, after 15 rounds of negotiation, it was signed when Helen Clark, the former New Zealand Prime Minister, visited Beijing. The CNZFTA is the first comprehensive FTA that China has ever signed as well as the first FTA that China signed with an OECD country, covering Trade in Goods (TIG), Trade in Services (TIS) and Investment. It entered into force on 1<sup>st</sup> October 2008.

*Text of Trade in Goods*

The text of the TIG agreement is a simple document of 11 articles (from article 5 to article 16) presented in 4 pages. The first four articles fell into a conversational root of accelerating tariff elimination, with article 12 reiterating the significance of protecting intellectual property rights. Annex I and II respectively itemized detailed schedules of cutting tariffs on two-way merchandise goods between the two partners. In annex I, China promised to eliminate tariffs on 35% of NZ products immediately after the FTA entered into force. Customs on 31% of NZ goods would be abolished progressively over the first five years after the FTA took effect, and the remaining tariff wall will be completely removed no later than 2019. It is estimated that the Chinese government will drop customs revenue of at least \$ 115.5 million per year.<sup>481</sup> According to Annex II, New Zealand conceded a lot in areas where China enjoyed comparative advantages, including footwear, gaiters and the like, articles of apparel and clothing accessories, and other assembled textile articles, etc. The NZ government promised that tariffs on these products (average 17%) would be gradually removed by 2016. In short, both parties made significant concessions in areas of most concern to their counterparts. Cross-border trade flows between China and NZ have experiencing dramatic growth since the FTA came into force. (See Figure 4.1)

**Figure 4.1: Sino-NZ Bilateral Commodity Trade Flows (US\$ millions)**



Sources: UN Comtrade Database, available at <http://comtrade.un.org/data/>

As can be seen in above table, the CNZFTA transformed New Zealand’s status in the Sino-NZ trade from deficit to surplus within the first year of its inception. Since then, although bilateral trade has shown great momentum, the gap in New Zealand’s favor

<sup>481</sup> The Ministry of Commerce of China and The Ministry of Foreign Affairs and Trade of New Zealand, "A Joint Study Report on a Free Trade Agreement Between China and New Zealand," (The Ministry of Commerce of China and The Ministry of Foreign Affairs and Trade of New Zealand, 2004).

has been expanding enormously. In 2013, it was estimated at \$4122 million, where exports to China were \$8,253 million, recording an increase of \$2,442 million (47%) on the previous year. China accounted for approximately 21% of New Zealand's overall merchandise trade exports. In the meantime, China's exports to New Zealand were valued at \$4,131 million, less than 0.19% of China's total exports. China's importance to New Zealand has grown significantly. It now ranks as NZ's biggest single trading partner, highlighting the latter's asymmetric dependence. This transformation has generated significant political ramifications including Wellington's decision to accommodate China in the TPP. I will discuss this phenomenon in detail in the strategic section of this chapter.

The CNZFTA is the first tentative step that Beijing took to open its market to an agriculturally advanced country, but this step is not bold enough. For example, China made huge progress on agricultural liberalization. A large number of farm products under traditional protection such as glucose and artificial honey (base rate 30%), processed vegetables & fruits (base rate 25%), soy sauce (base rate 28%), vermouth & other wine of fresh grapes (base rate 65%) etc., have been duty-free since 2013. But there is still a wide range of agricultural products that do not appear on the tariff reduction schedule. Tariffs on wheat, maize seed, rice, rice seed, grain, grain seed, some sorts of edible oil, some kinds of sugar, etc., are still under Most Favored Nation (MFN) tariff rates, and show no indication of liberalization before 2019. Moreover, China also imposed Tariff-rate Quotas on certain wool products and Special Safeguard Measures (SSM) on some dairy products to prohibit the possible "dumping" of New Zealand products.<sup>482</sup>

However, blocking progress on the FTA is not a way to protect domestic markets. According to the *Two-year Review Joint Report*, in 2010, New Zealand's exports are predominantly agricultural, including dairy products (44%), timber and forestry products (23%), meat (8%), fish and fish products (7%), and wool (6%).<sup>483</sup> Among these products, the significant increase in dairy imports from New Zealand is of

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<sup>482</sup> See Annex II, Special Agricultural Safeguard Measures, and Annex IV, China's Country-Specific Tariff Quotas for Wool and Wool Tops.

<sup>483</sup> China-New Zealand FTA Joint Commission, "China-New Zealand Free Trade Agreement 2-Year Review Joint Report," ed. Chinese Ministry of Commerce and NZ Ministry of Foreign Affairs and Trade (2010).

particular concern to China. According to statistics released by the UN Comtrade Database, the value of dairy imports from New Zealand has increased 978% since 2008, and the average annual growth rate (from 2008-2013) was as high as 81%. (See Table 4.1)

**Table 4.1: Dairy Products that China Imported from New Zealand <sup>(1)</sup> (\$ millions)**

	2008	2009	2010	2011	2012	2013
Imports Value	0.34	0.59	1.26	1.64	1.97	3.64
Increase Rate	--	74%	114%	30%	20%	85%

(1) Only for types of dairy products are calculated – HS0401: milk and cream, neither concentrated nor sweetened; HS0402: milk and cream, concentrated or sweetened; HS0405: butter and other fats and oils derived from milk; and HS0406: cheese and curd.

*Resource:* The UN Comtrade Database, available at <http://comtrade.un.org/data/>

#### *Agreement on Treaty in Services*

China made some GATS-plus commitments under the TIS.<sup>484</sup> For instance, in sectors such as software implementation, data processing and environmental services, wholly owned New Zealand enterprises will be allowed. But many restrictions remain. For example, NZ’s law firms can only provide legal services in a restricted number of Chinese cities, and have no authority to employ local Chinese registered lawyers. As for onshore oil-field services, NZ enterprises have to cooperate with China National Petroleum Corporation (CNPC) when carrying out petroleum exploration in designated areas approved by the Chinese government. Further, NZ oil service suppliers “shall furnish CNPC accurately and promptly with the reports on the petroleum operations, and shall submit to CNPC the data and samples as well as various technological, economic, accounting and administrative reports related to petroleum operations”.<sup>485</sup> Additionally, NZ service providers in China need to meet various stringent requirements: owners of hotels and restaurants who seek to work in China should “have signed contracts with joint venture hotels and restaurants in China”; medical and dental staff being granted a temporary visa for 6 months (which may extended to 1 year) should have professional certificates issued in NZ. Moreover, no commitment was made

<sup>484</sup> This refers to commitments beyond New Zealand’s openness under the General Agreement on Trade in Services (GATS). For specific commitments under the CNZFTA, see Annex VIII, Part A: China Schedule of Specific Commitments on Services.

<sup>485</sup> Annex 8, part 1: China-New Zealand FTA

to “ship’s crew and key personnel employed by other forms of commercial presence for the supply of international maritime transport services”.<sup>486</sup>

New Zealand also offers China a number of GATS-plus privileges in selected areas: business services (professional services such as accounting and taxation, computer and related services, rental/leasing of equipment without crew services), communication services (telecommunication services<sup>487</sup> and audiovisual services), construction and related engineering services (general construction work for buildings, general construction work for civil engineering<sup>488</sup>, installation and assembly work, building completion and finishing work, etc.), distribution services (commission agents, wholesale trade, retail trade), education services, environmental services (waste water management, waste management refuse disposal, protection of ambient air & climate, remediation & cleanup of soil & water, noise & vibration abatement, etc.). China will benefit from these clauses through learning from NZ’s world leading high-tech and advanced managerial skills. For instance, an agreement on Film-Co-production was signed by Premier Wen Jiabao and Prime Minister John Key in Beijing in July 2010, which is estimated to greatly improve China’s movie industry.<sup>489</sup>

New Zealand also committed to attract Chinese visitors through speeding up visa applications. Generally speaking, transnational visitors can be divided into ‘temporary entry’ and ‘temporary employment entry’ categories.<sup>490</sup> Under the expeditious application procedure, relevant NZ agencies shall inform an applicant of the final

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<sup>486</sup> Annex 10, part 1: China-New Zealand FTA

<sup>487</sup> The Articles of Association of the Telecom Corporation of New Zealand Limited limit the shareholding by any single overseas entity to 49.9%. At least half of Board directors are required to be New Zealand citizens.

<sup>488</sup> Certification of certain works involving health and safety is limited to Registered Engineers, who to become registered must ordinarily reside in New Zealand.

<sup>489</sup> John Key, "Film Co-Production Agreement Signed With China," (The Official Website of The New Zealand Government, July 2010).

<sup>490</sup> Temporary entry refers to “entry by a business visitor, and intra-corporate transferee, and independent professional, a contractual service supplier, or an installer or servicer, as the case may be, without the intent to establish permanent residence and for the purpose of engaging in activities which are clearly related to their respective business purposes”; and temporary employment entry means “entry by a natural person of a Party, including a skilled worker, into the territory of the other Party in order to temporarily work under an employment contract concluded pursuant to the law of the receiving Party, without the intent to establish permanent residence”. See C-NZ FTA, Chapter 10, Article 125.

decision, or advise he/she when the result would come out, within 10 working days after an application was received. As for the granting of ‘temporary entry’, NZ will not “require labor certification tests, or other procedures of similar effect; impose or maintain any numerical restriction relating to temporary entry; or require labor market testing, economic needs testing or other procedure of similar effects as a condition for temporary entry”.<sup>491</sup> As for the grant of ‘temporary employment entry’, once an applicant was “qualified under all applicable immigration measures” and is under genuine employment from an employer in NZ, then a visa should be issued in the assigned time.<sup>492</sup> Significantly, New Zealand made a unilateral commitment by providing 800 jobs to skilled Chinese. (See Table 4.2)

**Table 4.2: New Zealand’s Promise in Temporary Employment Entry**

Occupants	Traditional Chinese Medicine Practitioners (TCM) and nurses	Chinese Chefs	Mandarin Teaching Aides	Chinese Wushu Martial Arts Coaches	China Tour Guides
Quantity	Up to 200	Up to 200	Up to 150	Up to 150	Up to 100

Sources: Annex 11, China-New Zealand FTA

Tourism remains a key sector in the bilateral services trade. The number of visitors from China to New Zealand continues to grow, increasing 147% between 2010 and 2014. China has been New Zealand’s second largest source of overseas visitors since 2012, with a bulk of them holiday tourists. (See Figure 4.2) According to the *New Zealand’s Tourism Sector Outlook (2012-2018)*, in 2011, Chinese visitors surpassed their Japanese counterparts as the highest daily spenders when staying in New Zealand, accounting for 8% of the country’s total visitor revenue.<sup>493</sup> (See Figure 4.3 and Appendix 4.1) On the other hand, only 128,600 New Zealanders visited China in 2013, making NZ China’s 23<sup>rd</sup> largest source of overseas visitors.<sup>494</sup>

<sup>491</sup> Chapter 10, Article 129: China-New Zealand FTA

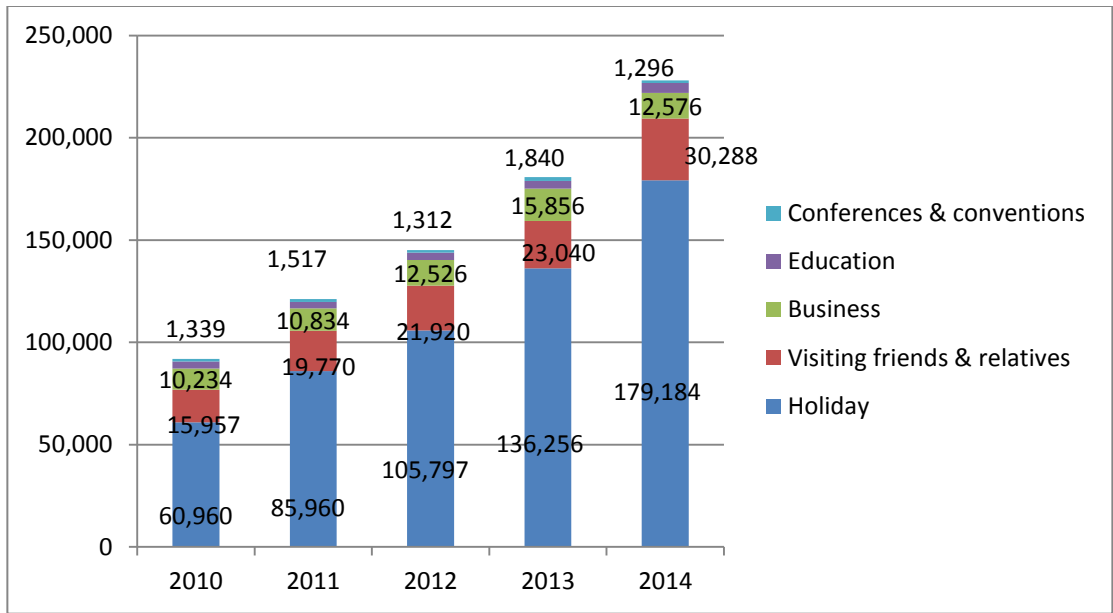
<sup>492</sup> Chapter 10, Article 129 and 130: China-New Zealand FTA

<sup>493</sup> Innovation & Employment New Zealand Ministry of Business, "New Zealand’s Tourism Sector Outlook: Forecasts for 2012-2018," (Wellington: New Zealand Ministry of Business, Innovation & Employment, 2012).p.43, p.21

<sup>494</sup> See Database of the China National Tourism Administration, available at <http://www.cnta.gov.cn/html/2014-1/2014-1-16-15-51-87470.html>

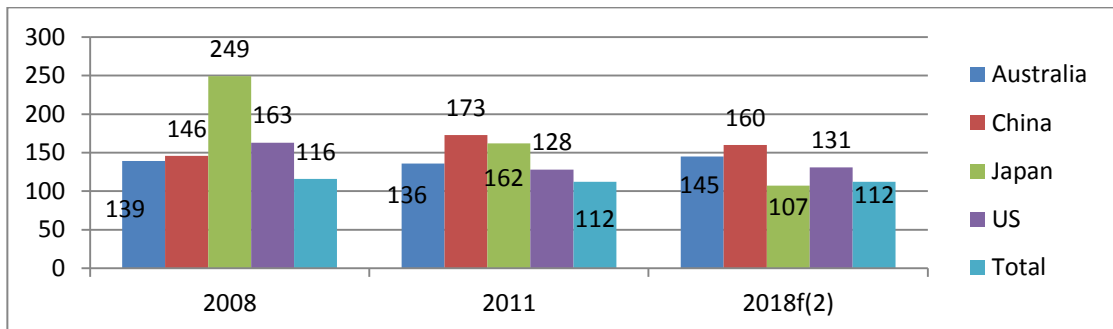


**Figure 4.2: Visitors from China to New Zealand (Year ended January 2010-14)**



Resource: *International Visitor Arrivals to New Zealand: January 2014*, available at [http://www.stats.govt.nz/browse\\_for\\_stats/population/Migration/international-visitor-arrivals-jan-14.aspx](http://www.stats.govt.nz/browse_for_stats/population/Migration/international-visitor-arrivals-jan-14.aspx)

**Figure 4.3: Per visitors' average spend per day in New Zealand (NZ\$)**



Resource: *New Zealand's Tourism Sector Outlook (2012-2018)* available at: <http://www.med.govt.nz/sectors-industries/tourism/pdf-docs-library/tourism-research-and-data/forecasts/Tourism-forecasts-2012-2018-Nov-2012.pdf>

Note: "f" refers to forecast.

International education is one of New Zealand's leading export service sectors – in 2012, it was worth an estimated \$2.6 billion to the economy and was the country's 5<sup>th</sup> most valuable export.<sup>495</sup> As revealed by the NZ Ministry of Education, after the signature of the CNZFTA, the near-doubling in Chinese students from 2008 to 2013 is apparent,

<sup>495</sup> New Zealand Ministry of Education, "Exchange Rates and International Student Enrolments in New Zealand (2003-2013)," (Wellington: International Division, New Zealand Ministry of Education, 2014), p.4

making China the largest source of overseas students. (See Table 4.3) It is noteworthy that the eight universities are the primary contributor to NZ's education revenue, with Chinese students making up the single largest proportion of fee-paying enrolments (42.3% in 2013).<sup>496</sup> On the other hand, according to data released by the Chinese Ministry of Education, in 2012, 4,388 students came from the Oceania area, accounting for 1.34% of total international enrolments in China.<sup>497</sup> (There is no specific figure available to count New Zealanders studying in China, due to their limited number.)

**Table 4.3: International Fee-paying Students in Schools by Source County**

	2008	2009	2010	2011	2012	2013
China	2,082	2,170	2,465	3,022	3,618	4,002
South Korea	6,597	5,619	5,292	4,374	3,719	3,009
Japan	1,672	1,620	1,809	1,827	2,255	2,345
Germany	1,672	2,008	2,327	2,141	1,907	1,764
Total	15,660	15,462	16,064	15,609	15,643	15,742

Resource: *New Zealand Schools: Trends in International Enrolments*, available at <http://www.educationcounts.govt.nz/statistics/international/international-students-in-new-zealand>

China is clearly in an unfavorable position in trading services with New Zealand. But this asymmetry, similar to the merchandise trade, while crucial for the New Zealand government, which is eager to reduce government debt, advances Beijing's interests in other issue-areas when negotiating and cooperating with Wellington.

#### *Text of Investment*

In terms of investment openness, the CNZFTA operates between controlled entry and full liberalization. According to Chapter 11, all investments of a party in the territory of the other party shall be given either the National Treatment or the Most Favored Nation Treatment. The former refers to "each Party shall accord to investments and activities associated with such investments, with respect to management, conduct, operation, maintenance, use, enjoyment or disposal, by the investors of the other Party treatment no less favorable than that accorded, in like circumstances, to the investments and

<sup>496</sup> Ibid.p.6

<sup>497</sup> China Ministry of Education, "2012 Statistic Report: Overseas Students in China," (China Ministry of Education, 2013). Available at <http://www.cfce.cn/a/news/zhxw/2013/0309/831.html>

associated activities by its own investors”.<sup>498</sup> The latter means that each party shall accord to investors of the other party terms no less favorable than that accorded to investors of any third Party. However, both sides reserved their rights to “adopt or maintain any measure that accords differential treatment to third countries under any free trade agreement”.<sup>499</sup> This means that investors of both countries cannot enjoy preferences they granted to their other FTA collaborators. Besides, upon arrangements involving fisheries and maritime matters, new preferential treatment to third countries may not accrue to the CNZFTA, which indicates that the rights to entry given by the CNZFTA are closer to the controlled-entry, rather than full liberalization.<sup>500</sup>

CNZFTA’s limited openness is also reflected in its incompatibility with the two countries’ national law. For example, according to New Zealand’s *Overseas Investment Act 2005*, the country retains the right to scrutinize any foreign investment seeking a 25% shareholder stake or more in either: (1) assets worth NZ\$100 million or above; and (2) sensitive land. In other words, despite the CNZFTA’s declared “investment facilitation” clauses, many Chinese bids still need to face NZ’s domestic screening mechanism, and so face the possibility of being declined. Articles 142, 144 and 145 elaborate measures to safeguard fair and equitable treatment, compensation for losses, and expropriation, which provide key protections to improve investors’ confidence. According to these measures, neither China nor NZ shall expropriate or nationalize investments of investors of the other Party in its territory, unless it is in accordance with applicable domestic law, or for a public purpose, or carried out in a non-discriminatory manner. Although these arrangements help “minimize the risk of arbitrary government action on established investment and ensure that any such actions are appropriately compensated in the event they occur”<sup>501</sup>, the implication is that two parties only concede to transfer limited sovereignty and that domestic laws still bear paramount significance (particularly in a form of veto) over transnational investment disputes.

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<sup>498</sup> Chapter 11, article 138: China-New Zealand FTA

<sup>499</sup> Chapter 11, article 139: China-New Zealand FTA

<sup>500</sup> Paul Comrie-Thomson, "Uncertain Opportunities: Chinese Investors Establishing Investments in New Zealand," (Wellington, New Zealand: New Zealand Contemporary China Research Centre, University of Wellington, 2013).p.9

<sup>501</sup> NZMFAT New Zealand Ministry of Foreign Affairs and Trade, "New Zealand - China Free Trade Agreement - National Interest Analysis," (2009).p.21

As indicated in the *2011 Joint Report*, Chinese investments in New Zealand used to be concentrated in the property and natural resource sectors but more recently these have extended into other sectors such as dairy processing and manufacturing. (See Table 4.4) In addition, as a supplement to CNZFTA, the People’s Bank of China and the Reserve Bank of New Zealand signed a bilateral local currency swap agreement (NZ\$ 5 billion) in April 2011 to facilitate two-way investment. Then, in April 2014, the two parties announced the renewal of this deal (NZ\$ 5 billion), which has a three-year maturity and can be extended if both agree.

**Table 4.4: Major Chinese Investments in New Zealand (2008-2013, millions)**

Time	Investor	Quantity	Share Size	Partner	Subsector
2012-04	Shanghai Peingxin	\$170	100%	Crafar Farms	Agriculture
2012-10	Haier	\$680	89%	Fisher & Paykel	Consumer
2012-11	Yili Industry	\$170	100%	Oceania Dairy	Agriculture
2013-02	Yashili International	\$180	n/a	n/a	Agriculture
2014-03	Beijing Capital	\$800	n/a	Transpacific	Utilities

Source: *China Global Investment Tracker Interactive Map*, available at <http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map>

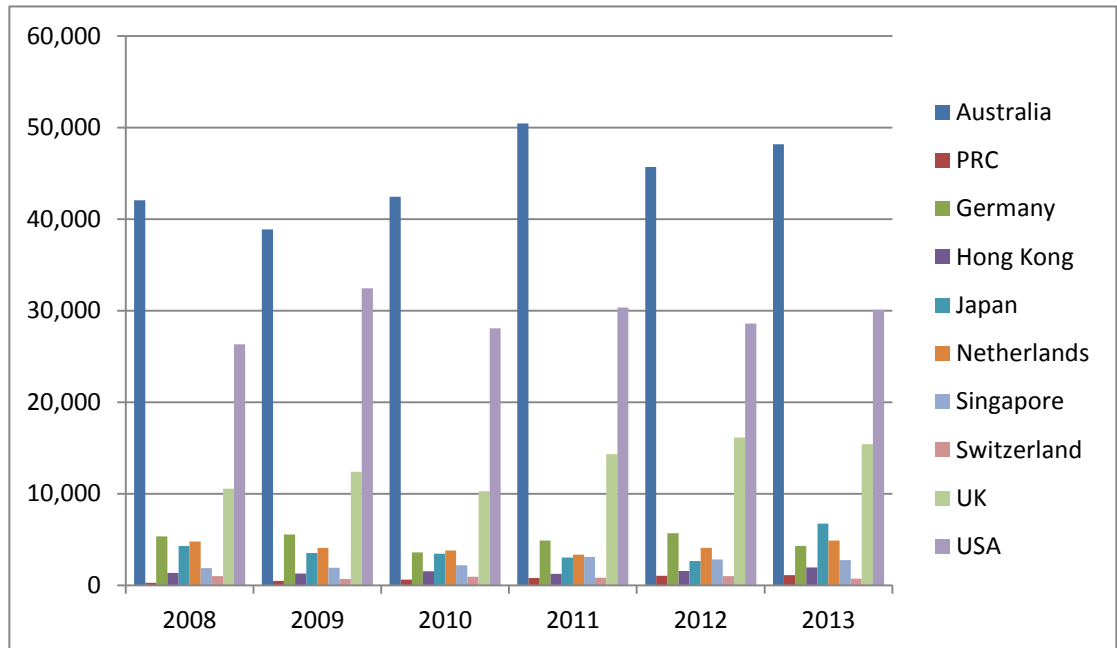
Five years after inception, changes in investment flows as a consequence of the FTA are minimal. Neither party ranks high in its counterpart’s investor list. As shown in Figure 4.4 (and Appendix 4.2), in 2013, New Zealand was China’s 9<sup>th</sup> largest investor - while the investment amount reached an historic high, its share of China’s overall investment declined.<sup>502</sup> In the meantime, China was New Zealand’s 10<sup>th</sup> largest investor, which is anomalous with its position as Asia’s largest outward investor and New Zealand’s biggest trading partner. It should be noted that New Zealand is not the only country that gives Chinese investors the cold shoulder. As stated by Pascal Lamy, the WTO Director-General, there was a perception that China was “grabbing resources, being colonialist ... stealing technologies ... it gives the view that this is a country that doesn’t play by the rules”.<sup>503</sup> As will be further discussed in the strategic analysis, although Beijing tries to salvage its reputation, partly by trying to ensure its investments follow CNZFTA rules, its image still has not improved. Worse, this adverse image has

<sup>502</sup> Commission, "China-New Zealand Free Trade Agreement 2-Year Review Joint Report." p.41

<sup>503</sup> Louise Armistead, "Davos 2012: China calls for forbearance over its image problem," in *The Telegraph* (2012).

greatly impeded its ongoing FTA negotiations with other developed economies, such as Australia.

**Figure 4.4: New Zealand’s Inward Investment (NZ\$ million) <sup>(1)</sup>**



Note: (1) Includes stocks of financial derivatives.

Resource: *Balance of Payments and International Investment Position: Year ended 31 March 2013*, available at

[http://www.stats.govt.nz/browse\\_for\\_stats/economic\\_indicators/balance\\_of\\_payments/BalanceOfPaymentsYearEnded\\_HOTPYe31Mar13.aspx](http://www.stats.govt.nz/browse_for_stats/economic_indicators/balance_of_payments/BalanceOfPaymentsYearEnded_HOTPYe31Mar13.aspx)

In short, this section reveals that the bilateral merchandise trade gap in New Zealand’s favor has grown significantly since the inception of the CNZFTA, particularly in dairy exports. As we shall see in the next section, this phenomenon has raised deep concerns in China and greatly shaped its ongoing dairy reform. The result also finds that Sino-NZ economic relations are highly asymmetric. In both merchandise and service trade, New Zealand enjoys an obvious surplus with China, exposing its asymmetric reliance on the Chinese market. The other asymmetry exists between trade and investment. Compared with the burgeoning bilateral trade, two-way investment remains stagnant, revealing the FTA’s limited effects on investment promotion. In the following section, I will analyze how the CNZFTA’s asymmetric nature shapes its diffusion effects in other free trade deals such as the CAUFTA and TPP.

### 4.3 The CNZFTA and China's Dairy Reform

Dairy products account for the bulk of New Zealand's exports to China, a seemingly logical result of the CNZFTA. The FTA was signed in the immediate aftermath of China's 2008 Sanlu Company melamine crisis. After drinking baby formula tainted with melamine and produced by Sanlu, 6 children died, 53,000 became ill and 13,000 were hospitalized for kidney stones.<sup>504</sup> This episode is frequently cited by scholars as the catalyst for the Chinese government's liberal inclination to 'regulate' the domestic dairy industry by introducing foreign competition. Yet closer scrutiny of China's dairy industry refutes this viewpoint. The CNZFTA is closely intertwined with China's two-phase dairy reform, led by the Hu Jintao and Xi Jinping administrations. In order to investigate their correlation, this section selects the Chinese Mengniu Company and the New Zealand Fonterra Company, both deeply involved in the Sanlu crisis, as empirical cases. A periodization might be useful here, with the handover of power from Hu to Xi as a watershed. In the initial stages of FTA reform and liberalization, foreign dairy giants were invited to facilitate China's dairy reform. But when the feeling of economic insecurity emerged, the Chinese government, manipulating the second stage of reform, began to crack down on foreign companies. Meanwhile, the government kept guard over national dairy giants from beginning to the end, rendering it susceptible to a realist assessment that maintaining economic sovereignty always outweighs market efficiency.

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<sup>504</sup> On the eve of Sanlu crisis, most dairy companies' raw milk was sourced from small and private milk stations without license. In the lust for profits, these stations either fed cows with illicit feedstuff bulked up with industrial chemical melamine, or directly added melamine into milk. Dairy companies were no less to blame – they bought whatever raw milk was available, even though they knew that their raw materials were poisonous. This condition would get worse when dairies and local leaders collude – the former can gain an upper hand over competitors by rent-seeking, whilst the latter provide political umbrella to improve *zhengji* (政绩, record of governmental performance). Politically, the central government regulated the dairy industry by assigning different dairy segments to different administrative agencies. For instance, the Ministry of Agriculture (MOA): the production of raw milk; the Ministry of Health (MOH): dairy consumption; the General Administration of Quality Supervision, Inspection and Quarantine (GAQSIQ): dairy processing; and provincial governments: the overall dairy security in their jurisdictions. (Eventhough, the Chinese central government still enjoys a control power over dairy companies, which can be seen its effectiveness in initiating and implementing policies in the market.) In this circumstance, agencies would naturally shift responsibility to each other whenever a dairy crisis breaks out. See Luke Nottage, "Consequences of Melamine-laced Milk for China, NZ, Japan and Beyond," (East Asia Forum, October 2008).

The dairy case illustrates Beijing's desire is not only to attain self-sufficiency, but also to project promising national brands into the global dairy market.

### **4.3.1 The first round of dairy consolidation**

#### *China's crisis-driven liberal trial*

From 2000 to 2007, China's dairy industry experienced a golden era, with total dairy production jumping from about 14 million to 70 million tons. It took less than one decade to achieve what its western counterparts took many decades to achieve, but this apparent success concealed many problems, eventually culminating in the 2008 Sanlu crisis. Soon twenty-seven countries banned Chinese-sourced dairy products. Worse, breaking out shortly after the historically successful Beijing Olympics, the Sanlu incident thrust the CCP government into an unflattering spotlight regarding its contradictory state capacity: the same government capable of pulling off mega projects and events like the Olympics could not even ensure food safety.<sup>505</sup> To revive its international image and appease the domestic public, Beijing launched the first round of national dairy reforms on the one hand, and signed a free trade agreement with New Zealand, on the other.

The reform was initiated by the State Council and implemented by the General Administration of Quality Supervision, Inspection and Quarantine (GAQSIQ), the country's quality watchdog. In a nation-wide inspection, 1,031 dairy companies and 145 baby formula producers were all required to re-apply for production licenses – a core component of the inspections was to determine whether they had advanced devices to test additives. The price of such a device is 3-4 million RMB. Apparently, small and medium-sized companies could not raise enough money to buy such expensive equipment. In the end, only half the inspected companies passed this criterion: 426 were shut down immediately, while 107 were required to update their equipment.<sup>506</sup>

In the meantime, Beijing made a bold decision to speed up the implementation of the CNZFTA. Before ratifying the CNZFTA, Beijing was cognizant of possible negative economic effects, as documented in the Feasibility Study, and there were many warnings from Chinese economists.<sup>507</sup> Nonetheless, it only took 6 months for the trade

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<sup>505</sup> Yuefan Xiao, "The Politics of Crisis Management" (University of Warwick, 2013), p.259

<sup>506</sup> Xinhua, "426 Dairy Firms to Close After Inspection," China Daily April 03, 2011.

<sup>507</sup> Zealand, "A Joint Study Report on a Free Trade Agreement Between China and New Zealand."

deal to enter into force (from April to October 2008), making it the shortest period between signing and implementation amongst all Chinese bilateral FTAs.<sup>508</sup> Perhaps not coincidentally, this period overlapped with the Sanlu crisis. Clearly, the CNZFTA may not have been implemented in such a speedy fashion without the melamine panic as a stimulus. Given the two countries' comparative advantage, this trade deal was geared to serve as a means of: (1) justifying domestic reform and dampening the opposition of vulnerable domestic dairies; (2) providing external incentives for domestic dairies to improve enterprise performances and efficiency; and (3) studying advanced management and production experiences from New Zealand. To many China observers, Beijing was sliding toward liberalism because the FTA's logical starting point is congruent with liberal arguments regarding using international regimes to promote domestic economic reforms.<sup>509</sup>

Immediately after exposure of the melamine scandal, foreign-sourced dairy products, particularly infant formula, became white gold in the eyes of Chinese parents, who cannot afford to take risks due to the "one-child policy". China soon became the most lucrative market in the eyes of international dairy enterprises. Fonterra has been one of the biggest beneficiaries, even though it held 43% of Sanlu shareholding when the crisis broke out. To many people's surprise, it was not charged for complicity with its former joint-partner. Instead, the company successfully distanced itself from Sanlu by responsibly working with the New Zealand government to push China to disclose information about poisoned products. It also quietly wrote off \$200 million of its shareholding in the now-defunct joint venture, and donated a US\$5 million "check" to the Song Qingling Foundation to support the construction of maternal and infant community hubs in rural China.<sup>510</sup> This was successful crisis management, with Fonterra exhibiting a responsible entrepreneurial spirit to the Chinese public. Thanks to the CNZFTA's fresh impetus, China became Fonterra's biggest offshore market and the

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<sup>508</sup> Normally it takes a year or longer for China to approve the implementation of an FTA. The China-Costa Rica FTA, for example, signed in April 2010 and entered into force in August 2011. Among all Chinese bilateral FTAs, the CNZFTA is the fastest to take effect.

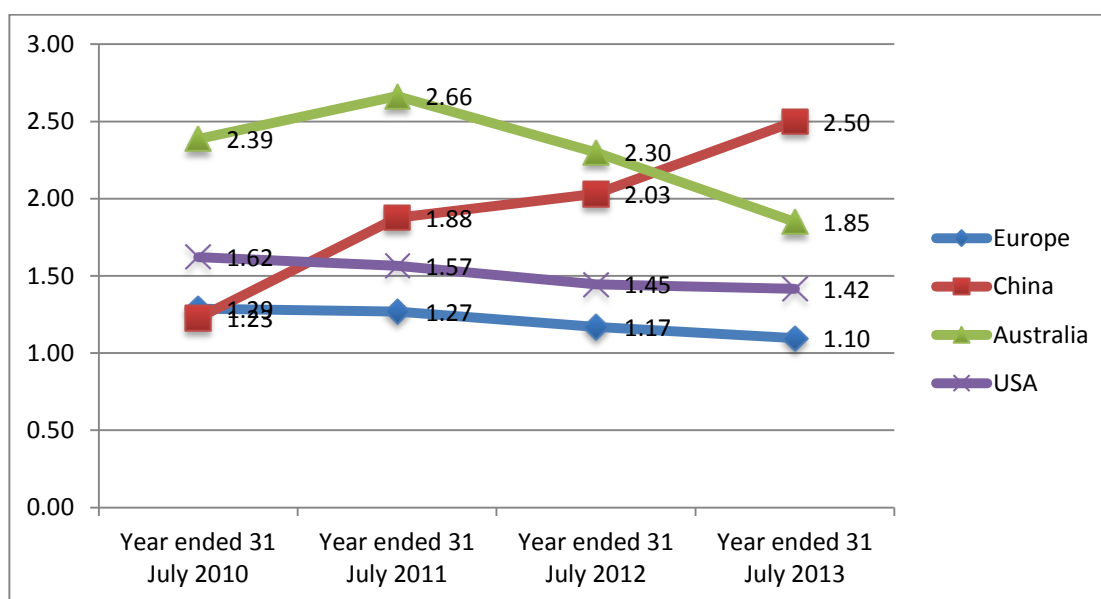
<sup>509</sup> See Jian Yang, "China's Competitive FTA Strategy: Realism in a Liberal Slide," in *the International Symposium "Competitive Regionalism"* (Waseda University, Tokyo: Waseda University Global COE Program, 2008).

<sup>510</sup> Fran O'Sullivan, "So Long, Sanlu," *The New Zealand Herald* May 2, 2009.



second largest revenue resource in 2010 - Australia was the largest one, but was surpassed by China in 2013 (see Figure 4.5).<sup>511</sup>

**Figure 4.5: Fonterra’s Geographical Segment External Revenue (US\$billion)**



*Resource: Fonterra Annual Report 2011, 2012, 2013*

Fonterra was not the only New Zealand company to seize a “white gold rush” opportunity in China – more than 100 baby milk brands (many with links to Chinese speculators) were created in New Zealand to feed China’s demand.<sup>512</sup> At the end of the first round of reform, the top 20 global dairy giants such as Nestle all had a notable presence in China, either exporting final products, or building joint ventures with local farmers and processors. According to a 2012 AC Nilsen report, foreign infant formula entrepreneurs successfully grabbed more than 70% of the Chinese market compared with less than 30% prior to the 2008 scandal.<sup>513</sup>

#### *Economic security is paramount*

<sup>511</sup> FTA sceptics, in contrast, may voice reservations or cautions about ascribing Fonterra’s expansion purely to the CNZFTA. However, a closer look at the sharp divergence in dairy export performance between New Zealand and Australia indicates that the FTA does seem to be playing an inextricable role. After achieving an FTA with China, NZ has experienced an eightfold increase in the total volume (tonnes) of dairy exports to that country, while Australia has only seen modest export growth during the same period. See Noel Campbell, "Dairy Bakns on China FTA: tariff on exports should fall to the same level as NZ," *The New Zealand Herald* July 22, 2014.

<sup>512</sup> Christopher Adams, "End of the White Goldrush?," *The New Zealand Herald* Mar 7, 2014.

<sup>513</sup> "In China, Premium Sells: From Toothpaste to Cars to Banking," (AC Nielsen, May, 2013).

The massive inroads of foreign dairy producers heightened Beijing's feelings of economic insecurity.<sup>514</sup> This is a concept highlighted in neorealist literature, which assumes that states' economic sovereignty is gradually weakened by globalization and liberalization.<sup>515</sup> In the China context, economic security (*jingji anquan*, 经济安全) is defined as "the security of those factors crucial to national economic (including technological) strategic development, which enable a state to maintain a lead in international competition and economic cooperation, and particularly in maintaining the domestic market and expanding its export market".<sup>516</sup> Obviously, the aftereffects of the CNZFTA went against the Chinese-style definition of "economic security".

The Chinese government believes that poor economic security would engender political disorder.<sup>517</sup> The dairy sector is a crucial economic artery. It not only matters to consumers, but is also associated with the welfare of millions of farmers and herdsmen. Losing control over the sector also means losing status as a price setter, mounting market uncertainty, increased costs of adjustments, and decreased macro tightening ability (*hongguan tiaokong*, 宏观调控). Decades of reform experience taught Beijing that "big government is by definition uncompetitive".<sup>518</sup> Taking notes from this logic,

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<sup>514</sup> See Martin Wolf, "Will the nation state survive globalization?," *Foreign Affairs* 80, no. 1 (2001); Hongying Wang, "China's Changing Approach to Sustainable Development," *Development* 50, no. 3 (2000).

<sup>515</sup> Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?," p.791. See also Haggard, "The Political Economy of Financial Internationalization in the Developing World."

<sup>516</sup> Jiao Hong, "Shixi 21 shijichu woguo anquan huanjing mianlin de tiaozhan [An Essay on the Challenges Facing China's National Security Environment at the Beginning of the 21st Century]," *Guofang Daxue xuebao (Journal of the National Defence University)* 3, no. 31 (2000), p.3. China's nation-wide discussion on "economic security" first began in 1997, amidst the turmoil of the Asian Financial Crisis. The 16<sup>th</sup> National Congress of the Communist Party of China, "safeguarding national economic security" was raised to the strategic level. See Yeung, "China in the era of globalization: the emergence of the discourse on economic security." , and Zhengyi Wang, "Conceptualizing economic security and governance: China confronts globalization," *Pacific Review* 17, no. 4 (2004), p.528

<sup>517</sup> On April 5, 2014, President Xi Jinping raised the notion of "national security with Chinese characters", with people's security as the goal, political security as the fundamental mission, economic security as the basis, military, cultural and social security as its guarantee, and international security as the major support. Different "securities" undertake different missions, which are closely intertwined with each other, and none of them is dispensable. See Xiangyang Chen, "Xi's Speech A Rallying-Call For National Security" (China vs US Focus, April, 2014).

<sup>518</sup> See Christopher Pierson, *Beyond the Welfare State?* (Cambridge: Polity Press, 1991). Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?." For example, Japan's temporary

the CNZFTA may not be a road to prosperity, but a path to dependency and crisis. As we shall see, the Mengniu saga in the post-Sanlu era testifies to the fact that Beijing's liberal inclination is much weaker than much contemporary rhetoric suggests. As Yang Jian noted, in terms of China's FTA strategy, while liberal thinking has laid a foundation, its actual practice is still determined by realist logic.<sup>519</sup>

In an *ad hoc* overhaul of the dairy industry launched at the end of 2008, the GAQSIQ announced that there were twenty-one more major baby formula producers adding melamine to their products, including Mengniu, a reputable private company in China. Unprecedented consumer boycotts of domestic-sourced milk powder caused Mengniu a loss of RMB460 million in 2008. Soon afterwards, Mengniu's stock dived to HK\$6.03, having traded at HK\$35.80 in October 2007. Then in July 2009, when Mengniu was at its lowest ebb, the China Oil & Foodstuffs Cooperation (COFCO), China's biggest state-owned food company, together with Houpu Investment Management, injected HK\$6 billion into Mengniu. This bid made COFCO the major shareholder in Mengniu (about 20.3%). At the end of 2011, it raised its shareholding to 28.4%. In July 2011, the COFCO's president, Frank Ning, a member of the Chinese People's Political Consultative Conference in 2008, was appointed as Mengniu's chairman, marking Mengniu's formal entry into COFCO.<sup>520</sup>

The entry of a government-owned player injected not just a much-needed dose of cash, but more significantly, identity as a quasi-SOE. This is why many Chinese netizens joke

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protection of its domestic market ensured that local producers of items such as semiconductors and computers achieved international competitiveness. See Charles Lipson, "The Transformation of Trade: The Sources and Effects of Regime Change," *International Organization* 36, no. 2 (1982), p.249

<sup>519</sup>Yang, "China's Competitive FTA Strategy: Realism in a Liberal Slide.", p.7

<sup>520</sup> Frank Ning's career history suggests that he is by no means an agricultural liberalizer but the opposite. On his website, he tells a story of "a tiger and 26 small pigs." –When a wolf came into a new mountain, it found 26 small pigs and ate them one by one without resistance; one day the wolf encountered a tiger which it thought was as weak as those small pigs, but the result was that the wolf was eaten by the tiger. This story clearly represents Frank Gao's economic ideas – foreign enterprises (wolves) may enter into China and squeeze-out small-scale local companies (pigs), but they can hardly conquer local giants (SOEs). He always calls himself the "cowherd of SOEs" – the Mengniu-bid actually introduced another cow into his herd. See <http://baike.baidu.com/view/273378.htm?fr=aladdin>

that the Mengniu (蒙牛) is now a Hongniu (红牛, red-cow).<sup>521</sup> China watchers may be familiar with marriages between problematic private companies and SOEs, a practice identified with traditional Chinese statecraft and coined “grasp the big and abandon the small” (*zhuada fangxiao*, 抓大放小). In the first round of reform, small and weak ones were forced to withdraw from the market, whilst the rest were rescued inasmuch as they were “too big to fail”. Such a practice allows Beijing to reap the general benefits of liberalization without hurting economic security. Some scholars identify it as “Sino-capitalism” – the CCP trusts less in free market and free competition, but more in unitary state rule, orderly competition, and increasing state assets.<sup>522</sup>

International dairy giants also invested in MengNiu. For example, both Danone (France) and Arla Foods (Denmark) became Mengniu shareholders, holding 4% and 5.7% respectively.<sup>523</sup> These companies are expected to improve Mengniu’s technology and provide an image of internationalization, but COFCO remains the single largest shareholder. This is equivalent to building a controlled subsidiary in the form of joint venture by ceding a small proportion of its shares to foreign companies. The parent SOE actually improves the value of assets being controlled by government. Due to these efforts, Mengniu maintained its leading role in the Chinese dairy market (mainly in terms of liquid milk). As *The Economist* pointed out:

The crisis of liberal capitalism has been rendered more serious by the rise of a potent alternative: state capitalism, which tries to meld the powers of the state with the powers of capitalism. It depends on government to pick winners and promote economic growth.

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<sup>521</sup> The name Mengniu (蒙牛), means “cows in Inner Mongolia”, where the company was built. Hongniu (红牛) is a pun: on the one hand it refers to a famous energy drink (red bull), on the other hand it means “cows in Inner Mongolia” where cows are colored red because red normally symbolizes communist authorities.

<sup>522</sup> See McNally, "Sino-Capitalism: China's Reemergence and the International Political Economy." p.757; and Yukyung Yeo and Martin Painter, "Diffusion, transmutation, and regulatory regime in socialist market economies: telecoms reform in China and Vietnam," *The Pacific Review* 24, no. 4 (2011).pp.383-384

<sup>523</sup> According to the latest J.P. Morgan report, Danone raised its stake in Mengniu to 9.9% (4% previously). COFCO remains as the largest shareholder with 16.3% stake (18% previously) and Arla reduced to 5.3% (5.7% previously). J. P. Morgan, "China Mengniu Dairy CO. Ltd.," in *Asia Pacific Equity Research* (J. P. Morgan, February, 2014).

But it also uses capitalist tools such as listing state-owned companies on the stock market and embracing globalization.<sup>524</sup>

All in all, trapped between a domestic problematic dairy industry and increasing public concerns over food security, China's dairy strategy in the latter phase of Hu administration is characterized by introducing international competition on the one hand, and consolidating the domestic market on the other. As a result, what Hu left to his successor was the emergence of domestic giants, the exodus of small producers, and an influx of foreign brands.

This period also saw the emergence of a distinctive economic feature "drastically Bring-in and hardly Going-out." Whilst China became the largest dairy importer, Chinese dairies enjoyed little presence internationally, connoting their limited appeal in other countries. The signature of the CNZFTA kicked off Fonterra's magic journey in China, but given Mengniu's marriage with the COFCO, much left to be desired in the post-Hu era. The remainder of this section now turns to China's second round dairy reform to solve the puzzle of Beijing's apparent "pro-liberalism" position under Xi Jinping's leadership.

#### **4.3.2 The second round of reform and dairy consolidation**

Soon after Xi Jinping and his six colleagues on the Politburo Standing Committee came into power in March 2013, the second round of dairy reform was launched. At an executive meeting of the State Council held on 31<sup>st</sup> May 2013, Premier Li Keqiang vowed to launch national campaigns to ensure the security of dairy products, supervise milk sources, standardize manufacturers and sellers of baby formula, and punish producers who do not meet the standard.<sup>525</sup> A week later, Vice-Premier Wang Yang held a special seminar, requiring the Ministry of Industry and Information Technology (MIIT), and other concerned ministries, to formulate a draft for promoting mergers and acquisitions (M&A) among baby formula producers. Then at the 2014 State Council No. 1 Central Documents, agricultural developments were made a key priority and the industrial sector was required to back and promote agriculture.<sup>526</sup> Taking their cue from top leaders, the MIIT issued a famous action-plan to improve dairy quality and boost

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<sup>524</sup>Special Report: state capitalism, "The Visible Hand.," *The Economist* 402, no. 8768 (2012).p.3

<sup>525</sup> An Baijie and Wang Xiaodong, "Li Calls for Action on Baby Milk," *China Daily* June 01, 2013.

<sup>526</sup> Xinhua, "No.1 Central Document Targets Rural Reform," (Xinhuanet, January).

consumer confidence.<sup>527</sup> Soon afterwards it cooperated with eight other government agencies and announced the new quality control guidelines for infant formula producers.<sup>528</sup>

These activities entrenched the MIIT as the spearhead of the second round of consolidation. In the meantime, widespread speculation emerged that the Ministry would handpick five dairies as the “national team” to share government subsidies (30 billion RMB, \$4.92 billion).<sup>529</sup> At least three of the selected five confirmed this fund.<sup>530</sup> However, in a press conference held in September 2013, MIIT officially denied this speculation. Some analysts conjectured that the CCP wanted to abstain from an image of blatantly intervening in the market. As stated by a report, “the ministry spent three months on a list (of big companies swallowing smaller rivals) but can’t publicly admit to supporting the idea of a national team, as it should support market behavior.”<sup>531</sup>

But the latest reform plan, drafted by the MIIT and approved by the State Council, suggests that the above conjecture is wrong. According to this plan, by the end of 2018, the production share of the top 10 Chinese infant formula companies will increase from current 43% to more than 80%; the other goal is to cultivate 3-5 baby formula giants with annual sales over RMB 5 billion. In other words, China’s dairy industry is heading towards an oligarch era. Hence, will the Chinese government gradually withdraw from the market? No, the CCP is doing the exact reverse. Does China care about a negative

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<sup>527</sup> MIIT, "Regulation on the Supervision and Administration of the Quality and Safety of Dairy Products," ed. Ministry of Industry and Information Technology of China (Beijing 2013).

<sup>528</sup> The rest of the Ministries are respectively, China Food and Drug Administration, the Ministry of Public Security, General Administration of Quality Supervision, Inspection and Quarantine, National Health and Family Planning Commission, Ministry of Agriculture, Ministry of Commerce, General Administration of Customs, and State Administration for Industry & Commerce.

<sup>529</sup> See J. P. Morgan, "China Infant Formula Industry Consolidation: Famous Five? - Alert," in *Asia Pacific Equity Research* (J. P. Morgan, September 23, 2013). Wang Fangqing, "China's Dairy Industry Heading for Consolidation," (Nikkei Asian Review, November 20, 2013). Adam Jourdan, "China Milk Makers Including Yili, Mengniu to Get State Support: report," (Reuters, September 22, 2013). The five members are Mengniu, Yili, Wondersun, Treasure of plateau, and Feihe. The scale of the national team was expanded into six, with Wissun International Group was also selected.

<sup>530</sup> Qu Yunxu and He Chunmei, "China's Dairy Market Policies Clear as Milk," (Caixin Online, October 23, 2013).

<sup>531</sup> Ibid.

image emerging from intervening in the market? No, economic security and independence are always more important. As David Shambaugh puts it:

China is, in essence, a very narrow-minded, self-interested, realist state, seeking only to maximize its own national interests and power. It cares little for global governance and enforcing global standards of behavior (except its much-vaunted doctrine of noninterference in the internal affairs of countries). Its economic policies are mercantilist and its diplomacy is passive.<sup>532</sup>

The new round of consolidation emboldened Mengniu to make tremendous investments in both upstream and downstream segments of the industry chain. Upwardly, it increased its stake in the Modern Dairy Holdings Ltd., China's biggest dairy farming company to better control its locally-sourced milk.<sup>533</sup> Downwardly, it purchased a US\$1.6 billion stake in Yashili, a Chinese leading baby formula producer with a 5 percent market share, to entrench better performance in this lucrative segment (previously a mere 0.2%).<sup>534</sup> This purchase is the biggest acquisition in the dairy industry in China, and J. P. Morgan estimated it would add 19% to its estimation of Mengniu's earnings for the 2014 fiscal year.<sup>535</sup> These successful acquisitions should strengthen Mengniu's position as a quasi-SOE, which enables it to get highly preferential treatment such as easy access to cheaper lands, more government funds, and tax rebates.

It is noteworthy that prior to Mengniu's bid, Yashili was already well underway with its investment (approximately RMB 1.1 billion) in New Zealand where it was building an infant formula plant to produce 52,000 tons of milk powder for export to China.<sup>536</sup> New Zealand's Overseas Investment Office (OIO) approved this proposal in March 2013, in accordance with the CNZFTA, which allowed Chinese companies to buy New Zealand farmland legally. The well-timed acquisition of Yashili contributed a lot to Mengniu's initial entrance into the global market. It now holds more than 30 percent of the Chinese dairy market, ranking it the second in the domestic market and 15th in the world, with a

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<sup>532</sup> David L. Shambaugh, *China goes global : the partial power* (New York: Oxford University Press, 2013).p.310

<sup>533</sup> Bylsabella Steger, "China's Scandal-Tainted Dairy Industry Takes a Step Forward," (The Wall Street Journal, May 8, 2013).

<sup>534</sup> Morgan, "China Infant Formula Industry Consolidation: Famous Five? - Alert."

<sup>535</sup> Alexander Speirs, "China's Dairy Revolution," *The New Zealand Herald* April 16, 2014.

<sup>536</sup> Alexander Speirs, "China's Champions of the Dairy Boom," *The New Zealand Herald* April 16, 2014.

share of 5.7 percent in the global market in 2013.<sup>537</sup> Given the fact that Beijing continues to support the scaling up of domestic dairy giants, and the solid execution of Mengniu's ongoing acquisition, the company is expected to play a bigger international role in the foreseeable future. This again reminds us the Chinese-style "economic security" – surviving domestically is only a matter of expediency, the ultimate goal is "to form large state enterprises in the pillar and strategic industrial sectors to take full advantage of economic scale and technological spillover effects, and compete with Western giants on a level playing field".<sup>538</sup>

In contrast to Mengniu, Fonterra experienced different fortunes after Xi Jinping came to power. In January 2013, the NZ Ministry of Primary Industry issued a statement about traces of the agricultural chemical dicyandiamide (DCD) being found in some Fonterra products. Then in August 2013, Fonterra announced that 38 tons of whey protein concentrate it exported to seven countries (including China), was suspected of being contaminated with bacteria, which may cause botulism.<sup>539</sup> Danone, Mengniu's second largest shareholder (9.9%), immediately terminated its contract with Fonterra and started legal action against it. Two weeks later, Westland Milk, another New Zealand company, revealed excessive levels of nitrate in two batches of lactoferrin powder (a protein product) also sold to China.<sup>540</sup> In response, the Chinese government temporarily suspended importation of the company's whey powder and dairy base powder. Zhang Fan, the Commercial Counselor at the Chinese Embassy in Wellington, warned New Zealand that "Mistakes should not be repeated again and again. Three times and you are out".<sup>541</sup>

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<sup>537</sup> According to the report, Fonterra remained as one of the top 4 global dairy companies with a market share of 16%, whilst Yili moved up to 12<sup>th</sup> with a share of 6.5%. See Fonterra, "Fonterra Annual Report 2013," (Fonterra, 2014). In 2013, Mengniu's milk powder revenue was RMB 1.5 billion, of which Yashili contributed 68.9%. See "Mengniu Endeavours to Transformation, Splitting Non-Milk Powder Business From Yashili," (Chinese Business Journal, April 02, 2014).

<sup>538</sup> Hong Yu, "The Ascendancy of State-owned Enterprises in China: development, controversy and problems," *Journal of Contemporary China* 23, no. 85 (2013).p.164

<sup>539</sup> Botulism is a potentially fatal illness with symptoms including blurred vision, muscle weakness and paralysis. See Christopher Adams, "Reputation will Return: economist," *The New Zealand Herald* August 21, 2013., and Wang Shanshan, "Closer Look: Fonterra Disappoints Public with Handling of Latest Dairy Crisis," (Caixin Online, August 07, 2013).

<sup>540</sup> Adams, "Reputation will Return: economist."

<sup>541</sup> Shanshan, "Closer Look: Fonterra Disappoints Public with Handling of Latest Dairy Crisis."



Although Fonterra dealt with these problems poorly, Chinese importers were equally incompetent because not a single importer or producer of the tainted Fonterra products found the bacteria during their production process. But in the ensuing Chinese media coverage, all responsibilities were shifted to Fonterra, claiming that “foreign milk powder is stepping down the altar” and “Fonterra’s losing its iconic image”.<sup>542</sup> Panic over New Zealand dairy products soon spread amongst Chinese parents, because the country accounted for 80% of China’s dairy importation. Some New Zealand netizens believed that this was a deliberate crackdown on Fonterra, and struck back. “Their (Chinese) state media denigrates our national brand at every opportunity and at the same time they’re aggressively trying to buy productive land”.<sup>543</sup>

Worse for Fonterra, a remarkable characteristic of the second round of reform was a clamping down on foreign dairies - a measure seldom observed during the Hu-Wen era. In July 2013, the National Development and Reform Commission, China’s top economic planning body, slapped fines on six foreign dairy giants (including Fonterra), totaling 670 million RMB, for alleged price collusion and for violating China’s anti-monopoly law.<sup>544</sup> Moreover, a month after the botulism crisis, the SAQSIQ issued a new regulation that all baby formula producers exporting to China were required to be registered with the Chinese Government by May 1, 2014. In March 2014, four inspectors from China’s Certification and Accreditation Administration arrived in New Zealand to audit local baby formula producers (including Fonterra and Westland Milk). Although audits are commonplace in the food industry, it is the first time Chinese officials audited New Zealand companies, indicating an ever-stricter scrutiny of foreign

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<sup>542</sup> Peng Jinmei, "Foreign Milk Powder Frequently Appear in the "Black Board" - Stepping Down From the Altar [Yang naifen zaihua pinshang "heibang", weilai huojiang zouxia "shentan"]," (China Economic Network, December 31, 2014); "DCD Makes Foreign Milk Powder Fall From the Altar [erju qingan rang yang naifen zouxia shentan]," (People.com, January 28, 2013).

<sup>543</sup> Tim Groser, "Our China Footprint," *The New Zealand Herald* April 16, 2014.

<sup>544</sup> At the same time, a two-litre bottle of New Zealand made milk can be sold at a skyrocket price of NZ\$23 in Beijing and Shanghai, a price no Kiwi would expect to pay at the local dairy, making China the most lucrative market in the world. See David Fisher, "China Likes Our Milk at \$23 a Bottle," *The New Zealand Herald* March 15, 2014. The other five are Nestle, Danon’s Dumex unit, Mead Johnson, Dumex,(repetition of Dumex) Biostime. See Fangqing, "China's Dairy Industry Heading for Consolidation." , and Shefali Sharma and Zhang Rou, "China's Dairy Dilemma: The Evolution and Future Trends of China's Dairy Industry," in *Global Meat Complex: The China Series* (Institute for Agriculture and Trade Policy, February 2014).p.20

brands.<sup>545</sup> As a result, only 13 New Zealand dairies (including Fonterra) met the new standard, with more than 100 small players being wiped from the supermarket shelves.<sup>546</sup>

### *Fonterra leans towards Mengniu*

Currently, Beijing sends a clear signal to foreign dairies that if they want to be a shareholder in China's dairy market, they need to make their contribution to improving it. Fonterra's board read the Chinese government's semaphore. As Fonterra's chairman Kelvin Wickham stated, "It is very important that we look at the role we can play to help support the dairy industry. We bring our farming upstream technology, we invest and we've got a relationship with the Ministry of Agriculture."<sup>547</sup> The important signal Fonterra received from Beijing is that it needs to partner with one of China's national champions. As Wickham put it: "Over time it makes sense to have partners in China, to be part of one of the winning amalgamations that will inevitably emerge here."<sup>548</sup>

But this compelling realization was a little bit late. In August 2013, the Fonterra CEO Theo Spierings went to China to deal with the botulism scare and to seek to talk with Mengniu's top managers. According to a report released by the Hong Kong Phenix Media, Mengniu leaders tactfully refused to meet him for fear the public would misunderstand any cooperation between the two. Frank Ning was an exemption – but he chose to see Theo Spierings in COFCO's dining room to avoid being exposed by the media.<sup>549</sup> This episode recalls that, five years earlier, Fonterra chose to keep at an arm's length from Sanlu – its former chairman, Henry van der Heyden, flew to Beijing to meet

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<sup>545</sup> See Adams, "End of the White Goldrush?." This activity is equally applied to all countries. For example, China banned all imports of British cheese after inspectors found evidence of poor hygiene standards. The ban triggered some British officials to adopt a 'tit for tat' retaliation against Chinese food imports. See Valerie Elliott, "Great Wall on China: Beijing Slaps Ban on All British Cheese After Visit to Just One Dairy, Which Does't Even Import There," *Daily Mail* May 04, 2014.

<sup>546</sup> Rebecca Howard, "Chinese Rules Won't Much Alter New Zealand Formula," (The Wall Street Journal, April, 2014).

<sup>547</sup> J. P. Morgan, "China Baby Nutrition Industry: The Goden Era is Not Over, Pressure to Build in the Long Run," in *Global Equity Research* (J. P. Morgan, September, 2013).

<sup>548</sup> Alexander Speirs, "Dairy Consolidation No Surprise: Fonterra," *The New Zealand Herald* April 16, 2014.

<sup>549</sup> Liping Liu, "Ning Gaoning Met Fonterra Leader in COFCO's Dinning Room, Prasing His Strict Controle Over Products Quality [Ning gaoning yu hengtianran zongcai shitang huimina, zanqi dui zhiliang guankong yanjin]," (Phenix Finance, Januray 11, 2014).

Wen Jiabao to clarify that Fonterra was not involved into the melamine crisis, and after his China journey the *New Zealand Herald* published an article titled “So Long, Sanlu”.<sup>550</sup> Yet the secret meeting between Frank Ning and Theo Spierings did not result in much cooperation between the two companies, mainly because Mengniu already had foreign partners like Danone from France, the world’s No. 2 dairy company. Spierings conceded that his company was “pretty late” in joining China’s dairy reform and needed to “remain on its toes to be successful”.<sup>551</sup>

After Spierings’ unsuccessful trip, the New Zealand government claimed that it would take over responsibility for managing the Fonterra crisis.<sup>552</sup> The NZ Prime Minister John Key, being well aware of the Chinese culture of “saving face”, headed to Beijing to placate the Chinese government. The timely milk diplomacy marked the third time the countries’ top leaders met within 12 months, confirming that “the advantage bestowed when New Zealand became China’s first partner in a free trade agreement in 2008 remains intact.”<sup>553</sup> Wang Lutong, Chinese ambassador to New Zealand, commented “I don’t think the Chinese top leadership has met other foreign leaders so frequently ... The figure for last year said everything about it – it was not affected (by the botulism scare).”<sup>554</sup> More importantly, according to Michael Barnett, a chief economist of the Bank of New Zealand, the brand crisis and its management were a “wakeup call” for NZ politicians and businessmen to “come to grips” with the CNZFTA.<sup>555</sup>

Market fundamentalists may feel dissatisfied with this situation and argue that free competition is *the* fundamental force for improving market efficiency. But these scholars should not forget that many developing countries have learnt bitter lessons about free markets and their industrial independence. Using the baby food/infant formula case as an example, Nestle alone controlled 74% of the Indian market; Nestle

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<sup>550</sup> O’Sullivan, “So Long, Sanlu.”

<sup>551</sup> Fran O’Sullivan, “Fonterra Ramps up China Strategy,” *The New Zealand Herald* April 16, 2014.

<sup>552</sup> Zhou Wenting, “Two More Companies Recall Milk Products,” *China Daily* August 07, 2013.

<sup>553</sup> Editorial, “Key’s Visit to China Gives Reassurance of Lasting Link,” *The New Zealand Herald* March 21, 2014.

<sup>554</sup> Claire Trevett, “Botulism Scare Made Us Wiser, Envoy Says,” *The New Zealand Herald* March 15, 2014.

<sup>555</sup> Michael Barnett, “New Zealand Urged to Lift Game: Botulism Scare a Wake-up Call,” *The New Zealand Herald* October 04, 2013.

and Mead Johnson together controlled 91% of the Philippines market.<sup>556</sup> In this context, there is a common perception among Chinese decision-makers that what China needs at the moment is to improve competitiveness, rather than expand market access. Otherwise, China would never become a global pacesetter but simply a lucrative market. This is why Beijing cracks down on foreign dairies in the name of “anti-monopoly”, whilst simultaneously nurturing its own oligopolists to prepare for its own monolithic dairy kingdom. Given this attitude, over Xi’s first year and a half in office, China’s dairy market seemed to take one step forward “Going-out” whilst taking one step backward “Bring-in”. The previous “drastic Bring-in” evolved into the current “selective Bring-in”, and the “hardly Going-out” was paving the way to “gradually going-out”.

From the perspective of maintaining economic independence, it is true that the CCP correctly diagnosed China’s dairy illness, and the proposed treatment plan seems to be in the right direction. Based on overseas lessons from France and South Korea, it is also true that SOEs can outperform private companies.<sup>557</sup> But this treatment is not without byproducts and consequences. For example, strong warnings made by government proved to be ineffective. In December 2011, the GAQSIQ announced that some Mengniu products were found to have excessive levels of aflatoxin M1 (a carcinogen) in a sampling inspection.<sup>558</sup> Although the GAQSIQ (alongside state-led media) repeatedly reinforced that domestic dairy products are safe, consumers’ anxiety seems hard to appease. The Chinese public is no longer satisfied with the government’s *ad hoc* and one-off solutions toward continuing tainted milk incidents. Mengniu’s quasi-SOE identity became the target of public criticism in the social media Weibo, which was inundated with comments expressing dissatisfaction over the government’s partial protection of Mengniu; and cynical comments were made suggesting China’s dairy insecurity was due to politician-business complicity. Against this background, the demand for foreign infant formula has leapt since Xi came to power. In 2013, China’s imported milk powder reached a historic level of 1 million tons.

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<sup>556</sup> CORIOLIS, "Infant Formula Value Chain: Part fo the ZN Pacific Economic Cooperation Council (NZPECC) Dairy Chain Project," (Auckland: CORIOLIS, January, 2014).

<sup>557</sup> B. and Chang Rothorn, H. J., "Public Ownership and the Theory of the State," in *The Political Economy of Privatization*, ed. Thomas Clark and Christos Pitelis (London: Routledge, 1993).p.57

<sup>558</sup> See Steger, "China's Scandal-Tainted Dairy Industry Takes a Step Forward.", and Caixin, "Questions Remain Over Mengniu Milk Scandal, Experts Say," (Caixin Online, December 12, 2011).

To conclude, the post-consolidation landscape will see fewer big dairies – including giant foreign players – competing for China’s market share. It indicates that Xi, similar to his predecessors, is not a risk-taker; in many respects, he is still playing the same deck of cards as Hu Jintao: the bring-in and going-out strategy. As Arthur Koeber accurately depicts: “Xi is not some Chinese version of Ronald Reagan or Margaret Thatcher: for him and his colleagues, the market is a tool, not an end in itself. Hence in choosing between an international image as a liberal, and national interest, the latter always wins.”<sup>559</sup> All in all, China’s dairy reform is at best a half-won battle - consumers get to taste the future. The transformation of Mengniu to red bull is not enough; the government needs to plan how to further transform the “red bull” into a clean, green bull. Otherwise, if China’s dairies cannot restore Chinese consumers’ trust, they won’t build a successful presence in other countries – a failure that will cast a cloud over Xi’s going-out strategy.

#### **4.4 CNZFTA and its Regime Diffusion Effects**

“Diffusion” is a core concept in institutional studies, which is defined as “the process by which institutional characteristics spread to international institutions from a point of innovation to points of potential adoption”.<sup>560</sup> It should be noted that diffusion has different orientations – a frequent classification is horizontal (cross country groups) and vertical (cross issue-areas). A given regime may generate divergent diffusion outcomes alongside different directions. Scholars provide varying explanations for successful regime diffusion, or lack thereof. Looking from the perspective of *regime supply*, realist regime literature in general highlights the role of powers, hegemonic powers in particular, in the process of regime diffusion. In contrast, liberal approaches, from the lens of *regime demand*, stress transaction costs and uncertainty amongst determinants stimulating cross-regime emulation. Constructivism, on the other hand, regards the tributary regime as a *learning platform*, by which recipient regimes acquire information and preferences in determining whether to emulate or not. All these assumptions provide much needed theoretical guidance. But in empirical research, as this section below demonstrates, it would be misleading to refer to any single paradigm

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<sup>559</sup> Arthur Kroeber, "After the NPC: Xi Jinping's Roadmap for China," (Brookings Institute, March 11, 2014).

<sup>560</sup> Ovodenko and Keohane, "Institutional diffusion in international environmental affairs." p.524

exclusively.<sup>561</sup> In line with the analytic eclecticism this thesis adopts, “we can gain a great deal by being explicit about underlying assumptions and what each approach can and cannot explain”.<sup>562</sup>

The CNZFTA provides an analytical window to explore regimes’ diffusion function for two reasons: (1) upon its establishment, the CNZFTA was widely regarded as a tool to showcase the under-negotiated China-Australia FTA,<sup>563</sup> representing a good case to test the horizontal diffusion; and (2) New Zealand is one of the founder countries of the TPP, and thus its stance on whether the TPP should contain or accommodate Beijing serves as a good testing ground for CNZFTA’s vertical diffusion effects. In both directions, the CNZFTA plays a role of tributary regime, and the CAUFTA and TPP are recipient regimes. This section argues that the processes of vertical and horizontal diffusion are not mutually exclusive but closely interwoven with each other. During this process, intervening variables including economic interdependence, military alliance and mutual learning are all at play, confirming the thesis’s eclectic approach.

To develop this idea, I first explore CNZFTA’s bumpy horizontal diffusion: why does the CAUFTA take the two countries over after nine years and 21 rounds of negotiation? The second part of this section examines CNZFTA’s smooth vertical diffusion: why New Zealand today is the most, if not the only, TPP member that strongly opposes using the TPP to curb China’s development? The third part of this section tries to answer a bigger question: since the CNZFTA locks New Zealand into TPP, will Australia emulate its Trans-Tasman neighbor to accommodate China over TPP issues after finalizing CAUFTA? I conclude by positing that Australia is unlikely to follow

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<sup>561</sup> As noted in the theoretical chapter, in studying “regime diffusion”, Alexander Ovodenko and Robert Keohane introduced a structural-liberal-constructive synthesis in regime studies. They identified several necessary and sufficient conditions for regime diffusions. As representatives of neo-liberal institutionalists, they argue that a successful diffusion requires similarities of problem structure and prior regime effectiveness as a necessary condition. But they in particular adopt an eclectic approach by encompassing factors like private interests, and power and norms as sufficient conditions. See *ibid*.

<sup>562</sup> Haggard and Simmons, "Theories of International Regimes." p.499

<sup>563</sup> Robert Ayson, "Choosing Ahead of Time? Australia, New Zealand and the US-China Contest in Asia," *Contemporary Southeast Asia: A Journal of International & Strategic Affairs* 34, no. 3 (2012); Reilly James, "Counting on China? Australia's Strategic Response to Economic Interdependence," *The Chinese Journal of International Politics* 5(2012); Tom Emerson, "What Does An Australia-China Free Trade Agreement Offer Australia?," (CMAX Communications, December 20, 2013).

New Zealand's steps due to CNZFTA's "bad" demonstration effects, and China's immature diplomacy with Western countries.

#### **4.4.1 Horizontal diffusion: from CNZFTA to CAUFTA**

*No demand, no diffusion - a liberal perspective*

From the perspective of merchandise trade, New Zealand outstrips many other countries without an FTA with China, particularly in agricultural exports. Some analyses thus view the CNZFTA as a reward to Wellington, which aims at showcasing to more powerful countries, Australia in particular, that similar rewards might accrue to them if they could secure a similar deal with China.<sup>564</sup> Australian agricultural groups, particularly dairy producers, have already voiced concerns over the CNZFTA, which disadvantaged their exports to China, and have been constantly lobbying the Australian government to seal the CAUFTA as soon as possible. As stated by Geoffrey Murray, "I have a strong feeling that the Australians are now only showing more enthusiasm because their close neighbor, New Zealand, negotiated an FTA with China in 2008 that achieved some beneficial concessions on the Chinese admission of agricultural products".<sup>565</sup> This opinion is verified by current Australian PM Tony Abbott: "Let's face it, the Kiwis, our friends across the Tasman, have had a series of agreements including one with China, which have been very good for their economy, particularly for their agricultural exports".<sup>566</sup> Therefore, the CNZFTA does generate certain benefits that Australia might want to accrue.

Looking at Sino-Australia trade over the past decade, it performed well despite the absence of a FTA. In 2013 for instance, Australia's merchandise exports to China were two times larger than its imports, recording an AU\$47.2 billion surplus.<sup>567</sup> As a result, the CAUFTA is not an urgent task to many Australians, including Craig Emerson, a former Australian Trade Minister:

My position is that, yes, it would be good to have free trade agreement – there is no doubt about that. But it hasn't ... the absence of a free trade agreement with China

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<sup>564</sup> Yang, "China's pursuit of free trade agreements: Is China exceptional?"; Yang, "China's Competitive FTA Strategy: Realism in a Liberal Slide."

<sup>565</sup> Geoffrey Murray, "Apathy, Dissent Threaten to Derail Sino-Australia FTA," *Global Times* January 20, 2014.

<sup>566</sup> Colin Bettles, "Australia: All Eyes on China FTA," *The Land* October 10, 2013.

<sup>567</sup> James Laurenceson, "Too Good to be True: Weighing up Australia's Exposure to China," (The Conversation, March 18, 2014).

hasn't in any way impeded what has been astonishing growth in the relationship. In 2010 for example, China became the biggest market for our services. We know that it's a big market ... for minerals and energy. I think there's fantastic future for good processing here in Australia for premium green products to be sold into China at what would be pretty good prices I can say. But our service industries are doing very good business in China. So I hope people don't just sit back and say 'well, we can't do anything until there's a free trade agreement'.<sup>568</sup>

As suggested by Ovodenko and Keohane, private interests always play a role in pluralist capitalist democracies, in shaping government policy on whether to join an institutional arrangement or not.<sup>569</sup> However, private interests may not always be uniform. This situation can make it difficult for governments to choose from amongst various policy preferences. Clearly, for those parties not harmed off by the CNZFTA, such as mineral exporters, a trade deal with China is not that necessary. Currently, the most enthusiastic Australian lobbyists for the CAUFTA come mainly from agricultural organizations – but their enthusiasm is likely to take a beating if they come to fully understand Fonterra's experiences in China. In this sense, the trade effectiveness of the CNZFTA would have some inevitable knock-on effects to Australia, but it does not suggest that a CAUFTA is an overwhelmingly necessity

Investment issues also help to illustrate CNZFTA's slow horizontal diffusion. This is particularly true when it comes to New Zealanders and Australians' shared aversion to Chinese investment, especially in farmlands. Some NZ media criticize the so-called "equal footing" under CNZFTA as absolute nonsense since the Chinese Land Law prescribes that people who buy a piece of land in China can only enjoy 70 years of proprietary rights, after which ownership reverts back to the government. In other words, NZ investors can only get leasehold land. Consequently, many New Zealanders now call on the government to stop "selling New Zealand to China".<sup>570</sup>

An optimal case reflecting NZ citizens' sentiment is the twisted road Shanghai Pengxin was forced to take in its efforts to buy 16 Crafar dairy farms, following the latter's

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<sup>568</sup> ABC News Business Today, "Australian Minister for Trade and Competitiveness," (April 26, 2013).

<sup>569</sup> Ovodenko and Keohane, "Institutional diffusion in international environmental affairs."p.540

<sup>570</sup> See Bernard Moran, "Kiwis Wary of China's Murky Takeover Bids," (New Zealand News Weekly, August, 2010); Bernard Keane, "They take our land! Abbott and Barnaby Go to War on Foreigners," (cRIKEY, July, 2012).



bankruptcy. Initially, Pengxin's bid was approved by the NZ Overseas Investment Office (OIO). Nevertheless, this purchase then encountered resistance from the New Zealand based Michael Fay-led consortium, which rendered Pengxin's bid subsequently rejected by the NZ Supreme Court. The NZ public also opposed Pengxin's bid. 'Campell Live', broadcast on TV3, showed that 97% of surveyed audiences did not agree with selling Crafar farms to Pengxin. But the New Zealand government finally approved Pengxin's application due to obligations prescribed under CNZFTA's MFN clauses. If Wellington had declined this application, according to Professor Jane Kelsey from the University of Auckland, it "could have faced an international law suit for breaching its free trade agreement with China".<sup>571</sup>

Now, as New Zealand enters an election year, opposition parties again raised the Pengxin case. While the current National government tries to be friendly to Chinese investors, some opponents (Labor, the Greens and Mana) have joined with the chauvinist First Party in a racist campaign to block Chinese from buying farmlands.<sup>572</sup> Clearly, Chinese investment in farmlands today is a sensitive political affair to New Zealand, even if it is of little significance to its national welfare. This is why Scott Brown, managing partner of RedFern Association, told the *New Zealand Herald* that Chinese investors were treated disgracefully: "There is a big Swiss company buying up 5 percent of our pastoral land. Japan and Australia both have invested plenty in New Zealand and the northern Europeans are buying farms in the South Island. But do we hear anything about that? Of course we don't – but we heard plenty about the Crafar farms controversy and that was a tiny deal in comparison".<sup>573</sup> Given Australia and New Zealand's similar multi-partisanship regime, what Canberra learnt from the CNZFTA is to be more prudent rather than blindly follow suit.

Beijing, on the other hand, recognized the importance of securing investment privileges under FTA arrangements. This recognition has prompted it to negotiate harder with Australia, where it has encountered enormous investment difficulties. Australia's current policy is that all investment proposals (whatever their size) from ventures with a

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<sup>571</sup> Jane Kelsey, "China Could Have Sued Under FTA If Crafar Farm Sale Declined," (Scoop, Politics - Independent News, January 30, 2012).

<sup>572</sup> Tom Peters, "New Zealand Calls for "Constructive Dialogue" on Chinese Air Defence Zone," (World Socialist Web Site, December 07, 2013).

<sup>573</sup> Paul Lewis, "Chinese Investors Treated Badly," *The New Zealand Herald* June 17, 2014.

15% or higher government stake should be approved by the Australian Foreign Investment Review Board (FIRB), the country's gatekeeper for deals with potential national-security implications. Private investments higher than the AU\$248 million threshold also require the board's approval.<sup>574</sup> Given the Australian public's attitude to Chinese foreign investment, in political and practical terms however, the threshold for most Chinese investment proposals stands at AU\$ 0, and this is reflected in a series of failed Chinese bids. Famous cases include Chinalco's bid to expand its stake in Rio Tinto<sup>575</sup> and Huawei's bid to supply parts to Australia's national communications network.<sup>576</sup> By comparison, thresholds for investments by firms from New Zealand, the US, South Korea and Japan all stand at AU\$1 billion.<sup>577</sup> Given the fact that the four countries respectively have bilateral FTAs with Australia, Beijing has made it clear that the conclusion of the CAUFTA may be clinched when Canberra relaxes investment rules.

Australia's public opinion further hinders the government making concessions. Although Chinese investors own less than 1 per cent of Australian farmland,<sup>578</sup> the 2014 annual Lowy Institute Poll shows that 56% of the population believes that the government is permitting too much Chinese investment, compared to a much smaller 34%

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<sup>574</sup> Treasurer, "Australia's Foreign Investment Policy (includes the 'Policy Statement: Foreign Investment in Agriculture'," ed. Foreign Investment Review Board Australia (Canberra 2013).

<sup>575</sup> Chinalco is a Chinese state-owned aluminium company and Rio Tinto is an Australian resource company. In February 2009, Rio Tinto's board announced its recommendation to shareholders to approve Chinalco's plan of increasing its stake from 9% to 18% with \$19.5 billion, a move designed to prevent a take-over bid proposed by BHP. BHP then turned to the FIRB to lobby against Chinalco's bid. On 5 June 2009, Rio Tinto broke up its agreement with Chinalco, incurring a penalty of \$195 million, and on the same day entered into a non-binding agreement to establish a production joint-venture that would cover "the entirety of both companies' Western Australian iron ore assets". Damien Danavan, "Contradictions in Chinese Foreign Policy" (University of New South Wales, 2013).pp.117-118

<sup>576</sup> The Australian government declined Huawei's investment proposal on the ostensible ground of "national security" – that was the only explanation given at the time by the Gillard administration. It was a decision that cut deep because Huawei is a private company with a benign reputation, and despite "all the suspicions and allegations of spying, there have never been any complaints of phone hacking or wrongdoing from the companies for which Huawei works". Kerrie Leishman, "Huawei a Key to Chinese Trade Talks," *Sydney Morning Herald* October 25, 2013.

<sup>577</sup> James Laurenseson, "Why an Australia FTA with China has never Stacked up," (The Conversation, October 23, 2013).

<sup>578</sup> Innes Willox, "Free Trade Deal With China Needs Clever Negotiation: Industry Must Be Party to the Talk," *The Australian* April 10, 2014.

saying the amount of investment from China is right, and only 4% arguing that Australia has not allowed enough Chinese investment.<sup>579</sup> Against this background, it is very unlikely that Abbott will court the CAUFTA and risk domestic voters' anger. Nor will he, like his NZ counterpart, create an opportunity for his opponents, since the issue of "selling farmland" very easily provokes domestic opposition. Instead, to assure the concerned public, Abbott promised that the FIRB would screen any farm purchase higher than \$15million or any agribusiness purchase more than \$53 million.<sup>580</sup>

At present, there are signs that Australian policy-makers might be more resolute to open to Chinese investment than their predecessors. However, in light of the Crafar case, the Abbott government is likely to open doors only to Chinese SOEs, rather than land-buyers hoping to cash in. For example, Abbott has announced his intention to allow investment from Chinese SOEs, and lobbies heavily to justify their "commercial nature". During his Shanghai trip in April 2014, Mr Abbott said, "We now appreciate that most state-owned enterprises have a highly commercial culture. They are not nationalized as we used to have in Australia".<sup>581</sup> Trade Minister Andrew Robb echoed this tone that Chinese SOEs are today highly commercialized, and are "no longer like the old nationalized industries we might remember in Australia and the UK".<sup>582</sup> Nevertheless, it would be naïve to assume that these comments would render Australia to open doors for Chinese SOEs. FTA negotiation is always a give-and-take game. If those entrepreneurs want to make inroads in the Australian market, then Beijing needs to offer some other bargaining counters in this deal. To date, full details of the AUFTA and agreement texts are yet published, what has been given-and taken is yet to know. Good news for Australian export firms is that Canberra has already secured the much-coveted Most Favoured Nation provision in the FTA, which enables Aussies to trade with China on the same footing as the US and the EU.

In sum, in terms of both trade and investment, the CNZFTA's "demonstration effects" are negative ones for Canberra. This result is scaled back commitments to CAUFTA. This confirms the liberal argument that if there is no demand, a regime can hardly be diffused. But the conclusion may encounter disagreement from realists, who suggest

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<sup>579</sup> Alex Oliver, "The Lowy Institute Poll 2014," (The Lowy Institute, 2014).

<sup>580</sup> David Crowe, "Abbott Reviews Veto for State-owned Companies," *The Australia* April 10, 2014.

<sup>581</sup> Phillip Coorey, "China Wants to Import Workers Under FTA," *Financial Review* April 15, 2014.

<sup>582</sup> Rowan Callick, "Chinese Enterprises May Escape FIRB Scrutiny," *The Australian* May 01, 2014.

that “supply” could just as well lead to regime diffusion, even if there is no sufficient demand. Considering China’s heavy reliance on Australia’s natural resources, it may not be inappropriate if we transplant the logic Hegemonic Stability theorists generated from the Gulf War, and apply it to the CAUFTA – the big power (the hegemon) will seek to institutionalize a steady flow of resources from its counterpart in the issue-area by forcing upon it a regime which is ‘distributionally’ biased in its favor.<sup>583</sup> Ovodenko and Keohane confirmed this idea and admitted it was an omission in prior liberal analyses. Under this scenario, regime diffusion “is likely to be affected by the exercise of power, based on asymmetrical patterns of interdependence, as states seek to promote their preferred institutions”.<sup>584</sup> The remainder of this section now turns to look at the supply side to further explore CNZFTA’s slow horizontal diffusion.

### *No supply, no diffusion – a realist perspective*

Realists argue that powerful countries, hegemonic powers in particular, are international regime providers. A flaw in this argument is that, in situations without a hegemon, we can hardly differentiate weak from strong, as the Sino-Australia case demonstrates. Judging from the perspective of economic dependence - China is Australia’s biggest trading partner whilst Australia only ranks 8<sup>th</sup> on China trading list - it is natural to regard China as more powerful in CAUFTA negotiations. An overwhelming majority of Australians hold a similar opinion – the country’s latest survey reveals that 83% of respondents believe China has the upper hand.<sup>585</sup> In the initial stages of the CAUFTA negotiations, Beijing also considered it had the initiative in this deal. Some Chinese scholars even suggest that the CAUFTA would be granted to Australia as a reward after Canberra recognized China’s Complete Economic Market Status.<sup>586</sup>

Guided by this thinking, Chinese negotiators assumed a very tough stance and frustrated their Australian counterparts. He Yafei, Director of North America and Oceania Department of the Ministry of Foreign Affairs, told the *Sydney Morning Herald* before the first round of negotiation that while the iron ore deal was a commercial matter, the FTA should contain a “resource clause” and governments “can certainly encourage companies to take a long-term point of view in setting prices ... don’t just look at the

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<sup>583</sup> Andreas Hasenclever, *Theories of International Regimes*. p.94

<sup>584</sup> Ovodenko and Keohane, "Institutional diffusion in international environmental affairs."p.538

<sup>585</sup> "China Has Upper Hand in Australian Trade Negotiations," *Trade Finance* March 05, 2013.

<sup>586</sup> Yang, "China’s Competitive FTA Strategy: Realism in a Liberal Slide."

benefits under their noses”.<sup>587</sup> Canberra responded that prices were pure business issues determined by the market, the government should not and could not intervene because Australia is a market economy.<sup>588</sup>

Owing to the same thinking, the Chinese negotiation team behaved very protectively in the initial stage, proposing to exclude from the FTA key areas including education, telecommunications, financial services, competition policy, investment, electronic commerce and government procurement, etc. Australia refused to continue after seven rounds of arduous negotiations, asking China to submit a substantially better offer.<sup>589</sup> This triggered Beijing’s dissatisfaction as Canberra was requesting more than China could offer. For example, Zhang Xiangchen, China’s chief negotiator, also the state’s WTO chief negotiator, complained that free trade talks with New Zealand were less complicated and less difficult than with Australia. “They [New Zealanders] have a narrow area of discussion, so maybe they can be finalized in one or two years”.<sup>590</sup> Australia was quite annoyed by China’s attitude. Ric Wells, former head of the China FTA Task-force, told a Senate committee that “The Chinese government does not want the FTA; they have no interest in doing that. We do want the FTA, so we have an interest in doing it”.<sup>591</sup>

Australia did not count for much in Beijing’s strategic thinking about great power relations. For example, when PM Howard offered the idea that Australia could act as an honorable broker between China and the US, Beijing’s response was coldly dismissive. To quote He Yafei: “I don’t see any role for brokering a deal between the US and China – we are in continuous dialogue with the US and we understand each other pretty well”.<sup>592</sup> As a response to China’s hubris, the diplomatic solution that Australia

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<sup>587</sup> Cited Jiang, "Australia-China FTA: China's domestic politics and the roots of different national approaches to FTAs."p.11

<sup>588</sup> Ibid.p.11

<sup>589</sup> Mary-Anne Toy, "China Free Trade Talks Drag on, and on, and on," *Sydney Morning Herald* June 23, 2007.

<sup>590</sup> Rowan Callick, "China's Free Trade Team Comes t Table with No Cards," *The Australian* September 08, 2006.

<sup>591</sup> Michael Sainsbury and Rowan Callick, "Crean Looks for New Way as China Trade Negotiator Quits," *The Australian* May 11, 2009.

<sup>592</sup> Baogang He, "Politics of Accommodation of the Rise of China: The Case of Australia," *Journal of Contemporary China* 21, no. 73 (2011).p.64

ultimately settled upon was to enhance cooperation with the US and its allies, and Japan in particular. As former Foreign Minister Bob Carr declared in his recently published diaries, Australia does not enjoy a very high place in China's estimation of states, and an approach to make Australian being taken seriously by the Chinese is to be more close to the US.<sup>593</sup> Unfortunately, Beijing did not notice this shift until Australia concluded bilateral FTA talks with its two important neighbors, and significant US military allies, Japan and South Korea within 24 hours. This left China as the only major nation in Northeast Asia without an Australian FTA. Given Australia's dual membership in both RCEP and TPP, as will be discussed in detail in the next section, the CAUFTA was indeed in Australia's hand in the second-half of the bargains.

The result is a need to broaden the realist notion of "power", which refers to material capability. But in the international regime realm, as the CAUFTA case shows, China's ostensible "power" in economic scale and military capability failed to institutionalize its preferences into the CAUFTA. Instead, Australia's power has expanded enormously for three reasons: (1) CNZFETA's "bad" demonstration effects to a great extent made Canberra rethink its interests in a trade deal with China; (2) FTA linkages with other Asian countries increased China's peer pressures from Japan and South Korea; and (3) Beijing needs Canberra's supports in its other overtures, such as the 21<sup>st</sup> Maritime Silk Road and the Aisa Infrastructure Investment Bank (AIIB). More importantly, China today has an unprecedented feeling of isolation due to the US-led TPP. Therefore, the CAUFTA is indeed more essential and desirable for Beijing, and it is more likely to make more concessions in Australia's favor to secure the deal. In this context, who is the supplier of the CAUFTA? The answer should be Australia, because power may be derived from "unequal opportunity costs" of absence.<sup>594</sup> According to Krasner, the actor less in need of cooperation can get its way by threatening to walk away from the bargaining table if its counterpart fails to be more forthcoming.<sup>595</sup> In other words, neither military power nor economic dependence is necessarily determinant – those who are less enthusiastic about the regime could be more powerful.

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<sup>593</sup> Cited from "Carr's Modern Classic: The Ex-Foreign Minister's Zest for Argument Exhibits a Zest for Life," *The Australian* April, 2014.

<sup>594</sup> Stephen D. Krasner, "Global Communications and National Power: Life on the Pareto Frontier," *World Politics*, no. 42 (1991),p.340

<sup>595</sup> See Stephen D. Krasner, "State Power and the Structure of International Trade," *World Politics* 28, no. 3 (1976),p.320; Krasner, "Global Communications and National Power: Life on the Pareto Frontier."; Krasner, "State Power and the Structure of International Trade."p.363

CNZFTA's "bad" demonstration effects, together with China's arrogant attitude in the CAUFTA negotiations, dissuaded the frustrated Australia, the regime provider, from signing the deal. In this sense, a realist perspective also explains CNZFTA's failed horizontal diffusion, which is compatible with the liberal proposition. "Supply" and "demand" are indeed two sides of a coin. By referring to both, we get a better understanding of the creeping CAUFTA negotiation.

#### **4.4.2 Vertical diffusion: from CNZFTA to TPP**

The TPP throws China's overall FTA strategy into disarray and puts New Zealand to a severe test. It is true that even a simple commercial set of FTAs can send important signals about big power rivalries - in an era when Washington returns to the Asia Pacific, and Beijing fears being contained, where Wellington places itself can have significant strategic ramifications. As we shall see, New Zealand now holds a steady stance to embrace China into the TPP, mainly due to the CNZFTA and the burgeoning two-way trade. At its minimum, it rejects the TPP as a potential anti-China tool. For instance, in answering "whether the US-led TPP is to curtail China", the NZ Trade Minister said "If TPP develops into some crude anti-China or China-containment exercise, let me put it in everyday language, we're out of there".<sup>596</sup>

From Beijing's perspective, the CNZFTA has diffused into the TPP, which embodies significant liberal principles. According to Keohane, "when sufficient interdependence exists ... opportunities will arise for the development of international regimes".<sup>597</sup> Given New Zealand's heavy reliance on China, a prosperous Chinese economy is to its benefit. In other words, if the TPP impeded Beijing's development, New Zealand can hardly avoid being embroiled. On the other hand, a major function of international regimes is reducing uncertainty between/among participants by providing high quality information.<sup>598</sup> Experiences accumulated in the CNZFTA not only entail NZ viewing Beijing's behavior in a TPP as predictable, but also stimulate NZ to develop a relatively

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<sup>596</sup> Joanne Black, "Will the Trans-Pacific Partnership Upset China?," (New Zealand Listener, March 24, 2012).

<sup>597</sup> Keohane, "The Demand for International Regimes." p.355

<sup>598</sup> See Barbara Koremenos, Charles Lipson, and Duncan Snidal, "The Rational Design of International Institutions," *International Organization* 55, no. 4 (2001); Black, "Will the Trans-Pacific Partnership Upset China?," Nye, *Power and interdependence*; Keohane, "International Institutions: Can Interdependence Work?."

favorable view of China. Therefore, instead of taking advantage of China, Wellington increasingly finds it in its best interests to reciprocate and cooperate with China across issue-areas.

Going further, does Australia welcome China joining the TPP? Not really. In a 2013 interview, when asked “would China be welcomed if they sought to be a part of the TPP”, former Australian Trade Minister Craig Emerson revealed a big difference with his NZ counterpart: “It’s up to China whether they indicate an interest or not. But if they indicate, they would go through exactly the same processes as Mexico did, as Canada did, and as Japan did.”<sup>599</sup> As a well-trained diplomat, he left the obvious unsaid, revealing an underlying view that it would be hard for Beijing to pass TPP’s “entrance examination”. The trans-Tasman neighbors’ divergence may give Beijing the impression that to make a vertical regime diffusion happen (from bilateral FTA to TPP), a horizontal diffusion needs to come first (from CNZFTA to CAUFTA). From a liberal perspective, as long as the CAUFTA remains in limbo, Beijing cannot predict Australia’s standpoint on the TPP. What follows would be China’s mounting uncertainty about its future economic environment, and thus more impetus to finalize the CAUFTA negotiations as soon as possible, with a further objective to encourage Australia to change its previous stance on supporting China’s bid for TPP membership. This explains why the 19<sup>th</sup> round of CAUFTA negotiations, held in Beijing from 4<sup>th</sup> to 6<sup>th</sup> June 2013, came just days after Beijing officially stated, for the first time, that it was considering joining the TPP.<sup>600</sup>

Another case in point, reflecting Beijing’s eagerness to hammer out the CAUFTA, was its silence over Japanese PM Abe’s latest high-profile visit to Australia from 7<sup>th</sup> to 10<sup>th</sup> July. Hardly coincidentally, on 9<sup>th</sup> July, Xi met the Australian former PM John Howard, also the initiator of the CAUFTA, in the Great Hall of the People in Beijing. The Chinese Ministry of Foreign Affairs said that Mr Xi told Howard that China was keen on finalizing the CAUFTA at the end of 2014.<sup>601</sup> It again reflects Beijing’s pragmatic appreciation that maintaining a benign relationship with Canberra and concluding the

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<sup>599</sup> Today, "Australian Minister for Trade and Competitiveness."

<sup>600</sup> "Australia-China Free Trade Agreement Negotiations," (Australian Government, Department of Foreign Affairs and Trade, 2014).

<sup>601</sup> "Xi Jinping Meets with Former Prime Minister John Howard of Australia," (Ministry of Foreign Affairs of the People's Republic of China, July 09, 2014).



CAUFTA is the best, if not the only chance, to fracture the looming FTA network of hostile states on its periphery. But it would be naïve, as revealed in the next section, to assume that the CAUFTA will automatically translate into Australia's support for China in the TPP bid. Now we turn to using a realist lens, by introducing the US as an intervening variable, to explore the correlations amongst the CNZFTA, CAUFTA, and TPP.

#### **4.4.3 The road to TPP now runs through Canberra?**

This section posits that New Zealand and Australia's divergence on a bilateral FTA with China, and whether to contain or accommodate China in a TPP, can be explained by studying the two Oceania neighbors' asymmetric strategic relationship with the United States. Drawing on Dittmer's strategic triangle, the rest of this section first explains how the AU-US-NZ trilateral relationship evolves from a *Ménage a trois* triangle to a *Romantic* one, and then turns to the US-AU-Sino trilateral relationship, which represented a strategic triangle in the form of a Stable Marriage. In the last part of this section, I analyze how the CAUFTA acts as a learning platform and thus hinders Australia from supporting China over TPP issues.

##### *The AU-US-NZ triangle*

The relationship between the US, Australia, and New Zealand had long been regarded as what Dittmer called a *ménage a trois* triangle, one which originated in the ANZUS Treaty as early as 1951. However, military ties between Washington and Wellington soured in the 1980s when the David Lange Labor government prevented potentially nuclear-armed warship from visiting New Zealand ports. This was taken by the US as a grave affront and it threw New Zealand out of the ANZUS alliance.<sup>602</sup> Although that standoff ended when the Clark Labor government committed New Zealand troops to Iraq and Afghanistan in 2003, Wellington can best be regarded as an "informal ally" of Washington.<sup>603</sup> As noted by Robert Ayson, "A formal alliance relationship (including a return to full ANZUS relations) still seems most unlikely, and it is not clear that public opinion in New Zealand regards it as a priority".<sup>604</sup> An inevitable result of these differences is that while Wellington views the relationship with its trans-Tasman neighbor as most important, Canberra does not share the same viewpoint but gives its

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<sup>602</sup> Colin James, "An Old Friend is Back. Will the New One Mind?," *Management Magazine* April 01, 2011.

<sup>603</sup> Peters, "New Zealand Calls for "Constructive Dialogue" on Chinese Air Defence Zone."

<sup>604</sup> Ayson, "Choosing Ahead of Time? Australia, New Zealand and the US-China Contest in Asia."p.347

diplomatic priority to Washington. The upshot is that the prior *ménage a trois* ANZUS triangle was gradually transformed into a *romantic* one - Australia sits in the pivot by enjoying a better relationship with the other two than either has with the other, whilst New Zealand turns to another big power, China.<sup>605</sup>

A consequence of the romantic triangle is the trans-Tasman neighbors' different FTA trajectories. For example, Canberra was rewarded with an FTA with the US, but Wellington was not. Nor did New Zealand get to have bilateral FTAs with US's military allies, such as South Korea and Japan. Instead, Wellington regards the FTA with China as more and more indispensable to its economy. Besides, New Zealand is the only state that has finalized free trade agreements with the Mainland, Hong Kong and Chinese Taipei. In horse racing terms this would give New Zealand the Greater China Trifecta – with hopefully significant economic potential.<sup>606</sup> Benign trade cooperation has greatly improved the pair's mutual-trust – not exclusively in the economic realm, but also diffused into the security area. A striking example is the 2012 public opinion survey conducted by the Asia-New Zealand foundation. It reveals that “more than two-thirds of New Zealanders (68 percent) agreed that China's growth has been good for New Zealand's economy” and that a similar proportion felt it would be unlikely China would become a military threat to New Zealand within 20 years.<sup>607</sup>

Australia holds a different view of China. The 2014 Lowy Poll indicates that almost half (48%) Australian people believe that China will be a military threat to their country in two decades time, 7% higher than the 2013 poll.<sup>608</sup> This public feeling, and Australia's pivotal position in the ANZUS triangle, made the US-AU-Sino trilateral relationship a *stable marriage* – the relationship between the US and Australia is better than either has

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<sup>605</sup> Dittmer, "Sino-Australian Relations: A Triangular Perspective." pp. 664-665

<sup>606</sup> With the acquiescence of Beijing, New Zealand signed a deal with Taiwan, named in the agreement as the “Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu”, the same name Taiwan used when it joined the WTO. This agreement marked another big achievement for New Zealand - the first OECD country to sign such a deal. Taking advantage of the Mainland's trust with regard to Taiwan, as well as Hong Kong, New Zealand exporters will further disadvantage their counterparts in the burgeoning Asian market. See Tony Alexander, "The China-Australia-NZ Link," in *Growing with China* (Bank of New Zealand, February, 2012).

<sup>607</sup> Ayson, "Choosing Ahead of Time? Australia, New Zealand and the US-China Contest in Asia." p. 354

<sup>608</sup> Oliver, "The Lowy Institute Poll 2014." p.5

with the third, “pariah”, China, and consequently, a “pariah” CAUFTA.<sup>609</sup> For instance, in October 2013, China declared a new Air Defense Identification Zone (ADIZ) in the East China Sea. Foreign Minister Julie Bishop publicly criticized this new move as not contributing to regional stability - recording Australia as one of only a pair of non-peripheral countries (the other is the US) making such a direct accusation. In what followed, Bishop declared Japan as Australia’s best Asian friend and summoned Chinese ambassador to express her concerns over the ADIZ - all these events happened before her imminent visit to Beijing (her first as Foreign Minister), and came as her Coalition government pushed aggressively to seal a much-vaunted free trade deal with its largest trading partner. Hume White warned that China might withdraw from FTA talks if Australia lent its support to Abe’s desire to change Japan’s defense posture. But Canberra may not take his warning seriously. Politicians like Bishop are well aware that their pro-Japan speech will be politically justified by threats made by China, and that they will be appreciated by their US ally.

In short, unlike New Zealand, which is “not obliged to take particular actions by dint of belonging to any political or security alliance”,<sup>610</sup> Australian politicians need to think about the potential repercussions a CAUFTA may have regarding Washington’s attitude; and also the response of domestic voters. Realists see the US’s influence on Canberra as “security externality” – free trade deals are more likely within, rather than across, political-military alliances.<sup>611</sup> In signing the CAUFTA, Australia needs to think about the potential losses and real income gains – losing alliance and domestic support will always exceed the economic gains from CAUFTA. Thus, behind the scenes, there are big power games being played out between China and the US. As noted by Li Xiangyang, Chief researcher of the China Academy of Social Sciences, “The Australian side always worries about its security when it is dealing with this agreement (CAUFTA). Considering those political elements, it is hard to give a specific prediction about when a deal will be hammered out. It depends on the judgment of the leadership on the political situation in the future”.<sup>612</sup>

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<sup>609</sup> Dittmer, "Sino-Australian Relations: A Triangular Perspective." pp. 664-665

<sup>610</sup> Audrey Young, "NZ Foreign Policy Can Depend on the Audience," *The New Zealand Herald* June 21, 2014.

<sup>611</sup> Joanne Gowa and Edward D. Mansfield, "Power politics and international trade," *American Political Science Review* 87(1993).p.1

<sup>612</sup> Scott Murdoch, "'Lack of Will' Has Delayed an FTA," *The Australian* April 10, 2014.

### *CAUFTA as an important learning platform*

The “security externality” is not the only reason for drifting Sino-Australia relations. Most regime theorists implicitly assume that even “cheap talks” over an international regime would generate mutual understanding and trust. In retrospect however, the CAUFTA talks do not share this misleading assumption, even though it was ultimately hammered out. Despite the CAUFTA’s significance, China’s bargaining strategy deserves some blames - Chinese negotiators took a very tough stance during talks and aroused Australia’s antipathy. For example, Beijing’s self-imposed “victimhood” made it particularly sensitive to high politics – it threatens to leave the negotiating table whenever bilateral diplomacy suffers setbacks. We have repeatedly witnessed the cooling of talks after PM Howard met Dalai Lama in 2007, after the Rudd administration issued a visa to the Uyghur leader Rebiya Kadeer in 2009, and after the Gillard government confirmed more US Marines in Darwin in 2011. More recently, as a strong response to Julie Bishop’s “defiant speeches” over the East China Sea issue, Commerce Ministry spokesman Shen Danyang stated that “we will give priority to free-trade negotiations with neighboring countries”, including the trilateral FTA with Japan and South Korea, and a single deal with South Korea. There was no mention of the CAUFTA.<sup>613</sup>

China’s overreaction to political challenges, in the form of economic hostility and delay, always backfires. It revives and reinforces the “China threat” alarm across the region, and further vindicates the realists’ assumption that “No rising power is ever a status quo power. Power is, by nature, expansionist ... Historically, rising powers are highly suspicious, paranoid powers: they think others are out to get them, and to stop their march to glory. Expecting too much too soon, they overreact”.<sup>614</sup> As pointed by David Shambaugh, “Beijing is hyper-vigilant and diplomatically forceful, but its attempts to defend these interests are often clumsy and wind up being counterproductive to its image and its goals”.<sup>615</sup> Apparently, China is still very inexperienced in transferring economic power into political clout. A better way to achieve its strategic objectives through the way of the FTA tool may be to not bind economic and political affairs too closely, but to disconnect them.

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<sup>613</sup> Scott Murdoch, "Chinese Experts Warn Abbott," *The Australian* April 08, 2014.

<sup>614</sup> Mohan Malik, "China and Strategic Imbalance: 'This is the decade of power transitions in Asia'," (*The Diplomat*, July 14, 2014).

<sup>615</sup> David Shambaugh, "The Illusion of Chinese Power," *The National Interest* (2014).

In the TPP context, where the Sino-US competition shifts from backstage to head-on, the impact of “security externality” on Australia will be expanded enormously. This situation would force Canberra to choose between sides. But it seems the Abbott government has already made its choice – the US is Australia’s best friend in the world and Japan is its best friend in Asia. It is more imperative for Canberra to prove this after it decided to join the AIIB, despite diplomatic pressures exerted by Washington. These pressures will not dissipate over time. Instead, Australia’s stance will be more closely scrutinized in the TPP – a main reason is that the Sino-US competition in the TPP vs. RCEP rivalry is much more symbolic than in the AIIB membership war. Clearly, Canberra today wants to keep a distance, rather than gets closer to Beijing regarding TPP - a costly price China’s has paid for its hubris during the CAUFTA negotiations. In this sense, constructivists are correct in positing that learning may undermine the foundation of regime-based cooperation altogether.<sup>616</sup> As stated by Kratochwil and Ruggie, “what constitutes a breach of an obligation undertaken within a regime is not simply an ‘objective description’ of a fact but an intersubjective appraisal”.<sup>617</sup> This makes “national interests” essentially dynamic phenomena, a notion counter to rationalists’ argument that interaction does not affect actors’ utility functions or identities.<sup>618</sup> In the CAUFTA case, Australia’s perception of gains from the deal gradually decreased with its growing perception that China is an assertive negotiator. In contrast, Beijing’s perception of “real national gains” from the CAUFTA increases with the looming TPP from which it is excluded.

In a nutshell, the CNZFTA is a market-driven one, and New Zealand’s cooperation with China is mainly due to the latter’s economic power. In contrast, Australia outmaneuvered China not by its own economic or political ability, but by its structural power – a power derived from its strategic calculus and delicate management of big power relations. Beijing should bear in mind that whereas the CAUFTA has been finally hammered out, it is closer to a strategically driven treaty, rather than the CNZFTA’s “horizontal regime diffusion”. Therefore, while diffusing CAUFTA into TPP may appear to be a good way forward, it is important to note that the foundations

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<sup>616</sup> See Joseph S. Nye, Jr., "Nuclear Learning and U.S.-Soviet Security Regimes," *International Organization* 41, no. 3 (1987),p.397; Peter M. Haas, "Introduction: Epistemic Communities and International Policy Coordination," *International Organization* 46, no. 1 (1992),p.30; and Andreas Hasenclever, *Theories of International Regimes*. p.148

<sup>617</sup> Kratochwil and Ruggie, "International Organization: A State of the Art on an Art of the State."p.774

<sup>618</sup> Andreas Hasenclever, *Theories of International Regimes*.p.25

of the CNZFTA and CAUFTA are absolutely different. This suggests potential blowback or resistance to any efforts to accommodate China over the TPP. What is more urgent for China in the newly signed FTA is to cooperate in more practical ways that concentrate exclusively on economic affairs, thus decreasing Australia's mounting distrust and the feeling that China as an assertive power, even if this is done for the sake of political interests.

#### **4.5 Conclusion**

The CNZFTA serves as an ideal case for us to look at China's domestic policy and international strategy simultaneously. Regarding the correlation between the CNZFTA and China's dairy reform, it would be superficial or misleading to describe the signature of the CNZFTA as evidence of Beijing's liberal tendency. Rather, the FTA policy is merely an extension of the domestic policy – it plays a supporting role in the process of China's dairy reform, but the leading role has always been by the government. Seen from a broader theoretical lens, China's dairy strategy rests on a hybrid of pro-neoliberal thinking on free trade, and a pro-realist tenet of economic security, which highlights the significance of both “policy autonomy” and “economic sovereignty”. Instead of depending on a single dimension of either international or domestic, my conclusion in this section is that the relationship between foreign trade regimes and state domestic policy is not unidirectional but mutually conditioning. It is this problem-driven approach that tells us that a government's paradigmatic inclination when making policies is not fixed, but varies with real conditions.

As for CNZFTA's diffusion effects, this chapter reveals that liberal considerations of absolute economic gains determines the CNZFTA's successful vertical diffusion into the TPP, and that realist arguments of “real income gains” is one determinant of CNZFTA's horizontal diffusion into the CAUFTA. Going further, national interests also cast doubts on whether Canberra will accommodate China under a TPP the way Wellington did. Although rationalist approaches explain how New Zealand and Australia's free trade preferences change due to external information conditions and structural changes, constructivist approaches play a complementary role in explaining how Australia's FTA preferences vary with perceptions derived from negotiations with China. In short, the roots of Australia and New Zealand's divergence toward a bilateral FTA with China are mixed and cannot be explained by any single research paradigm.

Thus analytic eclecticism enables us to unfold possible linkages between domestic and

global, liberal and realist, rational and cognitive. A caveat should be made here that the conclusion is not a conclusive one, but is contingent on the final outcome of China's ongoing dairy reform, as well as the ultimate formation of the CAUFTA and the TPP.

## Chapter 5 The China-Pakistan FTA (CPFTA)

### 5.1 Introduction

Pakistan, with its critical geostrategic position, is China's important southern gateway towards South Asia, and western gateway towards the Middle East. After decades of pouring money and arms into the world's second largest Muslim country, it has become one of the very few, if not the only friend of China, the "lonely rising power".<sup>619</sup> In a 2014 Pew Survey, only 3% of Pakistanis had a negative view of China, while 78% had a positive one, representing the highest favorable rating for China anywhere in the world.<sup>620</sup> This is a testimony to the two countries' so-called "all-weather brotherhood", often described by Pakistan's Prime Minister Yousuf Raza Gilani, as "higher than mountains, deeper than oceans, stronger than steel and sweeter than honey".<sup>621</sup> Against this background, the China-Pakistan FTA provides an interesting window to explore the Sino-Pak relationship.

Although there have been occasional journal articles on the CPFTA, most are devoted specifically to its economic results and neglect the associated political and diplomatic aspects.<sup>622</sup> A few analysts have recognized the geostrategic significance of the trade deal, but without thorough studies, they take it for granted the CPFTA is a political

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<sup>619</sup> Gideon Rachman, "Whether China Will Become a Global Power," (Financial Times, March, 2013).

<sup>620</sup> "Global Opposition to U.S. Surveillance and Drones, but Limited Harm to America's Image: Many in Asia Worry about Conflict with China," in *Global Attitudes Project* (Pew Research, July, 2014). Available at <http://www.pewglobal.org/2014/07/14/global-opposition-to-u-s-surveillance-and-drones-but-limited-harm-to-americas-image/>

<sup>621</sup> This statement was made when Meng Jianzhu, Chinese Minister of Public Security, visited Pakistan. See "Ties With China Hailed: Gilani Cautions US on Negative Messaging," (The Dawn, September, 2011).

<sup>622</sup> Naved Hamid and Sarah Hayat, "The Opportunities and Pitfalls of Pakistan's Trade with China and Other Neighbors," *The Lahore Journal of Economics* 17, no. Sep (2012); Sajid Chaudhry, "trade with china: pakistan suffer trade deficit of \$2.957bn," *Daily Times* 2007-11-04; Muhammad Nishat and Syed Zia Abbas Rizvi, "The impact of foreign direct investment on employment opportunities: panel data analysis: empirical evidence from Pakistan, India and China," *Pakistan Development Review* 48, no. 4 (2009); Meiling, "中巴自贸区服务贸易开放水平评估、提升方向及对策建议 - China-Pakistan FTA: Assessment, Improvement and Suggestions on the Liberalization of Service Trade."



reward for Pakistan's friendly support.<sup>623</sup> This chapter sets out to address these analytic deficiencies. Specifically, it tries to determine what role the CPAFTA plays in shaping the Sino-Pak relationship. What are the differences and similarities between the CPFTA and other Chinese FTAs? And what role does the CPFTA play in China's overall FTA diplomacy?

This chapter contains five sections. Section three will link the CPFTA with China-India-US relations in South Asia. It will show that the CPFTA was set up to hedge against India and the US's power projection in the region. Nevertheless, the CPFTA falls short of its full potential because neither China nor Pakistan has appropriate domestic environments for full implementation.

Section four delves into the correlation between the CPFTA and the Sino-Pak friendship. It will show that the rapprochement between the two parties provides an innate stimulant for the formation of the trade deal. However, beneath the friendship, there are a number of norm divergences in the two countries' foreign policymaking, and it is imperative for Beijing and Islamabad to acknowledge changes in each other's diplomatic mindset. Otherwise, the CPFTA, set up to deepen the Sino-Pak relationship, could ultimately be detrimental to their decades old friendship.

The fifth section studies the CPFTA and its two associated projects: the Sino-Pak Economic Corridor and the Gwadar Port projects. As I'll show, these projects reveal Beijing's grand ambition of building a wide trade network to enlarge global connectivity. To do so, China has adjusted its Pakistan diplomacy to a relatively neutral one in relation to the US and India so as to avoid direct confrontations with them.

This chapter concludes that the CPFTA is not an easy diplomatic instrument for China to manage. To maximize the FTA's political utility, Beijing needs to use all tools at its disposal to reverse trade imbalances and boost investment to ensure that the CPFTA's economic outcomes are not to Pakistan's disadvantage. In theoretical terms, this chapter undergirds the thesis's hypothesis, which proposes that a fuller picture of China's FTA policy requires an eclectic analysis to juxtapose the power-, interest- and norm-based

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<sup>623</sup> See Yang, "China's Competitive FTA Strategy: Realism in a Liberal Slide."; Leifur Sefton Sigurðsson, "China's Free Trade Agreement Strategy: What lies beneath?" (2014); Gao, "China's Strategy for Free Trade Agreements: Political battle in the Name of Trade."

paradigms of international regime theories. In diplomacy terms, this chapter finds that Pakistan will remain as the bedrock of China's South Asia policy. Moreover, although the Xi-Li administration is more confident than its predecessors in pursuing more assertive policies to have a bigger say on the global stage, accepting the current international order and keeping conciliatory relations with other big powers, will continue to characterize its diplomatic strategy.

## **5.2 The CPFTA and Its Economic Effects**

In April 2005, during former Premier Wen Jiabao's visit to Islamabad, China and Pakistan formally launched negotiations on a Free Trade Agreement. In December, the two countries signed an Early Harvest Program (EHP) agreement, which came into force in January 2006. In November 2006, the FTA was signed during former President Hu Jintao's visit to Pakistan. The Phase I tariff-reduction scheme of the CPFTA started in July 2007, containing agreement on Trade in Goods and Investment (TIG). In February 2009, Chinese State Councilor Dai Bingguo and Pakistani President Asif Ali Zardari witnessed the signature of the Agreement on Trade in Services (TIS), which took effect in October 2009. In March 2011, the first round of negotiations on Phase II tariff-reduction of the TIG was launched in Islamabad.

### *Early Harvest Program*

Under the framework of EHP, China agreed to eliminate tariffs on 769 categories of imported goods of Pakistani origin, relating mainly to vegetables, fruit, and cotton fabric. In the meantime, China reduced relevant tariffs by 50% on fish, dairy sectors, frozen orange juice, plastic products, rubber products, leather products, knitwear, woven garments, etc. On the Pakistani side, concessions covered 486 categories of imported goods of Chinese origin, mainly involving vegetables, organic chemical products, intermediary goods for engineering sectors, and the like.<sup>624</sup> With the implementation of the EHP, bilateral trade increased from \$ 4261 million in 2005 to over \$ 5246 million in

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<sup>624</sup> Compared with the EHP under CAFTA, in which China made concessions on about 600 agricultural products, the EHP under CPFTA enjoys privileges both in quantity and content. The significance of the EHP between China and Pakistan can also be observed by a comparison with the EHP under the Pak-Malaysia FTA, in which Malaysia's offer to Pakistan covers only 114 tariff lines. See Official website of Government of Pakistan Ministry of Commerce, available at [http://www.commerce.gov.pk/?page\\_id=205](http://www.commerce.gov.pk/?page_id=205) ; and Xinhua, "China, Pakistan sign agreement on "early harvest" preferential tariff program," *People's Daily* 2005-12-9.

2006 and then to a staggering \$ 6893 million in 2007.<sup>625</sup> (See Table 5.1 and 5.2) Cotton (HS52) accounts for 66.47% of Pakistan's exports to China, due mainly to the latter's exemption from customs duty on as many as 76 categories of Pakistani cotton and articles thereof. The fastest growing China's imports from Pakistan are copper (HS74) and ores, slag, and ash (HS26). This trend is in line with China's FTA priority of 'securitizing' raw material supplies through institutional arrangements.<sup>626</sup> Pakistan's imports are more value-added based, and dominated by electrical machinery and mechanical appliances (HS85), etc. Such high-tech items may not only help Pakistan with import substitution, but also help in improving local production efficiency, and moving progressively up in the global value chain.

**Table 5.1: Pakistan's Exports to China (US\$ million)**

HS Chapter	Chapter Description	2003	2004	2005	2006	2007	Growth	Share in Total
52	Cotton	453.13	451.38	580.78	708.30	733.79	12.81%	66.47%
74	Copper and articles thereof	0.01	35.61	84.34	129.44	107.24	974.43%	9.71%
26	Ores, slag and ash	9.26	22.41	28.48	33.96	89.18	76.14%	8.08%
41	Raw hides and skins (other than fur skins) and leather	27.17	39.91	51.49	61.84	70.78	27.04%	6.41%
29	Organic chemicals	37.37	4.21	46.77	16.40	19.79	-14.70%	1.79%

**Table 5.2: Chinese Exports to Pakistan (US\$ million)**

HS Chapter	Chapter Description	2003	2004	2005	2006	2007	Growth	Share in Total
85	Electrical machinery and equipment and parts thereof; sound recorders, etc.	225.75	327.55	564.14	779.47	1,025.8	46.00%	17.72%
84	Machinery and mechanical appliances; parts thereof	259.24	481.55	611.68	652.84	821.45	33.42%	14.19%
54	Man-made filaments	52.88	144.59	224.17	379.03	443.01	70.13%	7.65%
99	Commodities not specified according to kind	277.67	236.16	200.27	222.49	349.30	5.90%	6.03%
72	Iron and steel	41.99	24.87	44.78	144.02	248.00	55.89%	4.28%

Source: *Pakistan-China Free Trade Agreement – Analytical Report on Textiles and Clothing*, available at <http://www.rdacell.com/Documents/Pakistan-ChinaFree.pdf>

Trade issues are not as simple as they appear to be. Even though in absolute terms the EHP achieved its "desired results", in relative terms it caused a trade deficit to China's advantage. While Chinese goods' share of Pakistani imports improved substantially

<sup>625</sup> United Nations Commodity Trade Statistics Database, available at <http://comtrade.un.org/db/default.aspx>

<sup>626</sup> Jiang, "China's Pursuit of Free Trade Agreements: Is China Exceptional?."

from 13.66% in 2005 to 17.76% in 2007, Pakistani exports only experienced a moderate increase from 5.19% to 6.19% during the same period. Yet the influx of Chinese products has significantly altered Pakistan's market by hollowing out its local production. According to a market survey held by *The Dawn* in 2006, Chinese children's garments total more than 90% of the Pakistani market, followed by 80% of stationery items, half of all paints and women's clothing, over half of electrical products and shoes, and 100% of gents' jackets.<sup>627</sup> In this context, arresting the enlarging trade imbalance constituted the top concern at the parties' subsequent tariff-reduction negotiations.

### *Trade in Goods*

In the Phase I tariff-reduction package (1<sup>st</sup> January, 2006 – 31<sup>st</sup> December 2012), products were sorted into six categories representing different concession-stages. (See Table 5.3) Pakistan was granted free market access on textiles, such as cotton fabrics and bed linen, agricultural products including mangoes, citrus and vegetables, certain electronic machines like metal or mine detectors, etc. China gained market access with abolition of tariffs on more tech-added products, including machines for agriculture, horticulture or forestry, parts of nuclear reactors, aircraft (including satellites) and suborbital and spacecraft launch vehicles, etc. Specifically, due to religious and security concerns, 92 Pakistani products fall into its exclusion list (i.e. alcoholic beverages and spirits, fireworks, translations of the Holy Quran without Arabic text, military weapons (sub) machine-guns, etc.), which account for approximately 1% of the overall product lines covered in the FTA. With the conclusion of Phase I, China and Pakistan will respectively remove tariffs on 85% and 84% of imports to each other.

**Table 5.3 Tariff Reduction Modality of China and Pakistan (Phase I)**

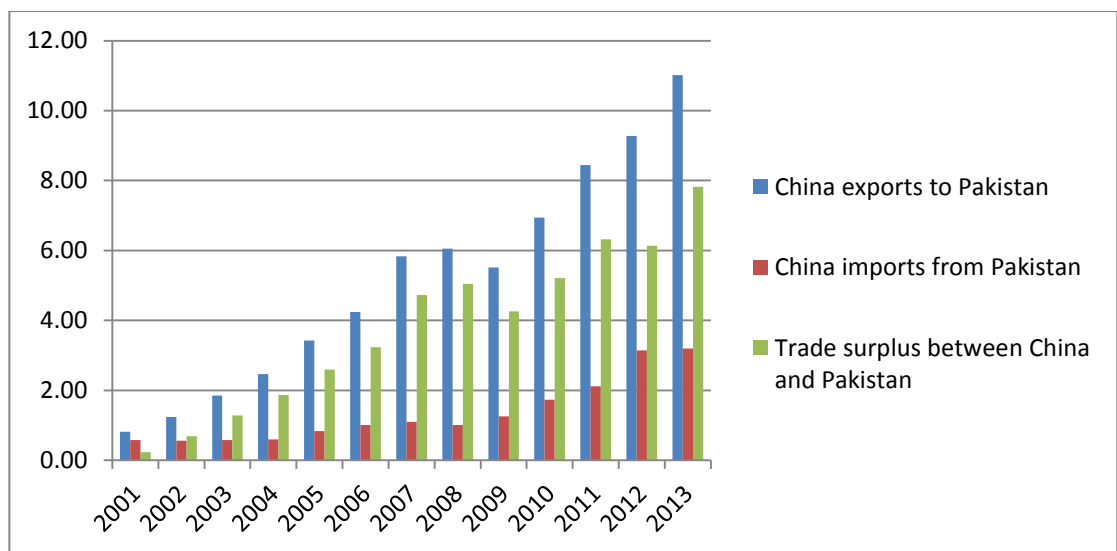
Category No.	Track	No. of	% of Tariff	No. of	% of Tariff
		Tariff Lines	lines at 8 digit	Tariff Lines	lines at 8 digit
		China		Pakistan	
1	Elimination of tariff (3 years)	2681	35.5%	2423	35.6%
2	0-5% (5 years)	2604	34.5%	1338	19.9%
3	Reduction on margin of preference of 50% (5 years)	604	8%	157	2.0%
4	Reduction on Margin of preference from 20% (5 years)	529	7%	1768	26.1
5	No Concession	1132	15%	1025	15.0%
6	Exclusion	-	-	92	1.4%

<sup>627</sup> Aamir Shafaat Khan, "The Chinese Connection," *The Dawn* 2006-01-12.

Source: CPFTA, Annex 1, see China FTA Network official website, available at <http://fta.mofcom.gov.cn/index.shtml>

In absolute terms, the Phase I tariff reductions have stimulated bilateral trade with overall trade volume climbing from \$5.25 billion in 2006 to \$12.40 billion in 2012. According to the Trade Development Authority of Pakistan (TDAP), China was Pakistan’s second biggest export destination (\$2.70billion) in the 2012-13 fiscal year (the US remained the largest at \$3.88billion). Nevertheless, in relative terms, the CPFTA outcome is not without flaws, which counters some analysts’ assertion that the trade deal is a reward that Beijing gave to Islamabad. (See Figure 5.1 and Appendix 5.1) Pakistan’s trade deficit with China ballooned remarkably to \$6.14billion in 2012, accounting for 31.3% of its overall trade deficit (\$19.6billion). While its share of China’s imports was only 1.68% compared to a 21% share of China in Pakistan’s overall imports, the severe inequity could bring about much larger negative impacts on the cash-strapped Pakistani government than the positive effects on the CCP government with huge cash reserves. Another disappointing outcome is that the trade pact failed to optimize Pakistan’s export structure. In the 2012-13 fiscal year, China was Pakistan’s largest consumer of rice, yarn, marble and stone, the second largest of manufactured onyx, and the third largest of leather and fish. Clearly, these imports were either raw materials or products with low profitability, placing Pakistan in a disadvantageous position in the global supply-chain.

Figure 5.1: China-Pakistan Two-way Trade in Past 13 Years (2001-2013, US\$ billions)



Source: Author’s own calculation based on the UN Comtrade International Statistics Database, available at <http://comtrade.un.org/>

Against this backdrop, in March 2011 the two sides embarked on the negotiation of modalities for the Phase II tariff-reduction. Islamabad moved quite cautiously in these new rounds, and at the time of writing details of its new tariff commitment has not been released. In contrast, in 2013, Beijing promptly announced its new tariff concession scheme on an additional 286 items,

which also covered the services sector, with the aim of achieving the trade target of \$15 billion by 2015.<sup>628</sup> This time gap, allowing China to further open markets to Pakistan, reveals the former's intention to narrow the trade gap with the latter.

Another noteworthy aspect of the new scheme is that many Chinese concessions were made to help expand Pakistan's exports. For example, in answering Pakistan's marble mining processing industry's request,<sup>629</sup> 65 marble related products were put in the new FTA scheme and granted tariffs lower than MFN rates, and 17 of them enjoy duty free status when entering Chinese markets. Although the TIG has not realized its full potential in fostering trade, considerable efforts have been made to balance its asymmetric nature. Considering that the CPFTA is still in the early stages of implementation, it is too early to make any definitive conclusions about its possible outcomes.

### *Agreement on Investment*

Chapter IX of "Investment" is an integral part of the CPFTA, including institutional arrangements like promotion and protection of investment, expropriation, compensation for damages and losses, transfers, subrogation, settlement of disputes between the two parties, settlement of disputes between investors and one party, etc. Compared to the Sino-Pak Bilateral Investment Treaty (BIT) signed in 1989, chapter IX involves no further liberalization and thus aroused scholars' skepticism about its actual effects.<sup>630</sup> However, the two governments have worked out a series of supporting measures to support its implementation. For example, in order to provide direct financial support to Chinese firms looking for commercial opportunities in Pakistan, the Sino-Pak Investment Company, supported by Pakistan's Ministry of Finance and the China Development Bank, was formally established in July 2007. Under a substantial deal signed between the two countries in December 2010, the Industrial and Commercial Bank of China (ICBC) has built branches in Islamabad and Karachi.<sup>631</sup> Moreover in December 2011, the Central Banks of both sides agreed on a RMB10billion currency

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<sup>628</sup> See Annex to Amending Protocol to China-Pakistan FTA, available at [http://www.tdap.gov.pk/china/custom\\_tariff.pdf](http://www.tdap.gov.pk/china/custom_tariff.pdf) and Khalid Mahmood, "Pakistan-China Strategic Relations," (Institute of Strategic Studies, Islamabad, August, 2011), p.13

<sup>629</sup> Shahid Javed Burki, "Pakistan-India Trade," (Institute of South Asian Studies, National University of Singapore, 2011).

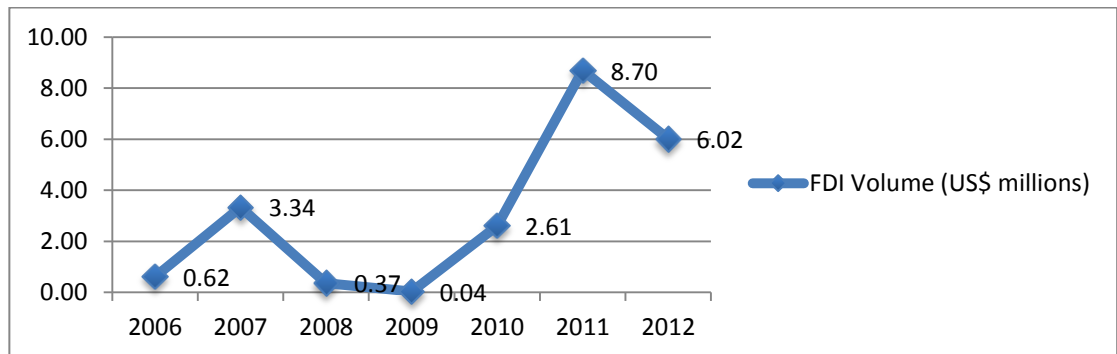
<sup>630</sup> See CPFTA Text in the China FTA Network official website, available at <http://fta.mofcom.gov.cn/english/index.shtml>

<sup>631</sup> Lync Migration Industry, "Entry of Chinese Banking Giant in Pakistan," (Lync Migration Resource Center, 2011-09).

swap scheme to finance bilateral investment and trade. This came into force in May 2013.<sup>632</sup>

According to statistics released by the Embassy of China in Pakistan, FDI flows from China to Pakistan are marked by two major features. First, China's investment in Pakistan remains low and is unbalanced considering the former's huge overall level of outbound investment (\$90.17billion as recorded in 2013).<sup>633</sup> In 2012, China ranked as only the 5<sup>th</sup> largest investor by investing a relatively tiny \$60.16million in Pakistan, and even this figure was down 30.8% on a year-on-year basis. Second, Chinese FDI flows have shown great fluctuations, indicating that investors' enthusiasm lacks consistency. (See Figure 5.2) For instance in September 2011, the Kingho Group, a private Chinese miner, even pulled out of a \$1.9billion deal – the biggest investment by a Chinese entrepreneur in Pakistan.<sup>634</sup> Then in March, the state owned Industrial and Commercial Bank of China (ICBC) withdrew its support from financing a gas pipeline between Pakistan and Iran.<sup>635</sup> Pakistan's domestic investment environment is an important reason hindering China's investment. At a 2013 Business & Investment Seminar held by the Embassy of Pakistan in China, Chinese companies voiced their concerns about personal insecurity and the immature infrastructure network in Pakistan.<sup>636</sup>

**Figure 5.2: China's FDI Flow to Pakistan**



<sup>632</sup> Shahan Rana, ed. China Sign Currency Swap Agreement Pakistan (The Express Tribune, December 24, 2014).

<sup>633</sup> Ministry of Commerce OF People's Republic of China, "Brief Statistics on China Direct Investment Overseas in 2013," (January, 2014).

<sup>634</sup> Ananth Krishnan and Anita Joshua, "Pakistan Faces Chinese Fury over Abductions and Killing of its Citizens," *The Hindu* 2012-02-29.

<sup>635</sup> Raffaello Pantucci, "Break Up Time for Pakistan, China?," (The Diplomat, June, 2012).

<sup>636</sup> See Article Archives in the official website of Pakistan-China Institute, available at <http://www.nihao-salam.com/news-detail.php?id=NDcyOA==>

Source: Official website of Economic and Commercial Counselor's Office of the Embassy of China in Pakistan, available at <http://pk.mofcom.gov.cn/?4205993465=316931864>

Generally, a large proportion of Chinese FDI is channeled to large-scale-project-based activities which would benefit Pakistan's long-term development. For example, some Chinese companies have started to help resolve Pakistan's chronic power shortages. In 2010, the China International Water and Electric Cooperation pledged to invest \$6.5 billion in wind-power projects of 1,000 MW in Punjab and Sindh (China also helps to transfer pertinent technologies and to assist Pakistan in manufacturing solar panels and turbines)<sup>637</sup>; in 2011, the Chinese Three Gorges Project Corporation invested \$1.2 billion in the 720 MW Karot Hydropower project. Also, a large part of Chinese FDI in Pakistan is linked with telecommunications. In 2007, China Mobile purchased a 100% share of Pakistan Paktel at a price of \$460million; in July 2013, Huawei announced a plan to build a \$44 million fiber-optic cable linking Xinjiang and Rawalpindi.<sup>638</sup> (See Table 5.4)

**Table 5.4: Major Chinese Contract Investments in Pakistan (2006-2014)**

Time	Investor	Quantity in US\$ Millions	Share Size	Partner	Sector	Subsector
2006-12	China Communication Construction	\$490			Transport	Autos
2007-01	China Mobile	\$280	89%	Paktel	Technology	Telecom
2007-05	China Mobile	\$180	11%	Paktel	Technology	Telecom
2007-05	Sinomach	\$150			Energy	Gas
2009-09	Great Wall Industry	\$200			Technology	Telecom
2010-03	Sinomach and Gezhouba	\$1510			Energy	Hydro
2010-03	China Communication Construction (CCC)	\$220			Transport	Shipping
2010-04	China Mobile	\$300			Technology	Telecom
2011-09	United Energy	\$750		BP	Energy	
2011-12	Three Gorges	\$130			Energy	Alternative
2012-02	Three Gorges	\$270			Agriculture	
2012-05	United Energy	\$200			Energy	Gas
2012-08	State Construction of	\$230			Real estate	Construction

<sup>637</sup> "China to Transfer Solar Power Technology," *Dawn* 2010-12-21.

<sup>638</sup> "Huawei to Build China-Pakistan Link as Sharif Woos Investors," (Bloomberg News, 2013-07-05).



	Engineering					
2013-01	China Communications Constructions	\$300			Energy	Hydro
2013-04	China Mobile	\$520		Pakistan fp [sic]	Technology	Telecom

Source: China Global Investment Tracker Interactive Map, available at <http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map>

Investment clauses need to keep pace with the operation of TIG. In an FTA Amending Protocol, the two parties amended the “China-Pakistan Investment Zones” to “special industrial zones located in the territory of Pakistan notified by the Board of Investment, Government of Pakistan having not less than 40% investment by approved Chinese investors”. The Haier-Ruba Industrial Park, with an initial investment of \$35million, is the first and as yet only “investment zone”, now the home of more than twenty Chinese companies.<sup>639</sup> Details on the zone’s effects are sketchy, but the deteriorating trade imbalance and Pakistan’s thirst for attracting more Chinese investors has at least partially revealed Islamabad’s dissatisfaction with the CPFTA.

#### *Trade in Services*

Under the GATS, Pakistan needs only to liberalize 45 service sectors, whereas China opened 93. Yet both endeavor to open some GATS-plus services within the framework of TIS. Beijing takes the lead in liberalizing business services, recreational, cultural and sporting services, as well as transport, mainly in the form of a commercial presence. Pakistan’s commitment appeared more comprehensive, mainly in business services, distribution, educational, environmental and transport services. (See Charts 5.1 and 5.2) China’s openness in TIS under CPFTA ranks second among all Chinese FTAs (next only to the CNZFTA), with 99 subsectors overlapping commitments under GATS, 12 subsectors presenting further liberalization and another 12 subsectors exceeding its GATS agenda. Pakistan made even greater concessions (both in terms of the number of sectors subjected to opening obligations and the level of openness), with 51 subsectors overlapping commitments under GATS, 7 subsectors subjected to deeper opening and 41 subsectors surpassing the GATS agenda. Significantly, a number of these newly-opened sectors are to pave the way for China’s large-scale construction projects in

<sup>639</sup> Deborah Brautigam and Tang Xiaoyang, "Economic Statecraft in China's New Overseas Special Economic Zones: Soft Power, Business or Resource Security?," *International Affairs* 88, no. 4 (2012).

Pakistan, including architectural services, supporting services for rail and road transport, maintenance and repair of road transport equipment, and the like.

**Chart 5.1: China's GATS-plus commitments under CPFTA**

GATS improvements	GATS new subsectors
<ul style="list-style-type: none"> <li>• Softwar implementation</li> <li>• Data processing</li> <li>• Real estate</li> <li>• Translation and interpretation</li> <li>• Courier services</li> <li>• Sewage services</li> <li>• Solid waste disposal</li> <li>• Cleaing services of exhaust causes</li> <li>• Noise Abatement</li> <li>• Sanitation services</li> </ul>	<ul style="list-style-type: none"> <li>• Research and developement</li> <li>• Market Research services</li> <li>• Project management</li> <li>• Services incidental to mining</li> <li>• Related scientific technical consulting services and management (iron, copper)</li> <li>• Placement and supply services of personnel</li> <li>• Printing of packing materials, on a fee or contract basis</li> <li>• Hospital services</li> <li>• Hotels and restaurants</li> <li>• Sporting and other recreational services</li> <li>• Maintenance and repair services of motor vehicles</li> <li>• Passenger transportation</li> </ul>

**Chart 5.2: Pakistan's GATS-plus commitments under CPFTA**

GATS improvements	GATS new subsectors	GATS new subsectors
<ul style="list-style-type: none"> <li>• Engineering services for building infrastructure</li> <li>• Packet-switched data, E-mail, internet and intranet</li> <li>• Circuit-switched data transmission</li> <li>• Insurance and insurance related services</li> <li>• Settlement and clearing services for negotiable instruments</li> <li>• Leasing</li> <li>• Cash or portpolio management</li> <li>• All forms of collective investment management</li> <li>• Custodial and depository services</li> </ul>	<ul style="list-style-type: none"> <li>• Legal services</li> <li>• Accounting and booking</li> <li>• Architectural services</li> <li>• Veterinary services</li> <li>• Services provided by midwives, nurses, physiotherapists, and Paramedical personnel</li> <li>• Maintenance and repair services for office machinery and equipment</li> <li>• R&amp;D services in the social sciences and the humanities</li> <li>• Inter disciplinary R&amp;D</li> <li>• Printing publishing</li> <li>• Agricultural storage facilities</li> <li>• Range land services</li> <li>• Courier services</li> <li>• Wholesale trade</li> <li>• Retailing services</li> <li>• Franchising</li> <li>• Higher Education</li> <li>• Adult education</li> <li>• Sewage services</li> <li>• Refuse disposal</li> </ul>	<ul style="list-style-type: none"> <li>• Sanitation and similar</li> <li>• Cleaning services of exhaust gases</li> <li>• Noise abatement</li> <li>• Theme parks attraction</li> <li>• Convention centres</li> <li>• Libraries, archives, museums</li> <li>• Sporting services</li> <li>• Passenger transportaion</li> <li>• Freight tranportation</li> <li>• Container terminal</li> <li>• Maintenance and repair of rail transport equipment</li> <li>• Supporting services for rail and road transport</li> <li>• Rental of commercial vehicles with operators</li> <li>• Maintenance and repair of road transport equipment</li> <li>• Cargo-handling services</li> <li>• Storage and warehouse</li> </ul>

Source: China-Pakistan Agreement on Trade in Services, See official website of the China FTA Network, available at <http://fta.mofcom.gov.cn/topic/enpakistan.shtml>

It is understandable that China and Pakistan’s commitments to service liberalization are low since both are service deficit countries. In 2011, Islamabad’s net service deficit was \$2.04 billion, whereas Beijing’s figure was \$54.92 billion.<sup>640</sup> Besides, the two parties are not complementary in their service trade structures. As for China, the deficit in transportation is the largest, amounting to about 15.1% of its total service imbalance. This situation is even worse in Pakistan, where transportation services account for 65.9% of its overall service deficit. In this context, it would be very difficult for the TIS to promote bilateral trade in services, because economic regimes facilitate trade interactions only when trade structures are complementary. Take tourism as an example. According to the Pakistan Bureau of Statistics, the number of Chinese people travelling to Pakistan was 27,900 thousand in 2010, accounting for only 3.1% of Pakistani overall inbound tourist arrivals.<sup>641</sup> Similarly, China failed to attract as many as tourists from Pakistan even after cancelling limitations on travel agencies and tour operator services, and the share of proportion of Pakistani visitors in China is almost negligible. (See table 5.5)

**Table 5.5: Pakistani Visitors in China by Purposes (thousands)**

Year	Purpose					Total	Share of Proportion
	Meeting/ Business	Sightseeing/ Leisure	Visiting relatives and friends	Workers & Crew	Others		
2013*	36.3	22.7	0.1	54	15.2	79.7	0.411%
2012	42.4	29.8	0.1	6.5	18.0	96.7	0.356%
2011	39.4	29.5	0.1	6.5	17.1	92.5	0.341%
2010	35.6	28.2	0.1	6.7	16.7	87.3	0.334%
2009	31.2	27.9	0.00	6.8	15.5	81.5	0.372%

\*2013 from January to September

Source: National Tourism Administration of the People’s Republic of China, available at <http://www.cnta.gov.cn/html/rjy/index.html>

To summarize the above economic analysis – FTAs economic growth effects are not significant in the Sino-Pak case. Nor are strategic analysts correct when they assert that

<sup>640</sup> See official website of Chinese Ministry of Commerce, available at <http://tradeinservices.mofcom.gov.cn/c/2012-06-13/98571.shtml> , and the official website of Trade Development Authority of Pakistan, available at <http://www.tdap.gov.pk/tdap-statistics.php>

<sup>641</sup> See official website of Pakistan Bureau of Statistics, available at <http://www.pbs.gov.pk/content/social-indicators-pakistan-2011-6th-edition-0>

the CPFTA is a reward that Beijing passes to Pakistan. To quote a Pakistani media query: “has Pak-China trade reflected the mutual friendship and beneficial relationship that one hoped for through the FTA?”<sup>642</sup> Clearly, not all stories relating to this FTA are documented by the statistical data. No discussion of China’s economic relations with Pakistan would be complete without looking at the political side. In the eyes of Beijing, the CPFTA, if it is not a political reward to Islamabad, then what is it? We now turn to examine the prominent connections between economic and political issues in the formation and evolution of the CPFTA.

### 5.3 CPFTA and the Two-level game

#### 5.3.1 Level I games and Strategic Triangles

Complex-interdependence underpinned by increasingly institutionalized economic interaction does not alter the balance-of-power scenario in South Asia. Quite the opposite, age-old *realpolitik* logic still thrives. Great powers, notably the US, India and China, all strive for a balance-matrix favorable to their own interests. In this context, this section delves into the CPFTA by drawing on Lowell Dittmer’s notion of “strategic triangle”.<sup>643</sup> Considering power complexity and dynamics in contemporary South Asia, it is more illustrative to discuss three strategic triangles rather than one - namely, the Sino-Indo-Pak, the Sino-US-Pak, and the Sino-Indo-US – to decipher the matrix of interlocked ties linking each power with Pakistan. Specifically, all three triangular relationships studied in this section can be categorized as Stable Marriages, consisting of “amity between two players and enmity between these two and the third”.<sup>644</sup> In the Sino-Indo-Pak and the Sino-US-Pak triangles, it is the Sino-Pak amity versus India or the US; and in the Sino-India-US triangle, it is the India-US amity versus China. Each triangle contains a logic and dynamic of its own which shapes, while being shaped by the other two. In what follows we show the connections between each triangle and the CPFTA.

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<sup>642</sup> Salman Siddiqui, "Does Pak-China Trade Reflect Mutual Benefit?," (The Express Tribune, 2010-10).

<sup>643</sup> Dittmer, "The Strategic Triangle: An Elementary Game-Theoretical Analysis."p.485

<sup>644</sup> According to Dittmer, the “ménage a trios” refers to a triangle in which all three powers maximize their interests; and the “romantic triangle” means one player has amity with two other players, and the latter two have an enmity with each other. See *ibid.*, pp. 489-490

### *The Sino-India-Pak triangle*

The long, bitter enmity between India and Pakistan has been plagued by the former's evident efforts to build a South Asian free trade network to encircle the latter. India established its first FTA with Sri Lanka in 1998, and then expanded it into a Comprehensive Economic Partnership Agreement covering service and investment clauses in 2004. It also inked Preferential Trade Agreements with Afghanistan and Bhutan in 2003 and 2006 respectively. India also revised the Trade Agreement with Bangladesh in 2006 and the Treaty of Trade with Nepal in 2009. These efforts have already reshaped regional economic dynamics. In 2006, Bangladesh, Nepal and Sri Lanka's exports to India accounted for 63.5%, 98.3% respectively and 86.6% of their overall regional exports, a significant improvement compared to 42.3%, 83.6% and 31.4% in 1995. In 2007, the India investment stock in Nepal accounted for 98% of the latter's total inward FDI absorbed from the South Asian Association of Regional Cooperation (SAARC).<sup>645</sup> In 2008, India's investment stock in Sri Lanka roared to \$126 million, ranking itself as the second biggest investor in the country.<sup>646</sup> Apparently, an India-centric economic integration is emerging in South Asia.

On this triangular chessboard, India's expanding power indicates the diminishing significance of the Sino-Pak alliance. Islamabad fears being further geostrategically squeezed out of the region if New Delhi translates its accumulated economic leverage into political clout. Beijing, "marching West" toward the Indian Ocean, an area where it hopes to increase its influence, is deeply concerned about an ascendant India, which is "looking East" toward the South China Sea with similar intentions.<sup>647</sup> Viewing international politics as zero-sum, a Sino-Pak FTA represents the most straightforward resort to hedge against India's power projection in the region and beyond. This hedging is why Beijing and Islamabad negotiated and signed the CPFTA in a speedy fashion – it provides China a pivot point to enter into the SA market, and reduce Pakistan's concerns about India's FTA activism. This practice fully fits the realist faith that "politics determines the framework of economic activity and channels it in directions

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<sup>645</sup> "SAARC Statistics Year Book 2008," (Statistics and Informatics Division (SID) Ministry of Planning, Government of the People's Republic of Bangladesh, 2009). Available at <http://www.sid.gov.bd/sarrcstat/>

<sup>646</sup> Cherian Thomas, "Sri Lanka Sees Foreign Investment Quadrupling as Civil War Ends " (Bloomberg, June 1, 2009).

<sup>647</sup> The notion of "March West" was proposed by Wang Jisi. See Yun Sun, "March West: China's Response to the US Rebalancing," (Brookings Institution, 2013-01).

which tend to serve ... political objectives".<sup>648</sup> What makes India more worrisome about China's intention is that Pakistan is seemingly not the only regional country that welcomes China's greater presence in South Asia. Chinese engagement in the region offers a balance in an otherwise asymmetric regional structure that even all states together do not match India's dominance. This is also an important reason of why the SAARC lacks substantial progress. After embarking on the "One Belt, One Road" project, China has, in a high-speed, endeavored into establishing bilateral FTAs with other South Asian countries. On 28<sup>th</sup> September 2014, the Sino-Sri Lanka FTA was officially launched. On 4<sup>th</sup> February 2015, China launched FTA feasibility studies with Maldives.<sup>649</sup> These undertakings will, to different extent, change the current delicate Sino-Pak-Indo triangular balance.

### *The Sino-US-Pak triangle*

Anti-terrorism has greatly sweetened the US-Pak ties. Facilitated by the US-Pak Trade and Investment Agreement signed in 2003, the US is the only major economy with which Pakistan has enjoyed sustained trade surpluses in the past decade.<sup>650</sup> It is also by far Pakistan's most important importer, absorbing 14.95% of the latter's exports in the fiscal year of 2012, followed by United Arab Emirates' at 9.74%, and Afghanistan' at 9.50%. China ranks fourth at 9.28%, leaving a gap of over Rp.129 billion with its US rival. China is also dwarfed by the US in terms of FDI and foreign aid; the latter remains Pakistan's biggest investor as well as donor. (See Table 5.6 and Table 5.7) In October 2009, the same month that the Sino-Pak TIS entered into force, President Barack Obama signed the Enhanced Partnership with Pakistan Act of 2009, also known as the "Kerry-Lugar-Berman Bill", budgeting \$7.5 billion civilian assistance over five years to improve Pakistani governance, facilitate its economic growth, and invest in its civil society.<sup>651</sup> What alarms China most is that, when the US and India launched

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<sup>648</sup> Benjamin J. Cohen, "The Multiple Tradition of American IPE," in *Routledge Handbook of International Political Economy (IPE): IPE as a Global Conversation*, ed. Mark Blyth (New York: Routledge, 2008), p.30

<sup>649</sup> See China FTA Network official site, available at <http://fta.mofcom.gov.cn/list/ftanews/2/catlist.html>

<sup>650</sup> According to the International Trade Administration of the US, the trade surplus between America and Pakistan climbed from \$1.7billion in 2003 to \$2.1billion in 2013. See official website of International Trade Administration, US Department of Commerce, available at <http://tse.export.gov/TSE/MapDisplay.aspx>

<sup>651</sup> "Statement by the Press Secretary on the Signing of Kerry -Lugar-Berman," (2009-10-15). Available at <http://islamabad.usembassy.gov/pr-09101601.html>

negotiations on closer economic arrangements, Islamabad zealously encouraged Pakistanis living in the USA “to lobby for Pakistan, to get trade access to US markets, by encouraging US decision makers at the highest level to have a FTA”.<sup>652</sup> This case constitutes a good example of the notion of a strategic-triangle:

... there will always be an incentive for each country in the triangle to hedge its bets somewhat in respect of the other two. No country will unequivocally and irrevocably support any other; each will maintain some degree of flexibility as to its ‘tilt’ between the other two. Triangles are sustained by this uncertainty. The fear that even an erstwhile ally could ‘defect’ to the other side and this defection is consequential maintains the triangularity of the system.<sup>653</sup>

**Table 5.6: Country Wise FDI Inflows in Pakistan (US\$ millions)**

Country	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
FDI Excluding Pvt. Proceedings	1980.7	4873.2	5276.6	3719.9	2150.8	1634.8	812.6	244.4
USA	516.7	913.1	1309.3	869.9	468.3	238.1	233.0	44.5
USA’s Share of Proportion	26.09%	18.74%	24.81%	23.39%	21.77%	14.56%	28.67%	18.21%
China	1.7	712.0	13.7	(101.4)	(3.6)	47.4	120.9	8.4
China’s Share of Proportion	0.09%	14.6%	0.26%	-2.73%	-0.17%	2.90%	14.88%	3.44%

Source: Board of Investment of Pakistan, available at

[http://www.pakboi.gov.pk/index.php?option=com\\_content&view=article&id=180&Itemid=137](http://www.pakboi.gov.pk/index.php?option=com_content&view=article&id=180&Itemid=137)

**Table 5.7: Average Annual Recorded Grant Assistance to Pakistan, FY2004-2009 (US\$ Millions)**

Country/International Organizations	US	Saudi Arabia	UK	Other EC and Euro OECD members	Japan	Multinationals (WFP, ADB, UN, WB, IBD)	China	All Others	Total
Amount	268	137	124	63	54	44	9	8	707
Share of Proportion	37.91%	19.38%	17.54%	8.91%	7.64%	6.22%	1.27%	1.33%	100%

Source: Centre for Global Development, “Aid to Pakistan by the Numbers: What the United States Spends in Pakistan”. Available at

<http://www.cgdev.org/section/initiatives/active/pakistan/numbers>

<sup>652</sup> Mughal, "Evaluation of Pakistan-China FTA."

<sup>653</sup> Satyabrat Sinha, "The Strategic Triangle: India-China-Pakistan," in *China Report* (2004), p.225

Washington's economic superiority in Pakistan has, intentionally or otherwise, to some extent affected the Sino-Pak alliance and successfully attracted Islamabad away from Beijing. Realists believe that Washington's strategy of linking Pakistan in various economic institutions will persist in the future decade because maintaining Pakistan as the "most allied of allies in Asia" remains a pillar in America's Middle East Policy in the post-Bin Laden era.<sup>654</sup> During the period of US-Pak rapprochement, China only played a "very low-key role" in Pakistan by providing some weapons and exploiting minerals - to quote David Shambaugh, "this is the image the world has of China's present role".<sup>655</sup> Islamabad's initiative of building an FTA with the US alerted China – America's economic superiority is gradually marginalizing its long time attraction to Pakistan. Thus, preventing Islamabad from further leaning toward Washington became the fundamental reason why the CPFTA gained serious attention from Beijing. Although Pakistan is far from a qualified free trade partner, an FTA can effectively lock-in China's influence by institutionalizing rules and procedures favoring itself and creating higher defection costs. After the establishment of the FTA, China vigorously proposed expanding bilateral trade to \$15 billion by 2015. If this were to happen, China would transcend America as Pakistan's largest trading partner in about five years.<sup>656</sup> The inferences from this case are that not just Beijing's unchanged zero-sum mindset about the Sino-US relation, but more notably, is that it starts to use economic regimes, rather than conventional military support, as a leverage to counter-balance the US.

### *Sino-India-US triangle*

The CPFTA also matters in triangular FTA rivalries in a broader sense. On the east side, India has devoted much to lead the construction of a region-wide FTA in South Asia (SAFTA), which was signed on 6 January 2004 and entered into force two years later.<sup>657</sup> Economically, the SAFTA reflects a low possibility of uniting regional

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<sup>654</sup> Mohammed Ayub Khan, "The Pakistan-American Alliance," in *Foreign Affaires* (Council on Foreign Relations, 2012).

<sup>655</sup> David Shambaugh, "Is China Ready To Be A Global Power?," (Institute of South Asian Studies, National University of Singapore, 2009-11).p.2

<sup>656</sup> Shahid Javed Burki, "China's Play in South Asia," (Institute of South Asian Studies, National University of Singapore, 2011-01-20).p.9

<sup>657</sup> The construction of the SAFTA is embedded into a broader regional organization – the South Asian Association for Regional Cooperation (SAARC) – wherein the SAFTA was signed, ratified and supported.



neighbors into a cohesive trading bloc within a short period.<sup>658</sup> Politically, Beijing, as an outside power, would see this collective arrangement as inimical to its self-designated role in this region. On the west side, the US-led Trans-Pacific Partnership (TPP), aiming at creating a liberalized Asia-Pacific trade arrangement, has frozen and excluded China. At the same time, except for prior established FTAs (the US-Singapore FTA, the US-South Korea FTA, etc.), Washington has deliberately kicked off a round of FTA negotiations in Asia to create a regional trade arrangement like the TPP.<sup>659</sup> For many Chinese strategists, these FTA initiatives explicitly seek to contain a rising China.<sup>660</sup>

In response to the US's FTA activism, China is proactively pitching for its own FTA strategy that stretches across Europe, Asia and Latin America. The CPFTA, at the first glance, is merely one of many chess pieces in the Chinese FTA board. Nonetheless, just as Pakistan's unique strategic position links the Indian Ocean and the Pacific, the CPFTA stands out as a critical juncture hedging against both the SAFTA and the TPP. On the western side, China successfully stepped into the SAARC club as an observer in November 2005 – after much Indian opposition.<sup>661</sup> It is now seeking to be upgraded to a dialogue-partner via the SAARC-China summit. Pakistan has been lobbying hard for this initiative, which won support from Bangladesh, Sri Lanka and the Maldives. The next stop is full-fledged membership in SAARC, for which Beijing has won supporters including Pakistan, Nepal and Bangladesh, etc.<sup>662</sup> Once it has succeeded, joining the SAFTA will become a logical consequence and China will no longer be an outsider but

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Except for Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, the SAARC ratified Afghanistan as the eighth member of the SAFTA.

<sup>658</sup> Dilip K. Das, "The South Asian Free Trade Agreement: Evolution and Challenges," (MIT International Review, 2008).

<sup>659</sup> Mohamed Jawhar Hassan, "Trust-Building in Southeast Asia: What Made it Possible?," *Global Asia* 8, no. 3 (2013). p. 54

<sup>660</sup> Zhang Jian, "The US Uses the TPP Counter-balance China's Rise, and Contain China's Development Room [美国推 TPP 制衡中国崛起, 牵制中国发展空间]," (The Oriental Morning Post [东方早报], November, 2011); Li Xing and Zhang Han, "The TPP is an "Overt Plot", China Should Deal With It With Easy [TPP 是“阳谋”, 中国可从容应对]," (Chinese Institute of Strategy, July, 2013); Fan Sicong, "The Strategic Characteristics of the US-led TPP: How Should China Face it? [美国主导下的 TPP 的战略特点与中国的应对]," (Chinese Academy of Social Sciences, July, 2014).

<sup>661</sup> Gautam Murthy, *International Trade and Economic Co-operation: India's Approach and Perspective* (New Century Publications 2010).p.133

<sup>662</sup> Ians, "China Unleashes Charm for SAARC-plus One Summit," (Thaindian News, 2011-11-14).

an integral part, of South Asian economic integration. On the east side, after the launch of the TPP in May 2005, the Bangkok Agreement was formally transformed into the Asia Pacific Trade Agreement (APTA), and the first session of the Ministerial Council was held in Beijing in November 2005. Given China's leading role in the APTA, its support of Pakistan and the extant CPFTA, there is a high potential that Pakistan will join this arrangement. Yet both APTA and TPP are still under negotiation. Nor can we predict any precise relation between them. But China's 'proactivism' in weaving its own FTA network illustrates that it will not sit passively by as the US and India launch FTA-containment to outflank its ascendancy.

The power-based analysis outlined above sheds fresh light onto South Asian studies. First, great-power-led FTA-rivalries are emerging as a new focal point in international relations. Second, Pakistan can choose to balance between China and the US but it is the only regional balancer that Beijing counts on. Third, the CPFTA, an oft-ignored institution, possesses greater strategic potential than many might expect. Following these realist analyses in international institutions, the CPFTA is expected to gain great economic significance, as has been demonstrated by the US-Israel FTA (the United States has sacrificed more than \$71 billion in the deal and the equivalent of an average of 100,000 jobs in each of the post-FTA years).<sup>663</sup> However, although some observers have gone so far as to speak of Pakistan as "China's Israel",<sup>664</sup> this is not the case with the CPFTA: the TIG has caused a severe trade deficit to Pakistan's disadvantage; investment and service clauses serve as more of symbolic references. According to a report by the Pakistan Institute of Trade and Development, due to tariff exemptions offered to Chinese products, Pakistan had suffered trade deficits of Rs139 million in 2006-07 during the EHP period, and Rs6.1 billion in 2009-10 during the FTA period.<sup>665</sup> Worse, Islamabad has lost trust in Beijing and the CPFTA today is often referred to as a bad deal during Pakistan's FTA negotiations with other countries.<sup>666</sup>

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<sup>663</sup> Ray Hanania, "Israel's Government Abuse Free Trade Agreement with US," (The American Muslim, 2009-03).

<sup>664</sup> Robert O. Wirsing, "'The Enemy of My Enemy': Pakistan's China Debate," in *Asia's China Debate* (Asia-Pacific Center for Security Studies, December, 2003).p.4

<sup>665</sup> Mughal, "Evaluation of Pakistan-China FTA."

<sup>666</sup> See Aftab Maken, "FTA Benefiting China More Than Pakistan," (The International News (Pakistan), August, 2011); Salman Siddiqui, "Does Pak-China Trade Reflect Mutual Benefit?," (The Express Tribune, October, 2010); Hayat, "The Opportunities and Pitfalls of Pakistan's Trade with China and Other Neighbors."

In reality then, the CPFTA is not a reward that China grants to its ally, but a booster to weaken asymmetric Sino-Pak economic relations. It is necessary to turn back to Dittmer's "strategic triangle", which suggests that "if the positive relationship between the two alliance partners is asymmetrical, the third party may be able to persuade the less beneficiary to defect, and thereby establish a new and more favorable balance".<sup>667</sup> Skeptics may query, since the CPFTA was established to counter-balance the US and India, why it so pervasively alienates Pakistan from China? Going further, since China has successfully ensured a CAFTA to ASEAN's advantage, why use the same means to produce the same (or similar) ends in the CPFTA? A possible answer is that realist "strategic triangles" explains only *some* of international regimes, not *all*. To illustrate, Dittmer argues that a strategic-triangle derives from when "states experience needs that cannot be adequately satisfied at the domestic level".<sup>668</sup> Dittmer, like many other realists, however, missed a significant part of the strategic-triangle – state needs can hardly be satisfied at the international level if its partner lacks the necessary domestic conditions. Therefore, realist analysis regarding states as unitary actors only explains the initiation stage of the FTA, but fails when deciphering its implementation and economic results. To overcome this deficiency, the following analysis now turns to a liberal lens by referring to China and Pakistan's domestic political economy.

### **5.3.2 Level II games and CPFTA's economic humbleness**

Neoliberal institutionalists allow for plurality in state behaviors. Accordingly, in spite of the central government, there are also other factors determining the fate of a regime, such as local governments, SOEs, private sectors, vested interest groups, and public opinions. Introducing these domestic variables needs to separate regimes (the "cause") and cooperation (the "effects"): regimes cannot be meaningfully hypothesized to further cooperation.<sup>669</sup> Therefore, where governments once dominated markets, now it is the markets that, on many crucial issues, dominant governments.<sup>670</sup> Cooperation is more likely to be attained only if the markets concomitantly accept regimes inked by

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<sup>667</sup> Dittmer, "The Strategic Triangle: An Elementary Game-Theoretical Analysis."p.490

<sup>668</sup> Ibid.p.486

<sup>669</sup> Andreas Hasenclever, *Theories of International Regimes*.p.33

<sup>670</sup> Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?." p.787; Evan A. Feigenbaum, "China's Pakistan Conundrum," (Foreign Affairs, Council of Foreign Relations, US, 2011-11).

governments. In this vein, since neither Pakistan nor China has qualified domestic conditions, the CPFTA as the “cause” cannot make headway toward “expected results”.

Pakistan has three major domestic problems that are responsible for the CAFTA’s low efficiency. First, its fragile economy – serious energy-shortages, low productivity, high levels of product concentration and the low sophistication of the country’s exports are all crucial factors that not only undermine its national welfare but also stir up public discontent and unrest. Worse, they exacerbate extremism which in turn increases Pakistan’s economic fragility.<sup>671</sup> Second, dismal governance – high rates of corruption and poverty, along with mounting friction between the military, the judiciary and the civilian government has seen Pakistan ranked as the 12<sup>th</sup> in the most-failed state index.<sup>672</sup> Third, inept political leadership – given that the CPFTA cannot produce immediate economic results for their official careers, Pakistani leaders focus more on soliciting aid from China rather than gaining access to its market.

Yet in China, despite the support of the top leadership, the CPFTA is not supported by all. To be sure, “socialism” has long been masked by a realist stereotype thinking that the CCP can allocate all social capital whenever and wherever it wants. It is often taken for granted that Chinese financiers generally follow the flag and Chinese firms can bear more risks than their western counterparts.<sup>673</sup> The ineffectiveness of the CPFTA, however, has caused that mask to slip. Contemporary China is undergoing a fierce domestic transformation from socialism to state-capitalism, or in its own words “socialism with Chinese characteristics” – a unique duality that combines top-down state guidance with bottom-up entrepreneurial private capital accumulation.<sup>674</sup> An increasing number of bureaucracies have stepped into China’s policy-making process, including state-entrepreneurs like banks and energy companies, major exporters of manufactured goods, and even the military. Instead of pursuing pure strategic objectives,

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<sup>671</sup> Hamna Ahmed; Mahreen Mahmud; Naved Hamid; Talal-Ur-Rahim, "A Strategy for Reversing Pakistan’s Dismal Export Performance," in *CREB Policy Paper No. 01-10* (Centre for Research in Economics & Business, Lahore School of Economics, 2010).

<sup>672</sup> Bruce Stokes, "Seeds of Unrest in Pakistan’s Economy," (Pew Research Global Attitudes Project, 2013-02).; and "Pakistan Ranks 12th on Failed States Index: Report," (The Express Tribune, 2011-07-21).

<sup>673</sup> Feigenbaum, "China's Pakistan Conundrum."p.2

<sup>674</sup> McNally, "Sino-Capitalism: China's Reemergence and the International Political Economy."; Shaun Breslin, "The Transition form Socialism: An Embedded Socialist Compromis?," in *China and the Global Political Economcy*, ed. Shaun Breslin (2007).

most of them seek resources or markets for commercial reasons. With loosening capital controls and decreasing macroeconomic supervision and regulation, top leaders today seem “unwilling or unable to meld the interests of these different groups into a coordinated grand strategy”.<sup>675</sup>

Liberals such as Robert Keohane stress that common interests are a basis for cooperation under international regimes. In the CPFTA case, top decision-makers in Beijing are well aware of the “common strategic interests” beneath the trade deal – a main reason it was established. But in Pakistan, poor public security and shabby infrastructure have made Chinese companies very skeptical about returns on their economic activities. Thus lacking “common commercial interests” explains the CPFTA’s implementation conundrum. A Chinese scholar’s interview in *The Hindu* supported this liberal argument. According to him, the government’s controllability “only goes so far” and “ultimately, whether or not a company decides to continue investing in Pakistan depends on whether the environment is suitable for business and profits can be made ... The government can’t force companies to continue operating, no matter what the political relationship is”.<sup>676</sup> Hence for liberal analysts, the CCP’s obsolete statecraft has lagged behind the development of its capitalism, which, to quote Carrett’s words, “like a horse and buggy haplessly trailing a sports car”.<sup>677</sup> This situation aptly fits with Ruggies’ conception of an “embedded liberalism”, or, in China’s case, the transformation of an “embedded socialism”.

To conclude, realists are correct in explaining the emergence of the CPFTA – it is a diplomatic tool to compete with India and the US. Nevertheless, liberals’ argue that choosing to participate in a regime is not the same thing as being able to control the way that such participation occurs – the CPFTA’s rocky implementation is a testimony to this argument. Theoretically, the finding of this section responds to regime analysts’ call for steps “towards a contextually richer theory that is able to explain international

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<sup>675</sup> Thomas Christensen, "The Advantage of an assertive China: Responding to Beijing's Abrasive Diplomacy," in *Foreign Affairs* (Council on Foreign Relations, 2011). p.3

<sup>676</sup> Ananth Krishnan, "Fearing Instability, Chinese Companies Rethink Pakistan Investment," *The Hindu* 2012-01-13.

<sup>677</sup> Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?."p.787

politics better than either vulgar realism or vulgar liberalism in isolation”.<sup>678</sup> Practically, we find that the challenges of making domestic Chinese constituents accept and obey any commitments under the CPFTA (the level II game) override the establishment of the CPFTA *per se* (the level I game). Of course, an embedded socialism does not mean that the CCP has lost its dominant position. Rather, in Shaun Breslin’s words, the transforming “-ism” in China is “one where state actors, often at the local level, remain central to the functioning of an economic system that has dysfunctionally emerged to suit their interests”.<sup>679</sup> In this sense, Pakistan’s strategic significance to China’s foreign policy will not change as long as Beijing’s political will remains unchanged.

## **5.4 The CPFTA and the Sino-Pak Friendship**

### **5.4.1 Is there a friendship between China and Pakistan?**

As noted in section 5.2, the economic results of the CPFTA are to Pakistan’s disadvantage. Nevertheless, even if Islamabad has not reaped its expected rewards from the trade deal, it does not appear to necessarily have caused a rift in the Sino-Pak relationship. Rather, according to a 2013 survey released by the Pew Organization, Pakistanis surveyed overwhelmingly held a positive opinion of China (81%), making Pakistan the only country that loves China more than China itself, indicating that the much-touted “friendship” is not an exaggeration.<sup>680</sup> This section now turns to constructivism, which argues that the CPFTA has important non-material connotations – a significant facet deeply embedded into the decades-long relationship, but one that has not received due attention.

The Sino-Pak friendship is not a given, nor should it be taken for granted. It started with the recognition of equality and mutual respect in some one-off acts of cooperation. It then advanced beyond occasional cooperation and gradually evolved into specific perceptions of reliability, trust and belongingness. Overtime, and along with both governments’ propaganda, the top-down political rhetoric of “China/Pakistan is our good friend” eventually elicited positive resonance from domestic audiences. After being tested by trying times over critical issues, a sense of “friendship”, or in their own

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<sup>678</sup> Duncan Snidal, "The Relative-Gains Problem for International Cooperation: Response," *American Political Science Review* 87(1993).p.213

<sup>679</sup> Breslin, "The Transition from Socialism: An Embedded Socialist Compromise?." pp.40-41

<sup>680</sup> Rafia Zakaria, "Breaking up with China?," (The Dawn, July, 2014).

words “brotherhood”, was finally established, with deep historic and mass support. In the 1970s, it was Pakistan that led the United Nations (UN) campaign for the restoration of the PRC as the legitimate UN representative, not Taiwan. In turn, at the UN Security Council, China used its veto power to stall Bangladesh’s independence movement in 1972.<sup>681</sup> Moreover, while Pakistan is not the only country that faithfully supports the One-China policy, it was one of the very few that strongly supported China after 4<sup>th</sup> June 1989. Yet what moves Chinese people most was that during the 2008 earthquake in Sichuan, Pakistan almost emptied its national storage of tents to support the disaster area; and that when the Olympic torch passed through Pakistan, local people reportedly showered rose petals upon the procession.<sup>682</sup> China, on the other hand, is not the only country that gives Islamabad military and economic support, but it was the only country, after the US took unilateral military action to kill Bin Laden in 2011, that publicly accused the US of violating Pakistani sovereignty.<sup>683</sup> Against this backdrop, the best ingredients for friendship between countries, similar to friendship between people, are not money and weapons but moral and diplomatic support through difficult times.

Realists argue that “there are no friends or foes in international relations”.<sup>684</sup> Nor do they believe that an international institution would appear without a material-base and external-enforcement. Assuming a worst-case scenario, realists believe in the “ineradicable tendency of states to evil”.<sup>685</sup> Thus they maintain that a country’s foreign diplomacy is morality-free.<sup>686</sup> As they see it, the endurance of the Sino-Pak friendship is mainly due to the persistence of strategic complementarities, particularly India – “The enemy of my enemy is my friend”.<sup>687</sup> Yet this doctrine lacks supporting empirical content. A case in point is the fact that despite the huge amount of money and arms that

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<sup>681</sup> Qandeel Siddique, "Deeper Than the Indian Ocean? An Analysis of Pakistan-China Relations," in *SISA Reports* (Centre for International and Strategic Analysis February, 2014).pp.9-11

<sup>682</sup> "Pakistan-China Relations," (Finding Neverland, May, 2011); IPS Study, "Pak-China Relations in the 21st Century: Regional Situation, Security, Economic & Trade Cooperation " (Institute of Policy Studies, Islamabad).

<sup>683</sup> Ananth Krishnan, "Respect Pakistan's Sovereignty, China Tells the US," *The Hindu* 20 May, 2011.

<sup>684</sup> Siddique, "Deeper Than the Indian Ocean? An Analysis of Pakistan-China Relations."p.13

<sup>685</sup> Jack Donnelly, *Realism and International Relations* (New York: Cambridge University Press, 2000).p.5

<sup>686</sup> Selina Adam Khan, "The Realist/Constructivist Paradigm: U.S. Foreign Policy Towards Pakistan and India," *Reflection*, no. 8 (2010).p.2

<sup>687</sup> Robert O. Wirsing, ""The Enemy of My Enemy": Pakistan's China Debate."p.2

Washington has poured into Pakistan (Pakistan has received \$22 billion in military and economic assistance since 9/11) it is viewed as “an opportunist who has used Pakistan at will in pursuance of its own strategic agenda”.<sup>688</sup> Ironically, in the same 2013 Pew Survey in which an overwhelming majority of Pakistanis surveyed held a positive opinion of China, negative opinions toward the US were recorded at 89%, much higher than any other country worldwide.<sup>689</sup> Against this backdrop, constructivists rightly pointed out that cooperation rests on goodwill rather than enforced obedience.<sup>690</sup>

Constructivists highlight the potential of norms that “lie at the core of strategies to deter and compel certain behaviors when dealing with friend and foe alike”.<sup>691</sup> They believe that the connection between interests and foreign policy “is at least as important as the nature of the policy itself”.<sup>692</sup> As will be discussed in next section, the CPFTA, the Gwadar Port project, and the Sino-Pakistan Economic Trade Corridor (ETC) were all the result of Pakistan’s invitations, rather than China’s initiative.<sup>693</sup> For example, in 2011, Pakistan’s Defense Minister Ahmed Mukhtar stated that Pakistan had invited China to build a naval base at Gwadar.<sup>694</sup> This invitation gave rise to speculation that Gwadar would grant China a foothold in the Indian Ocean to challenge American and Indian naval supremacy in the region. But these speculations were laid to rest when China denied any such intention.<sup>695</sup> Apparently, a country only invites friends to build military bases in its own territory, indicating that “A gun in the hands of a friend is a

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<sup>688</sup> See Rajshree Jetly, "Sino-Pakistan Strategic Entente: Implications for Regional Security," in *ISAS Working Paper* (Institute of South Asian Studies, National University of Singapore, February, 2012).p.13; Rizwan Zeb, "Pakistan-China Relations: Where They Go and From Where?," in *UNISCI Discussion Papers* (May, 2012); Mahmood, "Pakistan-China Strategic Relations."p.11; Siddique, "Deeper Than the Indian Ocean? An Analysis of Pakistan-China Relations."p.15; and "China's Queen, Pakistan's Pawn," (The Diplomat, May, 2011).

<sup>689</sup> "America’s Global Image Remains More Positive than China’s: But Many See China Becoming World’s Leading Power," (Pew Research Global Attitude Project, 2013-07-18).

<sup>690</sup> See John Kilcullen, "Locke on Political Obligation," *The Review of Politics* 45(1983); Ramesh Thakur, "Law, Legitimacy and United Nations' " *Melbourne Journal of International Law* 11, no. 1 (2010).

<sup>691</sup> Richard Ned Lebow, "The Role of Trust in International Relations," *Global Asia* 8, no. 3 (2013).p.18

<sup>692</sup> Khan, "The Realist/Constructivist Paradigm: U.S. Foreign Policy Towards Pakistan and India."p.3

<sup>693</sup> See Murthy, *International Trade and Economic Co-operation: India's Approach and Perspective*; Jetly, "Sino-Pakistan Strategic Entente: Implications for Regional Security."p.17,

<sup>694</sup> Richard Weitz, "China Ponders Pakistan's Naval Base Offer," (World Politics Review, May, 2011).

<sup>695</sup> "Friendly But Out of Loop: China Unaware of Gwadar Proposal ", (The Express Tribune, May, 2011).



different thing from one in the hands of an enemy, and enemy is social not material, in relationship”.<sup>696</sup>

This section argues that the CPFTA is, to a great extent, an extension of the Sino-Pak relationship which “was indigenously constructed rather than exogenously determined”.<sup>697</sup> To illustrate, both the China-ASEAN FTA and the CPFTA were preceded with an Early Harvest Program, signaling China’s unilateral concessions. Moreover, under both FTAs, China made more tariff concessions to ensure that these trade deals were to the advantage of its partners. While the CAFTA was set out to mitigate ASEAN’s wariness of China’s ascendancy, the CPFTA had no such intention, since a rising China poses no threat to Pakistan. In this sense, Beijing’s concessions to Pakistan are driven mainly by the idea of promoting its economic reform and bolstering its economy. The constructive rationale also explains why the CPFTA, failing to achieve its desired results, still successfully acquired a life of its own and entered a new phase of implementation. Liberals may contend that the ineffective CPFTA is Islamabad’s miscalculation, but constructivists counter-argue that friendship “blurs the distinction between means and ends because it has positive values in its own right, independently of any specific end it is intended to serve”.<sup>698</sup> From the constructive perspective, in the initiation of a regime, conventional costs-calculations rarely happen. Even once the regime has proved to be ineffective, the feeling of increased mutual accountability is always much more valued than economic losses. This is why the asymmetric economic relationship between China and Pakistan does not hinder their favorable impressions of each other – a perception of friendship provides buffers against the corrosive impacts brought about by disappointing economic interactions.

#### **5.4.2 A norm-divergence between the two friends**

Despite these positive aspects, there are some negative trends casting shadows on Sino-Pak friendship. China’s rapid growth has led its elites to develop more lofty and forward-looking ideas about where to go and what to do, in contrast to their Pakistani

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<sup>696</sup> Karl K. Schonberg, *Constructing 21st Century U.S. Foreign Policy: Identity, Ideology, and America's World Role in a New Era* (Palgrave Macmillan, 2009).p.8

<sup>697</sup> Sorpong Peou, "Realism and Constructivism in Southeast Asian Security Studies Today: A review essay," *Pacific Review* 15, no. 1 (2002).p.354

<sup>698</sup> Richard Ned Lebow, "The Ancient Greeks and Modern Realism: Ethics, Persuasion, and Power," in *Tragedy, Power, and Justice: Realism and Global Political Theory*, ed. Duncan Bell (Oxford: Oxford University Press, 2008).p.28

counterparts. This gap can be observed in the two countries' media reports on the CPFTA: whilst Chinese media regards the CPFTA as a crucial step toward a new path and a new mode of propping up the Sino-Pak friendship, some Pakistani media has expressed their disappointment, many times referring to the CPFTA as a failed and bad deal.<sup>699</sup> To explain these differences we can use a new constructivist concept of "norm divergence". Norm-based theories argue that norms collectively shared by decision-makers serve as roadmaps and when embedded in institutions, contribute to achieving positive outcomes in the absence of equilibrium.<sup>700</sup> Conversely, different or contradictory norms may be counter-productive to institution building. As these divergent norms evolve, both institutional disputes and misunderstanding will increase, so do regime norm divergences. This phenomenon has much relevance for understanding the implementation conundrum of the CPFTA.

For China, a poor and unstable Pakistan is a troublemaker, but a self-sufficient and economically self-sustained Pakistan will be a more prominent assistant regarding political issues. As Mathieu Duchatel observed, Beijing's priority in Kashmir has shifted from "weakening India, to tacitly accepting Indian power, to vigilance that Pakistan not become too weak".<sup>701</sup> Recognizing that there is no "external solution" to revive Pakistan, China turns to a bilateral FTA to internally bring its economy back on track. This is an apparent lean toward economic liberalism, which stresses that economic regimes provide "economically important collective goods – ranging from the accumulation of human and physical capital, to social stability under conditions of high market uncertainty, to popular support for the market economy itself – that are undersupplied by markets and valued by actors who are interested in productivity".<sup>702</sup>

Moreover, neo-liberalism is indeed an important rationale guiding the PRC's economic ascendancy. As Buzan and Lawson noted, global economic governance is far more

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<sup>699</sup> For China's viewpoints, see Ahmad Rashid Maik, "Pakistan Set to Win Multiple Benefits From China's Regional Leadership," (Global Times, April, 2014); "Wen's Visit to Elevate China-Pakistan Relations to New Level," (People's Daily Online, December, 2010). For Pakistan's viewpoints, see Salman Abduhu, "FTAs with China, Malaysia Damaging Poultry Industry," *The Nation* 28 April, 2014; Maken, "FTA Benefiting China More Than Pakistan."

<sup>700</sup> John Barkdull and Paul G. Harris, "Environmental Change and Foreign Policy: A Survey of Theory," *Global Environmental Politics* 2, no. 2 (2002).p.82

<sup>701</sup> Jetly, "Sino-Pakistan Strategic Entente: Implications for Regional Security."p.19

<sup>702</sup> Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?."p.823

institutionalized today. Even China, perhaps the most likely current candidate to seek to revise the way global markets operate, is firmly committed to extant institutions and regimes to ensure gains from globalization.<sup>703</sup> The CPFTA is an attempt to export China's successful model and resuscitate Pakistan's stagnant economy, and if possible, to socialize Pakistani elites into a similar liberal worldview. In Beijing's eyes, institutionalizing its economic cooperation with Pakistan is for the latter's own good. Over time, the trade pact will increase Pakistani government's propensity to cede power to the civilians, rather than persistent focusing on pure defense building. This would be a long process, but the process must begin – and the CPFTA is an apt starting point.

On the Pakistan side, after being repeatedly rewarded for its “political loyalty”, its ruling oligarchs have steadily become addicted to “foreign assistance” such as direct monetary aid from the US, Japan, and of course China.<sup>704</sup> For decades, Pakistanis have been the principle beneficiaries of material Chinese assistance.<sup>705</sup> Some Pakistanis even take China's aid for granted. As a commentary in Pakistan's *Dawn* newspaper tells it, “The Chinese know if there is a political will, there will be an economic way”.<sup>706</sup> Nevertheless, the easy access to foreign assistance has long kept Pakistan's development hostage – leaders are “prepared to take risks with the economy in the expectation that the country would be bailed out should it land in serious crises”, as it has been proved again and again.<sup>707</sup> Guided by this thinking, Islamabad shows only half-hearted support for the CPFTA – the government has not made any further commitment to the trade deal's Phase II negotiations, but has lobbied Beijing to invest in its mega infrastructure projects.<sup>708</sup> These lobbies are obviously very useful – when Xi

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<sup>703</sup> Lawson, "Capitalism and the Emergent World Order."p.87

<sup>704</sup> Rehman Sobhan, "The Problem of Regional Imbalance in the Economic Development of Pakistan," in *Politics of Modern South Asia (Critical Issues in Modern Politics)* ed. Subrata Mitra (London: Routledge, 1962).p.152; Bruce Riedel, "Three Ways to Help Pakistan," (The Brookings Institute, June, 2011).

<sup>705</sup> Robert O. Wirsing, ""The Enemy of My Enemy": Pakistan's China Debate."p.6

<sup>706</sup> Muhammad Amir Rana, "Threat to Sino-Pak Friendship," *Th Dawn* 23 September, 2014.

<sup>707</sup> Shahid Javed Burki, "Pakistan's Politics and Its Economy," in *Routledge Handbook of South Asian Politics : India, Pakistan, Bangladesh, Sri Lanka, and Nepal*, ed. Paul R Brass (London: Routledge, 2010).p.90

<sup>708</sup> "Pakistan Seeks Investment Lif," *China Daily* 20 May, 2011; "Preliminary Study on Pakistan and China Trade Partnership Post FTA," (The Pakistan Business Council, 2013).

Jinping visited Pakistan in April 2015, the two “iron-brothers” rolled out plans for a historic \$46 billion portfolio agreed under Sino-Pak Economic Corridor.<sup>709</sup>

Another factor that threatens to fray the Sino-Pak bonds of affection is India. To be sure, India, with which both Beijing and Islamabad have shared adversarial relations, remains a crucial factor in sustaining and cementing the Sino-Pak friendship.<sup>710</sup> Nevertheless, with India and China respectively growing into economic engines in South Asia and East Asia, the two have moved a long way from the political hostilities generated by the 1962 war, toward more economic pragmatism. Sino-Indo economic cooperation has grown rapidly in recent years. In 2005, China supplanted the US and became India’s largest single source of imports. In 2012, bilateral trade climbed to \$66 billion, 5.5 times higher than the Sino-Pak trade volume (\$12 billion).<sup>711</sup> China has been keen on building an FTA with India. According to a feasibility study finished in October 2007, the Sino-Indo FTA would be advantageous to both parties.<sup>712</sup> India therefore, with its great market potential and huge purchasing power, has emerged as China’s much-anticipated economic partner. Moreover, both countries now assume a collective identity as the BRICS bloc, the AIIB, as well as the RCEP. It is in the interests of China to cooperate with, rather than to act aggressively toward India in a medium-long term, because Beijing needs New Delhi’s collaboration over global issues in a broader sense, such as environmental protection, energy security, and anti-terrorism.

With this growing interdependence, China itself has a vested interest in befriending India and would not allow its relationship to cool when confrontations or even wars break out between Pakistan and India. Hence, barring any unfavorable developments, Beijing would continue to have a stake in maintaining the *status quo*. To this end, China is actively promoting a thaw in India-Pakistan relations, at least in the economic arena. For instance, in the wake of Pakistani President Zardari’s visit to India in 2012, Prime Minister Yousuf Raza Gilani said that it was “our best friend China ... [who] advised us to promote trade relations with India”.<sup>713</sup> An unspoken corollary is that Islamabad is not

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<sup>709</sup> Muhammad Shahbaz Sharif, “Xi’s heartwarming visit demonstrates iron brotherhood of China and Pakistan”, *Global Times*, 1<sup>st</sup> June, 2015.

<sup>710</sup> Jetly, "Sino-Pakistan Strategic Entente: Implications for Regional Security." p.16

<sup>711</sup> Ananth Krishnan, "India's Trade With China Falls 12%," *The Hindu* 2013-01-10.

<sup>712</sup> See the official website of China FTA Network,, available at <http://fta.mofcom.gov.cn/topic/enindia.shtml>

<sup>713</sup> Pantucci, "Break Up Time for Pakistan, China?."

particularly willing to improve economic relations with New Delhi. In fact, within Pakistan's political and military circles, an anti-India mentality is an important tool to assert their legitimacy.<sup>714</sup> Among the Pakistani general public, there is widespread suspicion of India - a 2010 Pew Survey reveals that 74% of respondents viewing India as a threat, with 53% of them believing that India was a "very serious threat".<sup>715</sup> Against this backdrop, Pakistani politicians have consistently blamed New Delhi for the lack of success of the SAARC, an India-led regional cooperation regime.<sup>716</sup> Moreover, Islamabad refused to comply with India's regional policies by constantly forming counter blocks to the SAARC.<sup>717</sup> This situation reveals a big norm divergence between China and Pakistan. As Qandeel Siddique noted, at present the notion is that India, as a common adversary binding the China-Pak friendship, carries greater weight for Islamabad than for Beijing.<sup>718</sup> Nevertheless, Pakistanis need to consider a troubling possibility that economic pragmatism, awakened by the opportunity of the joint pursuit by India and China of economic modernization, may increasingly drive China's policies in South Asia.<sup>719</sup>

China and Pakistan's variety of reactions toward the FTA policy, according to Kratochwil and Ruggie, indicates that "what constitutes a breach of an obligation undertaken within a regime is not simply an 'objective description' of a fact but an intersubjective appraisal".<sup>720</sup> Given this intersubjective divergence, Beijing may focus more on the CPFTA's positive effects on improving bilateral economic relations to a high level, rather than solely concentrate on political and defense relations. Islamabad,

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<sup>714</sup> Shairee Malhotra, "India: Recognizing Pakistan's Paradigm Shift," (The Diplomat, June, 2014); "Pakistan's Educational System Continues to Encourage Anti-India Sentiments," (The Economic Times, June, 2012).

<sup>715</sup> A point to note is that India remains more unpopular than al-Qaeda or the Taliban amongst the Pakistani public. See "Concern About Extremist Threat Slips in Pakistan," (Pew Research, July, 2010). Available at <http://www.pewglobal.org/2010/07/29/concern-about-extremist-threat-slips-in-pakistan/>

<sup>716</sup> See Sumita Kumar, "Pakistan and Regionalism," *Strategic Analysis* 6, no. 1 (2006).p.130; Hannes Ebert, Daniel Flandes, and Georg Strüver, "The Politics of Contestation in Asia: How Japan and Pakistan Deal with Their Rising Neighbors," *The Chinese Journal of International Politics* 7, no. 2 (2014).pp.255-256

<sup>717</sup> Ebert, Flandes, and Strüver, "The Politics of Contestation in Asia: How Japan and Pakistan Deal with Their Rising Neighbors."

<sup>718</sup> Siddique, "Deeper Than the Indian Ocean? An Analysis of Pakistan-China Relations."p.23

<sup>719</sup> Robert O. Wirsing, ""The Enemy of My Enemy": Pakistan's China Debate."p.5

<sup>720</sup> Andreas Hasenclever, *Theories of International Regimes*.p.179

however, may put a question mark over why Beijing insists on implementing the CPFTA, since the size of Pakistan's economy is very small when compared to the PRC's and foreign assistance to Pakistan only accounts for a small percentage of its huge foreign exchange reserves. In addition, whilst Beijing indicates that Pakistan's unstable domestic political economy and under-developed production structure are the main reasons impeding the CPFTA, a study by the Trade Development Authority of Pakistan complains that a cause of the FTA's ineffectiveness is that it has "too small tariff lines coverage and elimination of tariff under FTA elimination".<sup>721</sup> What's more, Pakistan's business circles have also voiced dissatisfaction with the CPFTA. To quote Fazal-ur-Rahman:

The common perception in the Pakistani business community is that the Chinese private and public sectors are not interested in investing in areas that could enable Pakistan to create an export surplus for Chinese markets as well as other destinations. Rather, they contend, Chinese entrepreneurs simply want to sell products and make quick profits while based in China and do not seem to be interested in generating profits from Pakistan through joint venture of private foreign ownerships.<sup>722</sup>

In this context, Islamabad may have the perception that there is no commensurate commitment from Beijing to match their "friendship". As for Beijing, a negative perception may arise if "Pakistan wants more out of its ties with China than China is willing to offer".<sup>723</sup> Consequentially, if neither party changes their norms, the CPFTA would undermine the foundation of friendship-based cooperation altogether. Given that Islamabad cannot embrace all neoliberal doctrines overnight, a wise choice for China may be to use all tools at its disposal to reverse trade balances and boost investment to ensure that the economic effects of the CPFTA are not to Pakistan's disadvantage.

In short, the growing asymmetry in economic-political relations between China and Pakistan has posed a big challenge to the time-tested friends. Fortunately Islamabad has recognized this phenomenon. For example, Ahsan Iqbal, Pakistan's Federal Minister of Planning, Development, and Reform, told the Wall Street Journal that "In the past, the

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<sup>721</sup> "Steps to Maximise benefits of Pak-China FTA Proposed," (Recorder Report, September, 2012).

<sup>722</sup> Fazal-ur-Rahman, "Pakistan-China Trade and Invesement Relations," in *Pakistan-China Relations - 2011: Year of Friendship* (Islamabad: Institue of Strategic Studies, Islamabad, 2011).p.4

<sup>723</sup> Harsh Pant, "The Pakistan Thorn in China-India-U.S. Relations," *The Washington Quarterly* 35, no. 1 (2012).p.92

economic relationship [with China] could not match the political one. Now the leadership on both sides has realized that we have to bridge that gap".<sup>724</sup> Moreover, Pakistan is inspired by the Chinese example that economies that have major political disputes can still trade extensively and become FTA partners, for example, the FTAs negotiated between China-India, China-Taiwan and China-Japan.<sup>725</sup> Islamabad has therefore indicated that it could explore the possibility of establishing an FTA with India.<sup>726</sup> In 2011, the Cabinet of Pakistan even decided to to grant the Most Favored Nation Status to India. Although the deadline was then missed again and again because political considerations involved, such "consideration" is still not a bad sign. In this sense, China's special relationship with Pakistan serves as a means to exhort the latter to moderate its policy toward India and potentially contribute to a stable regional environment. These are all encouraging signs that Pakistan is gradually leaning toward a pragmatic rationale that "economy first, politics second", an important norm that China adopted in its economic diplomacy.<sup>727</sup> If this momentum can be maintained, the pair will reverse from norm-diversion to norm-conversion, further consolidating their friendship. All in all, the close friendly relationship between Beijing and Islamabad seems likely to remain an enduring feature on the Asian political map.

## **5.5 The CPFTA and the Sino-Pak Economic Corridor**

### **5.5.1 The Sino-Pak Economic Corridor**

Realists are correct when they argue that, in contemporary Asia, many FTAs are set up to establish "security-embedded trade ties".<sup>728</sup> The Sino-Pak Economic Corridor (from Kashgar in China's Xinjiang Province to the Gwadar Port in Pakistan's Balochistan

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<sup>724</sup> Jeremy Page, "Pakistan Looks to China for Big Energy and Infrastructure Projects," (The Wall Street Journal, February, 2014).

<sup>725</sup> Niaz Murtaza, "Tradeing with India: Implications for Pakistani Businesses," *The Dawn* 21 April, 2014.

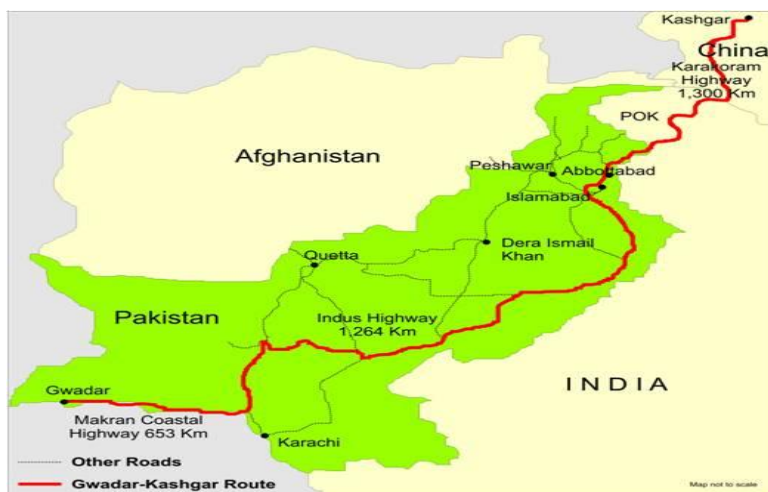
<sup>726</sup> Sujay Mehdudla, "Pakistan Could Explore FTA with India," *The Hindu* 27 September, 2013.

<sup>727</sup> Ramon Myers, "Relations Across the Taiwan Strait: The Curent Detente and its Limits," in *Charting China's Future: Domestic and International Challenges*, ed. David Shambaugh (New York: Routledge, 2012).p.132

<sup>728</sup> See Pang, "Embedding Security into Free Trade: The Case of the United States—Singapore Free Trade Agreement."; Oli Brown; Faisal Haq Shaheen; Shaheen Rafi Khan; Moeed Yusuf, "Regional Trade Agreements: Promoting Conflict or Building Peace?," (International Institute for Sustainable Development, October, 2005); Frost, "China's Commercial Diplomacy: Promise or Threat?."

province)<sup>729</sup> is a good example of such security projects embedded into trade pacts. (See Picture 5.1) The CPFTA provides institutional protection for subsequent Corridor building projects, and in turn, the Corridor gives Pakistan “the potential to make good on its free trade agreement with the dragon economy”.<sup>730</sup> Recognizing the failure to capitalize on the Phase I CPFTA, mainly due to Pakistan’s shabby local infrastructure and growing terrorism, the Economic Corridor project was inked on 18<sup>th</sup> October 2013 to drive the second Phase of the treaty. Preliminary work on Corridor building has begun, including upgrading the Karakoram highway; choosing station locations in Kashgar for the Sino-Pak railway (starting from the Pakistani southwestern port of Gwadar to the Chinese northwest city of Kashgar); and laying fiber-optic cable from Khunjerab to Rawalpindi. According to Khalid Shameem Wynne, Pakistan’s Joint Chiefs of Staff Committee Chairman, all corridor-related projects will be conducted under tightened security provided by the Pakistan military, security and intelligence agencies.<sup>731</sup>

**Picture 5.1: Pak-China Economic Corridor**



<sup>729</sup> In July 2013, Chinese Premier Li Keqiang and Pakistani Prime Minister signed eight memoranda of understanding with an eye towards accelerating Sino-Pak economic integration. Among these was a pact to develop the Sino-Pak Economic Corridor. Then in February 2014, Xi Jinping and Mamnoon Hussain, the Pakistani president, signed a series of agreements designed to breathe life into the Economic Corridor project. See Shahid Javed Burki, "Pakistan's New Choices in Economic Diplomacy," in *ISAS Working Paper* (Institute of South Asian Studies, National University of Singapore, May, 2014).p.11, Christopher Ernest Barber, "The Pakistan-China Corridor," (The Diplomat, February, 2014); Ebert, Flandes, and Strüver, "The Politics of Contestation in Asia: How Japan and Pakistan Deal with Their Rising Neighbors."

<sup>730</sup> Barber, "The Pakistan-China Corridor."

<sup>731</sup> Li Shen, "Pakistan, China to step up security cooperation," (中国网, 2013-09-04).



Source: Indian Defense Review, available at <http://www.indiandefencereview.com/news/china-at-a-crossroads-in-gilgit-baltistan/>

The Gwadar Port, as the western gateway of the Economic Corridor, is a warm-water, deep-sea port, situated at the apex of the Arabian Sea and Persian Gulf. China raised approximately 80% of the funds (\$0.198 billion) to support Phase I construction of the Port. After being handed over to Singapore (2007-2012), a state-owned Chinese company (the Chinese Overseas Port Holding Authority) reclaimed operational control in February 2013. Islamabad once expressed a wish to establish a free trade zone in Gwadar, and promised to grant it “a special status similar to that of Hong Kong”.<sup>732</sup> In response, in May 2014, a Chinese company submitted a blueprint for the free trade zone at Gwadar Port, along with a business and marketing plans, to the Pakistani authorities.<sup>733</sup>

The Economic Corridor also serves as an energy corridor. China, the biggest oil importer in the world, has long been afraid of a potential energy crisis if its major energy-shipping route was disrupted by whoever controls the Malacca Strait and the Indian Ocean.<sup>734</sup> The energy corridor offers a way to resolve the Malacca dilemma. Moreover, while the present oil-shipments from the Gulf region travel more than 3500 miles to reach the east coast of China, the distance from Kashgar to Gwadar via the overland route is only about 1000 miles, a reduction which could greatly reduce China’s traffic and time costs. Realists insist that China will eventually resort to Gwadar’s military utility.<sup>735</sup> According to Andrew Small, an IR scholar at the German Marshall Fund in Washington, “Even a project that is disappointing on the trade front such as Gwadar is still seen to have potential use as a naval facility, if not as a working port”.<sup>736</sup> Moreover, as the “largest pearl” in China’s alleged “string of pearls”, Gwadar also provides China with a “listening post” to “monitor U.S. naval activity in the Persian

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<sup>732</sup> Qaswar Abbas, "Pakistan's Gwadar Port May Got Special 'China' Status," (Mail Online India, 2013-09-01).

<sup>733</sup> Peer Muhammad, "Gwadar Port: Blueprint for Free Trade Zone to be Ready in May," (Tribune with the International New York Times, March, 2014).

<sup>734</sup> David Zweig and Bi Jianhai, "China’s Global Hunt for Energy," *Foreign Affairs* 84, no. 5 (2005).

<sup>735</sup> Peter A. Garvin, "Will China Extend Its Influence in the Indian Ocean by Building a Naval Base in Gwadar, Pakistan?," (Council on Foreign Relations, 2013).

<sup>736</sup> Andrew Small, "All-Weather Concerns: How Much Can Pakistan Expect From China?," (The German Marshall Fund of the United States, 2011-10-24).

Gulf, Indian activity in the Arabian Sea, and future U.S.-Indian maritime cooperation in the Indian Ocean".<sup>737</sup>

Interestingly, given that Gwadar and the corridor would both give China an indisputable strategic advantage, the Hu-Wen leadership and the Xi-Li authority have taken quite different approaches toward them. To illustrate, the corridor scheme can be traced back to 2006, when former Premier Musharraf initially proposed it as an energy corridor. Against many realist expectations though, it was not until December 2010 that Wen Jiabao declared that Beijing was unwilling to assume the security risks of building such a corridor. After eight years consideration, China finally accepted this proposal in May 2013, during Li Keqiang's first visit to Islamabad as Premier. Beijing's actual involvement in the Gwadar Port started in 2002 during former Vice Premier Wu Bangguo's visit to Pakistan. However, the Hu-Wen administration finally handed over operating rights to the Port of Singapore Authority (PSA) in 2006.<sup>738</sup> Significantly, it was in 2013 that a state-owned company, China Overseas Ports Holding Company Limited, re-acquired the management rights.<sup>739</sup> Both projects were initiated and inked in the first half year of Xi-Li's tenure as new leader, signifying a shift from emphasizing the economic dimension of the CPFTA, to the more strategic dimension, in order to prop-up the sagging "all-weather friendship" between China and Pakistan.

Realists suggest that Beijing's latest policy actions are due mainly to a blossoming sense of empowerment and ascendancy, and that the new Chinese government will behave more hawkishly than its predecessors.<sup>740</sup> But it is too early to rush to conclude that Xi-Li is deviating from the first half of Deng Xiaoping's eight-character axiom of "bide time and conceal capabilities" (韬光养晦, *taoguang yanghui*) to the second half of "do some things" (有所作为, *yousuo zuowei*).<sup>741</sup> Indeed, there are still many things that the new Chinese leaders are reluctant to do in Pakistan. For example, they kicked

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<sup>737</sup> Pant, "The Pakistan Thorn in China-India-U.S. Relations." p.86

<sup>738</sup> Farooq Yousaf, "Gwadar Port: Chinese Acquisition, Indian Concerns and Its Future Prospects," in *Spotlight South Asia* (Applied Political Science of South Asia, 2013).

<sup>739</sup> "China's Foreign Ports: The New Masters and Commanders - China's Growing Empire of Ports abroad is Mainly About Trade, Not Agression," (The Economist, June, 2013).

<sup>740</sup> Yun Sun; Julius Agbor; Jessica Smith, "China's New Leadership and Sino-Africa Relations," in *Africa Growth Initiative* (The Brookings Institutions, 2013).

<sup>741</sup> Shambaugh, "Is China Ready To Be A Global Power?."

off the corridor building, but cautiously named it a trade corridor rather than oil/energy corridor, since the latter contains too many strategic implications. As yet no plans have been announced on constructing oil or gas pipelines. At the same time, they repeatedly reassure other countries concerned about Gwadar that the port project will be a civilian one, rather than a naval base. These instances may puzzle realists – why did the Hu-Wen leadership stay inactive and tacit over these projects but the new administration showed great interest? Why did the new leaders adopt an apparently paradoxical policy by kicking off these projects in lofty tones but maintain a low profile to conceal their strategic aspirations? To address these puzzles, this chapter now turns to a neo-liberal perspective, which suggests that the CPFTA and its follow-up projects should be considered in a wider context to catch their potential implications for the US and India.

### **5.5.2 The CPFTA and China's global aspiration**

The debate on whether China wants to be a regional great power in Asia, or a global power, is old and inconclusive. Certainly, to some extent, a state's international orientations determine external behaviors. Being a regional power, China will understandably try its best to reduce the presence and influence of other big powers. An energy corridor (accompanied by the PLA's military footprint) may fill the vacuum left by America's retreat from the Middle East; and a navy base at Gwadar Port may neutralize India's power projection in the region. In realists' eyes, then, the new CCP leaders launched these projects proactively to project geopolitical and military influence. From a neoliberal perspective however, being a global power, Beijing needs to show its greatest sincerity in collaborating with America and India over international issues, rather than manipulating its special influence in Pakistan to prop up the latter's anti-American sentiments, or Indo-Pakistan confrontations.

In reality, a dramatic show of China's ambition to exercise regional leadership occurred during the 1997-98 Asian financial crises, and this ambition expanded worldwide ten years later, during the 2007-08 global financial crises. At present, China is working hard to achieve its goal of becoming a major power by 2050, and is determined to overcome any obstacles in its path.<sup>742</sup> In the Sino-Pak Economic Corridor case, China's Silk Road Economic Belt initiative (also abbreviated as New Silk Road) forms part of its global

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<sup>742</sup> Zeb, "Pakistan-China Relations: Where They Go and From Where?."p.47

ambitions.<sup>743</sup> The Silk Road, together with the Maritime Silk Road, officially named “One Belt One Road” (一帶一路, *yidai yilu*), constitutes Xi Jinping’s ambitious blueprint to build a wide trade network to enhance global connectivity.<sup>744</sup> This expanded ambition has brought considerable changes to China’s Pakistan diplomacy.

On the one hand, the Chinese authorities, while deeply concerned about America’s military presence in Pakistan, no longer views the US-led war on terror and the American foreign aid programs from a zero-sum perspective.<sup>745</sup> For instance, the US-Pak anti-terrorism coalition is indeed in line with China’s imperatives to combat the “three evil forces” in its western border area, abutting Pakistan’s northern frontier.<sup>746</sup> Besides, Pakistan’s social instability and stagnant economy have hindered China’s economic interests. American aid aimed at helping Pakistani civilian development thus becomes important. This explains why in 2008, when Pakistan needed \$7.5 billion to avoid defaulting on debt. Beijing granted a token \$500 million, pushing its “iron brother” to go instead to the US-led IMF as another backup. China justified this as by stating “we have done our due diligence, and it isn’t happening”, but its underlying meaning was that it did not want to be the only country financially obligated to Islamabad whenever the latter falls into crisis.<sup>747</sup> In the Gwadar Port case, there’s evidence aplenty that China is in no mood to take America head-on and, as Farrukh Salleem noted, “if America develops a serious interest in a particular region China backs off right away”.<sup>748</sup>

On the other hand, from a realism perspective, there is a widespread speculation that China’s New Silk Road and the Maritime Silk Road (MSR) initiatives are to hedge against India’s “Look East” policy.<sup>749</sup> A close examination of those initiatives, however,

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<sup>743</sup> Justyna Szczudlik-Tatar, "China's New Silk Road Diplomacy," (The Polish Institute of International Affairs, December, 2013).

<sup>744</sup> Robert Lawrence Kuhn, "The 'Silk Road Economic Belt' Strategy: Actualizing President Xi Jinping's Foreign Policy," in *Silk Road Economic Belt International Seminar* (China Go Abroad, June, 2014).

<sup>745</sup> China used to be wary of America’s growing presence and involvement in South Asia. See Jetly, "Sino-Pakistan Strategic Entente: Implications for Regional Security." p.14

<sup>746</sup>The “three evil forces” refer to terrorism, separatism, and extremism. See He Wenping, "Combating a Common Threat," *China Daily* 2013-09-25.

<sup>747</sup> Jane Perlez, "Rebuffed by China, Pakistan May Seek I.M.F. Aid " *The New York Times* 2008-10-18.

<sup>748</sup> Farrukh Saleem, "Peking Man," in *Captial Suggestion* (The International News (Pakistan), May, 2009).

<sup>749</sup> The “Look East” policy was launched in 1992 in the aftermath of the Soviet Union’s collapse. The main objective of this policy is to strengthen India’s relation with South East Asian countries. At present,

reveals that the speculation is unfounded. In fact, India is located at the convergence of the New Silk Road and the Maritime Silk Road. Beijing has invited New Delhi to join both projects. According to Gao Zhenting, Councilor of China's Ministry of Foreign Affairs: "The Chinese government believes that India naturally is an important partner in this One Belt and One Road ... We are open to all friendly neighboring countries to participate in this one belt and one road but of course we will not force any one to join nor will we give up if someone is not taking part."<sup>750</sup> Moreover, in China's new Silk Road blue print, the Bangladesh, China, India and Myanmar Trade Corridor (BCIM), originally initiated by China in Kunming at the end of 1990s (the so-called Kunming Initiative), also plays an important role. The BCIM, designed as a trade route that utilizes common trade agreements and the infrastructure of member countries to increase the flow and productivity of trade, has gained New Delhi's endorsement.<sup>751</sup> Now the Chinese government touts the BCIM as "the second Silk Road" to promote a closer economic relationship with India and other member countries.<sup>752</sup> To quote Xi Jinping's signed article published in *The Hindu* during his India visit in September 2014:

As the two engines of the Asian economy, we need to become cooperation partners spearheading growth. I believe that the combination of China's energy plus India's wisdom will release massive potential. We need to jointly develop the BCIM Economic Corridor, discuss the initiatives of the Silk Road Economic Belt and the 21st Century Maritime Silk Road, and lead the sustainable growth of the Asian economy.<sup>753</sup>

All these changes seem to counter the realist interpretation of the CPFTA as a tool to counter-balance the US and India. In contrast, pro-cooperation liberalists are correct by positing that strategic rivalry is muted, with economic interdependence and multilateral engagement at the fore.<sup>754</sup> In this sense, at the moment, the Gwadar Port represents just

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this policy has become a cornerstone of India's diplomatic agenda. See Szczudlik-Tatar, "China's New Silk Road Diplomacy."; Christina Lin, "The New Silk Road China's Energy Strategy in the Greater Middle East," in *Policy Focus* (The Washington Institute for Near East Policy, April, 2011); Tarun Basu, "Silk Road Diplomacy: Can India Respond Innovatively? - Analysis," (Eurasia Review July, 2014).

<sup>750</sup> "China Invites India to Join its Ambitious Silk Road Projects," (Press Trust of India, August, 2014).

<sup>751</sup> Nathan Barlow, "The Bangladesh-China-India-Myanmar Trade Corridor," (Asia Briefing, June, 2013).

<sup>752</sup> "China Invites India to Join its Ambitious Silk Road Projects."

<sup>753</sup> Xi Jinping, "Towards an Asian Century of Prosperity," *The Hindu* 17 September, 2014.

<sup>754</sup> Jagannath P. Panda, "Competing Relations in China-India Multilateral Discourse: Asia's Enduring Power Rivalry," *Journal of Contemporary China* 22, no. 82 (2013).p.669

an economic beachhead on China's "march west".<sup>755</sup> Similar to the BCIM, the New Silk Road and the Sino-Pak Economic Corridor also function as a bridge for China's commercial outreach to the Arabian Sea.<sup>756</sup> China is deviating from its prior regional Asia chessboard and ushering in a new global one.<sup>757</sup> To be sure, it still shares geostrategic understandings on various regional issues with Pakistan, such as distrust of India and America, but an open confrontation with them, in Beijing's understanding, would hinder its realization of its global ambitions.<sup>758</sup> On the new chessboard, the new generation of the Chinese leadership highlights a desire for a "new type of great power relations", the type of relations in which China and the US have a "mutual recognition that the prosperity and success of each nation is in the best interests of the other", and each nation's success is not *zero-sum* but *win-win*.<sup>759</sup> Moreover, to avoid irritating India, who "has always harbored a grudge over China's all-weather friendship with Pakistan", Beijing today alleges that it can "be a mutual friend to the two Asian rivals".<sup>760</sup> This rhetoric shift is reflected by Li Keqiang, who chose New Delhi instead of Islamabad as the first stop in his first overseas visit as Chinese Premier, staying three days against two in Pakistan.<sup>761</sup> As a perceptive analyst noted:

Pakistanis are still in love with the Peking Man ... The Peking Man, in the meantime, has moved on ... There is evidence that the old Peking Man was "able to control and use fire". There is evidence now that the new Peking Man has a singular goal – to double, triple and quadruple China's \$4 trillion GDP by 2050. And, any country that can help China go where it wants to go is a friend – or you are on your own.<sup>762</sup>

With the formation of China's global ambition, the Sino-Pak relationship is also in transition. In its initial phase realism best described the relationship, now neoliberal

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<sup>755</sup> Adam Hodge, "Karakoram Highway: China's Treacherous Pakistan Corridor," (The Diplomat, July, 2013).

<sup>756</sup> Aljazeera Center for Studies, "Pakistan-China Relations: A Perspective on the 'All Weather Friendship'," (Aljazeera Network, May, 2011).

<sup>757</sup> Shambaugh, "Is China Ready To Be A Global Power?."

<sup>758</sup> Zeb, "Pakistan-China Relations: Where They Go and From Where?."p.47

<sup>759</sup> Hadley Stephen, "A New Model of Great Power Relations," (ChinaUS Focus, 2013-10-16).

<sup>760</sup> Du Youkang, "China, India Made for Each Other " *China Daily* 2010-10-20; Sun, "March West: China's Response to the US Rebalancing."

<sup>761</sup> Sajjad Asharf, "India and Pakistan - The Economic Stand-off," in *ISAS Working Paper, No. 57* (Institutue of South Asian Studies, National University of Singapore, 2009-05-18).p.3

<sup>762</sup> Saleem, "Peking Man."

institutionalism works better. The CPFTA can be regarded as originating from a desire to accommodate and appease Washington and New Delhi. To illustrate, the problem of the CPFTA is not its economic inefficiency, but asymmetry, which is to China rather than Pakistan's advantage. Given the fact that China has already emerged as the world's second biggest powerhouse, a bold inference can be made that it is not that Beijing has no capacity to reverse the trade imbalance but that Beijing has no willingness to do so. The corollary of this insight is colossal –the CPFTA plays a role of a showcase to signify the gradually “normalized” Sino-Pak relationship, rather than the previous “strategic axis”. Moreover, a regime can effectively embed bilateral interactions into a relatively transparent platform. For example, past Sino-Pak cooperation, particularly in the military realm, was mainly kept in a “black box”. However, in the Phase II CPFTA customs tariff list, China released its tariff concession rates on arms and ammunitions, including artillery weapons, rocket launchers, torpedo tubes, etc. This practice, while it cannot completely allay concerns about the strategic implications of Sino-Pak relations, will at least provide some transparency and certainty about the content of their cooperative relationship.

In sum, China's seemingly paradoxical policy actions in Pakistan are mainly due to its two ambitions – to be a regional leader, it kicked off the Economic Corridor and the Gwadar Port programs; and to be a global leader, it chose to bleach their strategic significance. Compared with their predecessors, Xi and Li are more assertive and proactive towards South Asia. But this does not indicate a radically new direction of foreign strategy. Indeed, China's global ambition is proceeding in an orderly way and step-by-step: Pakistan's service and investment liberalization made under the CPFTA, which was established and carried out during the Hu-Wen era, have paved the way for Xi and Li to deploy larger projects.<sup>763</sup> This legally binding treaty, not only institutionally guarded the construction of Gwadar and corridor projects, it also provided Beijing with the legitimacy to carry out such activity. Therefore, the new leadership's initiatives cannot be fully understood without recognizing this legitimacy. While still keeping a low profile, the new authority will stay on the course designed by its predecessors. Beijing has done a lot to become a regional leader but at the same time has set out a clear vision and path for becoming a global power.

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<sup>763</sup> Cheng Li, "China's Political Transition: A Balanced Assessment of its Problems and Promises," (The Brookings Institute, February, 2013).

## 5.6 Conclusion

This chapter demonstrates that the CPFTA is not only about the Sino-Pak bilateral relationship *per se*, but also relates to China's big power relations, the US and India in particular. At the same time, the CPFTA acts as an institutional fulcrum for operationalizing concrete projects such as the Sino-Pak Economic Corridor and the Gwadar Port projects. The success of these projects will in turn enable Beijing to achieve its grand aspiration of building a wide-trade network to enhance global connectivity.

From a realist viewpoint, the CPFTA is an economic reward that Beijing granted Islamabad to counter-balance the US and India's influence in South Asia. Such a view is undoubtedly partly correct. As section 5.3 has shown, rather than maximize the trade deal's strategic leverage, both China and Pakistan are trapped into implementation conundrums. To account for such conundrums it is necessary to refer to the two parties' domestic political economy, an analytic dimension that liberal institutionalism focuses on. In this sense, realism works well in explaining CPFTA's birth, but does not sufficiently account for its near-death. Liberalism explains the zone's economic effects, but has little to say about its strategic connotations. A realist-liberal perspective thus generates powerful insights into the mixture of Level I great-power games and the Level II government-business games.

From a constructivist viewpoint, it is important to note that the friendship between China and Pakistan provides an internal motive for the formation of the CPFTA. Meanwhile, neoliberals may be gratified to see that Beijing is trying to "sell" its new neoliberal ideas to Pakistan. Nevertheless, Islamabad has not acknowledged this change in Beijing's mindset. A combination of constructivism and liberalism offers a new insight that an apparent norm-diversion is emerging between the decades-long friends. Only when they overcome such divergence can they maximize gains from the CPFTA.

In section 5.5, I find that realists usually make static assumptions about transnational relations in South Asia. In their eyes, today's regional situation is not different from the situation during the third Indo-Pak war of 1971, when China supported Pakistan to counterbalance India or the US-Indo alliance. It would be incorrect to assume that contemporary Chinese activities in South Asia to be the same as in 1971. Realists at



best get it half right when casting their age-old lights on China's policy toward South Asia. In practice, Beijing has recognized that if it continues supporting Indo-Pak confrontations, then Beijing can at best lead in Asia; but if it cooperates with New Delhi, then it is possible to acquire a world leadership. With this ambition in mind, China has adjusted its Pakistan diplomacy to a more neutral one to demonstrate that its engagement in South Asia is part of the solution, rather than part of the trouble. China's changed attitude to Washington's engagement in Pakistan also reflects a mixture of realist and liberal elements. Under the disguise of the CPFTA, Beijing has set up some officially unacknowledged but nonetheless evident policies to expand its strategic influences, and on the other hand maintained a low profile to show its sincerity to cooperate, rather than challenge American's traditional regional interests.

To conclude, an eclectic review of China's CPFTA policy demonstrates that all three regime-paradigms coexist as Beijing balances different strategic triangles to strive for more powers, simultaneously changing its diplomacy toward Pakistan but being constrained by domestic political economies. The CPFTA is a sign that Beijing's pure realist mindset in South Asia is gradually being transcended, and China's "New South Asia policy" has on some occasions given international society an impression that the Pakistan government is at the brink of being discarded. However, Pakistan's strategic position, and its role of a showcase to the Islamic world and Third World countries generally, secure it as the bedrock of China's South Asian diplomacy under the new leadership. Therefore, although Beijing is determined to play a stabilizing role and avoid taking sides, Premier Li Keqiang again laid out the partial vision of new CCP government toward South Asia by describing India as "an important neighbor" and Pakistan as "the most reliable friend". All in all, the interests-, power- and knowledge-based theories have respectively captured partial essences of China's CPFTA policy, but an eclectic analytic approach tells a more complete story of a more complex reality.

## Chapter 6: The China-Latin America FTAs<sup>764</sup>

### 6.1 Introduction

In the eyes of the People's Republic of China (PRC), Latin America has a mixed and multifaceted identity. It is a region possessing rich natural resources that Beijing regards as a lifeline for its domestic economy and export orientated industrialization. Yet it is also one of the last regions of support for Taiwan's sovereignty claim. And Latin America is a geographic zone where non-regional countries like China need to be particularly cautious when engaging in the US's traditional sphere of influence. Against this backdrop, China seeks to strengthen its ties with Latin American states, and such ties are reinforced by trade accords. This chapter examines China's relationship with its three cross-Pacific Latin American and Caribbean FTA partners, namely, Chile, Peru and Costa Rica (CR). The three Sino-LAC FTAs are distinct because they illustrate Beijing's growing ability to use its dominance of global markets to successfully engage in FTA diplomacy. Beijing's growing economic clout and FTA diplomacy are translating into growing levels of structural power in Latin America.

This chapter contains five sections. Section two presents an analysis of the economic effects of the three FTAs', particularly with regard to the trade in goods and foreign direct investment. It shows that both the China-Chile FTA (CCFTA) and the China-Peru FTA (CPFTA) are natural resource-oriented. China trades and invests heavily in the two

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<sup>764</sup> Latin America (LA) is a sub-region of the Americas, which comprises three parts: Central America, the Caribbean and South America. Among China's three FTA partners in this region, Costa Rica is located in the Central America, while Chile and Peru are located in South America. Sometimes these regions are collectively referred to as Latin America and the Caribbean (LAC). This chapter will use the region abbreviations of LA and LAC interchangeably.

countries' resource sectors. Costa Rica is not a resource-rich state, but with the rapid increase of China's crude oil imports from Latin America (mainly Venezuela and Ecuador), Beijing chose to process the crude oil in Costa Rica to reduce shipping and production costs. Given China's thirst for resources and energy, the three cross-regional free trade agreements are straightforward cases of the classical liberal economic theory related to comparative advantages.

Section three to five evaluate and apply the elements in the theoretical chapter to China's FTA diplomacy in Latin America. I identify three of Beijing's diplomatic motives embedded into the FTAs: (1) to isolate Taiwan; (1) to secure resource supplies; and (3) to engage with Latin America's regional integration. All three motives seem to alarm Washington. However, China's activities in this region to a great extent reflect its attitude to US – China relations. China's role in Latin America is, above all, based on trade, at least in the short-term. And China lacks both the capacity and willingness to challenge US economic predominance in the region.

This chapter concludes that the instrument of FTA strategy is relatively successful in achieving China's diplomatic goals, and that this strategy greatly reshapes, and is being reshaped, by corresponding US policies in Latin America.

## **6.2 The FTA Agreements: Text Analysis and Empirical Results**

China and Chile started FTA talks in November 2004, during former Chinese Chairman Hu Jintao's visit to Santiago. After five rounds of negotiation, the CCFTA, China's first FTA with a Latin American state, was signed in November 2005, taking effect in October 2006. Then, in April 2008, Hu Jintao and Chilean President Michelle Bachelet witnessed the signing of the *Supplementary Agreement on Trade in Services*. The two parties finalized their talks on bilateral investment in 2012. The initiation of a Free

Trade Agreement between China and Peru was made during Li Changchun's visit to Peru in March 2013. After eight rounds of negotiations, the Sino-Peru FTA was signed by the then Vice-Chairman Xi Jinping and former Peruvian Vice-President Alan Garcia during the latter's Beijing visit in November 2008. The trade deal entered into force in March 2010. FTA talks with Costa Rica begun in early 2009, and, after five rounds concluding in April of the following year, the FTA took effect in August 2011.<sup>765</sup>

### *Trade in Goods*

The C-LAC FTAs' effects on trade expansion are clear. According to the UNcomtrade statistics database, in 2012, Sino-Chile two-way trade peaked at \$US39,223 million, with Chile's imports and exports at recorded as \$12,601 million and \$26,632 million respectively. In 2013, Peru's trade with China also reached a historic high of \$14,597 million, with exports and import recorded as \$8,408 million and \$6,189 million respectively. In the same year, China's imports from Costa Rica were recorded at \$4,758 million, while the latter's imports from China amounted to \$927 million. It is noteworthy that China's three LA FTA partners all maintained a surplus in their trade balance (except for Peru in 2008), and their trade surpluses with China have shown an expansionist trend. (See Table 6.1) China is currently the largest trading partner of Chile and Peru, and the second largest trading partner of Costa Rica after the United States.

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<sup>765</sup> See China FTA Network official website, available at <http://fta.mofcom.gov.cn/topic/enchile.shtml>  
Data accessed on 06 October, 2013.

**Table 6.1: China-Chile/Peru/Costa Rica Trade, 2005-2013 (US\$ billions)**

	From China to Chile (imports)	From China to Chile (exports)	Trade Deficit	From China to Peru (imports)	From China to Peru (exports)	Trade Deficit	From China to CR (imports)	From China to CR (exports)	Trade Deficit
2005	4.90	3.23	-1.67	1.86	1.06	-0.80	0.92	0.23	-0.69
2006	5.26	4.39	-0.86	2.27	1.58	-0.69	1.75	0.41	-1.34
2007	10.51	6.07	-4.44	3.04	2.46	-0.58	2.31	0.57	-1.74
2008	8.52	8.27	-0.25	3.74	4.07	0.33	2.27	0.62	-1.65
2009	13.03	6.18	-6.85	4.08	3.27	-0.81	2.65	0.54	-2.11
2010	17.28	9.96	-7.32	5.43	5.14	-0.29	3.11	0.69	-2.42
2011	18.60	12.70	-5.91	6.96	6.32	-0.64	3.84	0.89	-2.96
2012	26.63	12.60	-14.03	8.46	5.33	-3.12	5.27	0.90	-4.37
2013	20.71	13.11	-7.60	8.41	6.19	-2.22	4.76	0.93	-3.83

*Source:* UNcomtrade Statistic Database and the author's calculation, available at <http://comtrade.un.org/db/default.aspx>, and the author's calculation Data accessed on 10 August, 2014.

The Sino-Costa Rica FTA aims at achieving zero tariff concessions in all traded goods over the next fifteen years. China and Costa Rica have respectively eliminated tariffs on 65.3% and 62.9% of goods imported from each other. By 2025, 100% of products that China imports from CR can enjoy tariff free treatment. Specifically, agricultural products dominated FTA negotiations between China and Costa Rica, with the latter's prized coffee brands enjoying a 90% reduction in tariffs when exported to China.<sup>766</sup> Considering CR's need to protect its domestic agricultural sector and facilitating agricultural exports, Beijing also agreed with the Costa Rican government to maintain the current import quota on some key agricultural products, and granted.<sup>767</sup> Since the C-

<sup>766</sup> Marc Lanteigne, "Commercial Diplomacy: Preferential Trade Agreements and Soft Power Projection," in *China and the International System: Becoming a World Power*, ed. Xiaoming Huang and Robert G. Putnam (New York: Routledge, 2013), p.75

<sup>767</sup> These agricultural products include frozen pork meat and kidney beans (black). Costa Rican products that will be protected as geographical indications in the territory of China include Banano de Costa Rica

CRFTA went into effect, CR's export sales to China have increased 53%. An examination of the import composition reveals that China's imports concentrate specifically on electrical and electronic equipment (HS85) that are manufactured in Costa Rica. In 2013, among overall Chinese imports from the Central American country, commodities under the category of HS85 were worth \$4,650 million, accounting for approximately 98% of CR's total exports to China.<sup>768</sup>

The CCFTA and CPFTA verify China's thirst for natural resources from Latin America. Both Chile and Peru are mineral-rich countries which can meet China's enormous demand of minerals for domestic and export manufacturing. The Chilean economy relies heavily on copper, which provides 20% of Chile's GDP and 60% of its exports.<sup>769</sup> Similarly, in recent years, minerals such as copper, iron and gold account for about 60% of Peru's overall exports, 13% of FDI and 14% of tax revenues.<sup>770</sup> In this sense, the CCFTA and the CPFTA are straightforward cases of the classical economic theory of comparative advantage.<sup>771</sup> For example, as China is the world's largest copper consumer and Chile is the world's largest copper producing country, it seems logical

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(Banana of Costa Rica), Café de Costa Rica (Coffee of Costa Rica), Guanacaste Madera (wood), Orosi (coffee), Tres Ríos (coffee), Turrialba (coffee), West Valley (coffee), Brunca (coffee), and Central Valley (coffee) and Guanacaste (coffee. By comparison, the PRC has no specific quota or geographical indication requirement on any of its products. In this sense, China made some unilateral concessions under the C-CR FTA. See the C-CR FTA text at China FTA network official websites, available at [http://fta.mofcom.gov.cn/gesidalijia/gesidalijia\\_xieyi.shtml](http://fta.mofcom.gov.cn/gesidalijia/gesidalijia_xieyi.shtml) Data accessed on 05 October, 2013

<sup>768</sup> All data is from the Uncomtrade Statistic Database, and the author's calculation. Available at <http://comtrade.un.org/> Data accessed on 06 March, 2014.

<sup>769</sup> The Economist Staff, "Copper Solution," (The Economist, April, 2013).

<sup>770</sup> Cynthia A. Sanborn and Alexis Yong, "Peru's Economic Boom and the Asian Connection," (Woodrow Wilson Center for Scholars, September, 2013).p.1

<sup>771</sup> See David Ricardo, *The Principles of Political Economy and Taxation* (London: Dent, 1973 (originally published 1911)); D. Hunt Shelby and Robert M. Morgan, "The Comparative Advantage Theory of Competition," *Journal of Marketing* 59, no. 2 (1995); Edward E. Learner, *Sources of International Comparative Advantage: Theory and Evidence* (Cambridge: The MIT Press, 1984).

that it remains the key commodity in China's trade with Chile.<sup>772</sup> In 2013, copper and its related commodities accounted for 77.51% of China's overall imports from Chile. In the same year, the major goods Peru sold to China were copper (and related commodities) and iron ores (HS2601), which respectively accounted for 58.01% and 15.64% of Peruvian exports to China.<sup>773</sup>

In contrast, the three Latin American countries' demand for Chinese products was labour-intensive manufactured goods, such as textiles and toys, and other value-added goods. For example, from 2008 to 2010, most Peruvian imports from the PRC belonged to capital goods and construction products, with growth rates of 59% and 54%, respectively.<sup>774</sup> Similarly, over 90% of Chinese exports to Chile are manufactured goods, with more than 42% medium and high-tech goods. These high-tech Chinese exports grew by more than 900% from 2003 to 2011.<sup>775</sup> In 2010, Chinese computers accounted for 72% of overall Chilean imports. Another notable example is that of Chinese motorcycles (HS8711) where exports to Chile increased nearly 29 times between 2001 and 2011. In fact, Chinese companies had already dominated more than three quarters of the Chilean motorcycle market as early as 2007.<sup>776</sup>

As noted, despite the growth of Chinese imports from Chile, they represent low diversification and low value-added ones and remain concentrated in primary

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<sup>772</sup> Those commodities mainly include "copper and articles thereof" (HS74) and "copper ores and concentrates" (HS26), etc. See Uncomtrade Statistic Database, available at <http://comtrade.un.org/> Data accessed on 08 April, 2014.

<sup>773</sup> See UN Comtrade Database, available at <http://comtrade.un.org/data/> Data accessed on 08 April, 2014.

<sup>774</sup> Geoffrey Cannock, "Peru and China as Competitors in World Markets: The Asparagus Case" (paper presented at the Agricultural Trade Linkages between Latin America and China, Rome, September, 2011).

<sup>775</sup> Carol Wise and Yong Zhang, "China and Latin America's Emerging Economies: Debates, Dynamism, and Dependence," in *ISA-FLACSO Conference* (Buenos Aires, Argentina July, 2014).p.22

<sup>776</sup> Evan Ellis, *China in Latin America* (Boulder: Lynne Rienner Publishers, 2009).p.39

commodities. Some observers have expressed their concern that the current Sino-LAC trade structure would ultimately replicate and reinforce dysfunctional patterns of Latin American development. Rosales, for example, argues that the Chinese demand for resources will intensify the region's export-commodity composition.<sup>777</sup> If the PRC's strong demand continues, the region risks returning to the historical pattern of export monoculture, or overconcentration in a small number of primary exports. This possibility has fuelled warnings about a "resource curse" that may triggered by China.<sup>778</sup> Although some of these warnings are sound, it is unfair to place most of the blame on China, given that the PRC is neither the only nor the biggest consumer of Latin American natural resources. For example, in 2008, China spent approximately US\$150 million on purchasing petroleum oils (HS2709) from Peru while the figure for the United States was US\$372 million.<sup>779</sup> Moreover, Beijing's thirst for minerals and other raw materials has made significant contributions to Latin American economies. The Chinese market accounts for 13.9%, 17.2% and 20.7% of Peru, Chile and Costa Rica's growth in exports.<sup>780</sup> According to a report released by the Economic Commission for Latin America and the Caribbean (ECLAC), China's strong demand for the region's commodities has played a crucial role in reducing the regional impact of

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<sup>777</sup> Rosales O., "The People's Republic of China and Latin America and the Caribbean: Towards a Strategic Relationship," (United Nations Economic Commission for Latin America, May, 2010).

<sup>778</sup> See Barbara Kotschar; Theodore Moran and Julia Muir, "Chinese Investment in Latin American Resources: The Good, The Bad, and The Ugly," (Peterson Institute For International Economics, February 2012); Barbara Kotschwar, "China's Economic Influence in Latin America," *Asian Economic Policy Review* 9, no. 2 (2014).p207. Likewise, some scholars warn that China's thirst for natural resources in Latin America has propelled Latin America into a series of "resource curse" outcomes. See Sanjaya Lall and John Weiss, "People's Republic of China's Competitive Threat to Latin America: An Analysis for 1990-2002," (ADB Institute, 2004); Kevin P. Gallagher, "A Catalyst for Hope: China's Opportunity for Latin America " in *The Oxford Handbook of Latin American Political Economy* ed. Javier Santiso and Jeff Dayton-Johnson (Oxford University Press, 2012).

<sup>779</sup> See UN Comtrade Official Website, available at <http://comtrade.un.org/>

<sup>780</sup> Rhys Jenkins, Enrique Dussel Peters, and Mauricio Mesquita Moreira, "The Impact of China on Latin America and the Caribbean," *World Development* 36, no. 2 (2008).pp.237-238



the 2009 global financial crisis, and providing a strong engine for rapid regional recovery.<sup>781</sup>

Whereas most Western Hemisphere FTAs have tough conditions regarding improving market access for manufactured imports, C-LAC FTAs seem to be quite different, and are exceptions to this pattern. For example, the CCFTA enables 92% of Chilean exports covered by the trade deal to enjoy immediate duty-free access to the Chinese market. Besides, China has made huge concessions by permitting 152 “sensitive” Chilean products, including wheat, flour, sugar, and some manufactured textiles and garments to be exempted from tariff reduction.<sup>782</sup> Similarly, the CPFTA allows 83.5% of Peruvian exports to enter China without any tariff. Specifically, China agreed to provide some protection for Peruvian manufacturing sectors that are most vulnerable to Chinese imports. Take textiles as an example, 56% of textile related products are excluded from Peru’s tariff reduction schedule.<sup>783</sup> These institutional arrangements reflect the Chinese government’s willingness to make concessions on imports and exports from Latin American countries to facilitate critical FTAs designed to secure natural resources.

C-LAC FTAs also facilitate LAC agricultural exports. For example, approximately 80% of China’s imported seafood comes from Chile and Peru.<sup>784</sup> As the largest fresh fruit exporter in the Southern Hemisphere, Chile ranks second only to Thailand in fruit exports to China.<sup>785</sup> Chilean grape wine has experienced a 906% growth in the Chinese

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<sup>781</sup> Matt Ferchen, "China-Latin America Relations: Long-term Boon or Short-term Boom?," *The Chinese Journal of International Politics* 4(2011).p.68

<sup>782</sup> Zhang, "China and Latin America’s Emerging Economies: Debates, Dynamism, and Dependence."p.22

<sup>783</sup> Yong, "Peru's Economic Boom and the Asian Connection."p.16

<sup>784</sup> Ignacio Lopez-Calvo, "China in Latin America: The Whats and Wherefores (review)," *China Review International* 17, no. 2 (2010).p.233

<sup>785</sup> Xinhua, "Chile's Fruit Takes Root in China," *China Daily* 2012-07-27.

market since the signing of CCFTA; and according to an Inter-American Development Bank report, the Sino-Peru FTA has brought Peru an increase of 48% in agricultural exports and 65% in processed food exports.<sup>786</sup> For Latin American countries keen to promote development, agricultural exports are important for increasing state revenue and social spending.

### *Foreign Direct Investment (FDI)*

As discussed, natural resources are critical to modernization and export manufacturing, and are therefore valuable commodities in high demand in international trade. During the process of trading, “uncertainties” pose the biggest challenge to importing countries – uncertainties about the geological and technical difficulties that will be encountered, about price fluctuation, and about current and future political risks.<sup>787</sup> To counter such uncertainties, importers need to formulate and foster more secure longer term transnational contracts/transactions in the form of foreign direct investment.<sup>788</sup> As part of the “going-out” strategy, the Chinese leadership encourages domestic companies to invest offshore to make the best use of global resources, including in the LAC region. Chen Yuan, former president of the China Development Bank, stated in 2006 that “South America is going to be the hot pot for Chinese investment in the coming ten years ... Entrepreneurs who want to ‘challenge the blue ocean’ should be ready to go to South America”.<sup>789</sup> Yet Chinese enterprises already have a significant presence in the region, particularly in, natural resources and infrastructure.<sup>790</sup> (See Table 6.2) For

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<sup>786</sup> Integration and Trade Sector, "Ten Years After the Take-off: Taking Stock of China-Latin America and the Caribbean Economic Relations," (Inter-American Development Bank, 2010).p.16

<sup>787</sup> Venables, "International Trade in Natural Resources: practice and policy."pp.25-29

<sup>788</sup> Ibid.25

<sup>789</sup> David Pilling and Henny Sender Geoff Dyer, "A Strategy to Straddle the Planet," (Financial Times, January, 2011).

<sup>790</sup> The LAC countries received \$174.5 billion inward FDI flows in 2012; of that, the PRC only took up \$9.2 billion, or 5.3% of the total. See Rebecca Ray and Kevin P. Gallagher, "2013 China-Latin America

example, in 2012, the PRC was only ranked as the 10<sup>th</sup> largest foreign investor in Peru, but it was the largest single investor by country in the mining sector, representing one fifth of overall FDI in that sector.<sup>791</sup> An estimation conducted by the UN Economic Commission for Latin America and the Caribbean showed that approximately 92% of confirmed Chinese investments in this region were in natural resource extraction, particularly in crude oil and mining.<sup>792</sup>

**Table 6.2: China's FDI in Chile, Peru and Latin America (US\$ millions)**

	1990-2009 (total)	2010	2011	2012
Chile	-	5	-	76
Peru	2,262	84	829	1,307
Total in Latin America	6,342	13,712	9,309	9,205

Source: Economic Commission for Latin America and the Caribbean (ECLAC), ECLAC Statistical Yearbook, available at [http://estadisticas.cepal.org/cepalstat/WEB\\_CEPALSTAT/PublicacionesEstadisticas.asp?idioma=i](http://estadisticas.cepal.org/cepalstat/WEB_CEPALSTAT/PublicacionesEstadisticas.asp?idioma=i) Data accessed on 08 April, 2014.

Chinese FDI in Chile includes Shunde Rixin's acquisition of a 70% shareholding of a Chilean iron ore company (US\$1910 million) in December 2009, and State Grid's shareholding in Quadra Mining (a Chilean copper company, (US\$1050 million) in March 2010. As in Chile, China's FDI in Peru concentrates on mining and other raw materials. For instance, in February 2007, Zijin, Tongling and Xiamen C&D Inc respectively acquired 45%, 35% and 20% shareholdings in Monterrico, a Peruvian

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Economic Bulletin," in *Global Economic Governance Initiative* (Global Development and Environment Institute, 2013).p.12

<sup>791</sup> Yong, "Peru's Economic Boom and the Asian Connection."p.27

<sup>792</sup> Rhys Jenkins, "Latin America and China—a new dependency?," *Third World Quarterly* 33, no. 7 (2012).p.1345

mining company (US\$190 million); Chinalco invested US\$ 190 million in Peru Copper in May 2008; Chinalco invested US\$2160 million for copper; Shougang invested US\$1.2 billion to double its Peruvian mine's production, in April 2014; and Minmetals invested \$5.850 million in Glencore, a Peruvian metal company.<sup>793</sup>

In comparison, China's FDI in Costa Rica was still relatively small. Major Chinese FDI in Costa Rica occurred in 2009, with Huawei Technologies' investing \$ 204 million in the Costa Rican Electricity Institute. In the same year, the China National Petroleum Corporation (CNPC) invested \$700 million to acquire a 50% shareholding of Recope, a Costa Rican oil company. Then in June 2013, the CNPC made an additional investment of \$650 million in the same company.<sup>794</sup> In addition, with the rapid increase of China's crude oil imports from Latin America (mainly from Venezuela and Ecuador), Beijing chose to process the crude oil in Costa Rica to reduce shipping and production costs. In 2008, the CNPC started to cooperate with Costa Rica's state-owned Refinadora Costarricense de Petroleo on a US\$1 billion joint refinery project.<sup>795</sup> Then in July 2013, during Xi Jinping's Costa Rica visit, he announced that China would help the country upgrade an old oil refinery to improve its processing capability from 18,000 barrels of crude oil per day to 65,000 barrels. The China Development Bank will provide US\$900

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<sup>793</sup> See China Global Investment Tracker of the Heritage Foundation. The Tracker does not provide the name of the Chilean iron ore company. Available at <http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map> Data accessed on 08 June, 2014

<sup>794</sup> The Heritage Foundation, "China Global Investment Tracker Interactive Map," (The Heritage Foundation, 2012).

<sup>795</sup> Amber Corrin, "China, Costa Rica Sign Agreements for Joint Refinery Projects," *Global Refining & Fuels Report* 12, no. 24 (2008),p.35

million of the \$1.5 billion overall upgrading costs, making it Costa Rica's biggest state investment.<sup>796</sup>

Generally speaking, there are two major mechanisms underpinning China's Outward FDI in Latin America. Firstly, given that the majority of Chinese companies investing in Latin America are state-owned enterprises (SOEs), the government has control over their investment destinations, resources and infrastructure.<sup>797</sup> According to a report conducted by the Hongkong Shanghai Banking Cooperation (HSBC), Chinese Overseas Direct Investment (ODI) in Latin America has been led by ten SOEs whose investments accounted for 65% of the \$84 billion in ODI from China to the Latin American region between 2004 and 2012.<sup>798</sup>

Second, two "policy banks," the Export-Import Bank of China and the China Development Bank, play important roles in boosting Chinese ODI in Latin America. For example, the Export-Import Bank can offer concessional loans to Latin American countries with interest rates below that of the People's Bank of China, and the Chinese central government would subsidize the difference.<sup>799</sup> Such preferential loans and investments are highly sought after by regional countries, and "they could be used as a

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<sup>796</sup> This investment was however halted by the Costa Rican government due to contractual violation. See Adam Williams, "Costa Rica Halts \$1.3 Billion China-Funded Refinery Plan " (Bloomberg, June 21, 2013).

<sup>797</sup> Friedrich Wu and Koh De Wei, "From Financial Assets to Financial Statecraft: the case of China and emerging economies of Africa and Latin America," *Journal of Contemporary China* 23, no. 89 (2014).p.784

<sup>798</sup> Ben Laidler; Q Hongbin; Todd Dunivant; Simon Francis; Thomas Hilboldt; Andre Loes, "South-South Special: What a Globalization China Means for Latin America," (HSBC November, 2013).p.3

<sup>799</sup> Kevin P. Gallagher; Amos Irwin; Katherine Koleski, "The New Banks in Town: Chinese Finance in Latin America " (Inter-American Dialogue, February, 2012).

bargaining chip in any bilateral negotiation process”.<sup>800</sup> With these two mechanisms on hand, as an American scholar has pointed out, China’s economic activities in Latin America both reflect and augment the country’s diplomatic objectives:

China’s use of state-owned companies and state-sponsored financing allows Beijing to incorporate many normal economic activities abroad into its diplomatic strategy in a way that most other countries cannot. Furthermore, China’s economic engagement is visible and concrete, because it focuses on construction of physical infrastructures. Such projects by nature garner widespread attention from local populations as well as leaders and foreign observers, which provide China opportunities to leverage its economic engagement for outsized diplomatic benefits.<sup>801</sup>

China’s trade and finance outreach to Latin America is only one part of its growing relationship with regional countries. This chapter now turns to explore the strategic motives underpinning China’s FTA diplomacy in this region. Specifically, I identify three factors that are directly linked to the three C-LA FTAs: (1) to isolate Taiwan; (2) to secure resource supplies to sustain economic development; and (3) to engage into Latin America’s regional integration. All three motives seem to alarm Washington; and conversely, China’s active deployment in this region to a great extent reflects its attitude to the US. The remainder of this chapter will explain this phenomenon in detail.

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<sup>800</sup> Wu and De Wei, "From Financial Assets to Financial Statecraft: the case of China and emerging economies of Africa and Latin America."p.784

<sup>801</sup> Caitlin Campbell, "China's Expanding and Evolving Engagement with the Caribbean," in *US-China Economic and Security Review Commission* (Security and Foreign Affairs of the United States, May, 2014),p.2

### 6.3 C-LA FTAs and the Mainland-Taiwan Sovereignty Rivalry

Since the Chinese Communist Party (CCP) took-over the Kuomintang (the KMT, which also spells as Guomintang in pinyin) authority on the Mainland (the continental territory of China) in 1949, Beijing and Chinese Taipei have been involved in long-lasting “diplomatic contests” over international legitimacy.<sup>802</sup> The Kuomintang, which literally means the Chinese National People’s Party, is a political party that used to rule China as the Republic of China (ROC, 1912-49) from 1928 to 1949. In 1949, the CCP triumphed in the Chinese Civil War and established the People’s Republic of China. The Kuomintang retreated from the Mainland to Taiwan where it ruled as the single ruling party of the ROC until mid-1980s. In 1986, the Democratic Progress Party (DPP) was founded and became the first meaningful opposition party in Taiwan. The DPP ruled Taiwan between 2000 and 2008. Most Latin American countries’ established diplomatic relations with the Kuomintang during the 1930s-40s. After 1949, as allies of the US, most Latin American governments followed its political stance and ignored CCP claims of authority over both the mainland and Taiwan and kept formal diplomatic relations with Taiwan as the official representative of all of China in the form of the ROC.

This situation changed in 1971 after the United Nations General Assembly expelled the Kuomintang administration and admitted the PRC government as the only legitimate representative of China. In 1972 US President Richard Nixon visited the Mainland and

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<sup>802</sup> See Chung-chian Teng, "Hegemony or Partnership: China's Strategy and Diplomacy Toward Latin America," in *China and the Developing World: Beijing's Strategy for the Twenty-first Century*, ed. Joshua Eisenman; Eric Heginbotham; Derek Mitchell (United States: M. E. Sharpe, 2007). Gabriel Aguilera Peralta, "Central America Between Two Dragons: Relations with the Two Chinas," in *Latin America Facing China: South-South Relations Beyond the Washington Consensus*, ed. Alex E. Fernades Jilberto and Barbara Hogenboom (United States: Berghahn Books, 2012). <http://en.wikipedia.org/wiki/Kuomintang>; [http://en.wikipedia.org/wiki/Democratic\\_Progressive\\_Party](http://en.wikipedia.org/wiki/Democratic_Progressive_Party)

subsequently, in 1979, Washington changed its diplomatic position, recognising the Mainland Chinese government's authority over Taiwan. Following Washington's suit, many Latin American governments also switched their diplomatic ties to the Mainland. The CCP regards the Taiwan Islands as an integral part of China and has formulated the "One China" (一个中国) policy as the core of its foreign policy – namely, preventing states from simultaneously maintaining diplomatic relations with Beijing and Taipei. Nevertheless, although the CCP claims authority over Taiwan, it has never taken it over and the ROC remains de facto independent.

Successive governments in Taiwan, on the other hand, have never given up restoring international recognition of sovereignty. When the DPP came to power in 2000, the Chen Shuibian government proposed the "One China, One Taiwan" (一中一台) policy, aimed at promoting Taiwanese independence and maintaining its international status. This policy has proved to be ineffective. During his eight-year tenure as Taiwan's leader, Chen Shuibian regularly lost diplomatic allies: Macedonia in 2001, Nauru 2002, Liberia 2003, Dominica 2004, Senegal 2005, Chad 2006, Grenada and Costa Rica 2007 and Malawi in 2008. By the time Ma Yingjiu won Taiwan's 2008 election and the KMT regained power, only twenty-two countries still maintained diplomatic ties with the island: the Holy See in Rome, Burkina Faso, Democratic Republic of Sao Tome and Principe, and Kingdom of Swaziland, Kiribati, Nauru, Palau, Republic of the Marshall Islands, Solomon Islands, and Tuvalu, and in Latin America and the Caribbean, Belize, Dominican Republic, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Paraguay, Saint Christopher and Nevis, Saint Lucia, and Saint Vincent and the Grenadines.<sup>803</sup>

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<sup>803</sup> See official website of the Ministry of Foreign Affairs, Taiwan, available at <http://www.mofa.gov.tw/Official/Regions/AlliesIndex/?opno=777f1778-f578-4148-b22a-b62f81be5f57>



The Latin America and Caribbean region was the hottest battleground for the PRC-Taiwan sovereignty contest as it comprised the last significant group of countries maintaining formal ties with Taiwan. Taipei consistently sought to attract LAC countries through heavy foreign aid, soft loans and direct investment (so-called checkbook diplomacy<sup>804</sup>). This strategy was employed particularly in the small and needy countries where it was relatively cheap to obtain the allegiance of governments.<sup>805</sup> When the Mainland became rich after the open-door policy, it too began to conduct checkbook diplomacy. China's power and wealth soon became visible in those countries severing ties with Taipei.<sup>806</sup>

Facing fiscal difficulties and diplomatic setbacks, the KMT leader Ma Yingjiu proposed a "cross-strait diplomatic truce" policy immediately after he took office in 2008, calling for an end to the poaching of allies through checkbook diplomacy. This policy was built around what Ma calls the "Three Nos": no pursuit of *de jure* independence, no unification during his term in office, and no use of force to resolve differences across the Taiwan Strait (不独、不统、不武). Recognizing Ma's difference with his pro-independence predecessor, Beijing reciprocated with diplomatic restraint. Thereafter no country switched recognition between the two (the only exemption being Gambia,

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<sup>804</sup> The term "checkbook diplomacy", also named "dollar diplomacy", refers to "any action taken in direct financial assistance, with no bind of audit regarding the direct transferred funds". See Erikson Daniel and Janice Chen, "China, Taiwan and the Battle for Latin America," *Latin Business Chronicle* 31, no. 2 (2007), pp.69-89

<sup>805</sup> He Li, "China's Growing Interest in Latin America and its Implications," *Journal of Strategic Studies* 30, no. 4 (2007).p.487

<sup>806</sup> Committee on Foreign Affairs, *The New Challenge: China in the Western Hemisphere*, 2008-06-11,p.3

which is alleged to have broken ties with Taiwan on 14 November 2013, but as of October 2014, the Mainland has not established diplomatic relations with Gambia).<sup>807</sup>

The “truce” has served to significantly reshape Taipei’s and Beijing’s LAC policies, including their FTA strategies. The following section is divided into two parts. The first part examines the pre-truce period, when the Mainland and Taiwan’s sovereignty rivalry in LAC focused mainly on checkbook diplomacy and the drive for as *many* FTA partners as possible. The second part examines the post-truce era, when the rivalry was transformed into FTA diplomacy and the drive to build extant FTAs as *strong* as possible.

### **6.3.1 The pre-truce era and Mainland-Taiwan diplomatic rivalry**

Prior to their diplomatic truce, both Taipei and Beijing did not camouflage their desire to buy sovereignty recognition in LAC. Costa Rica provides a typical example. The generosity of the assistance provided by the Chen Shuibian administration is evident and ranged from high-profile projects, such as San Jose’s public hospitals and the Taiwan Friendship Bridge cross over the Tempisque River, to expensive paychecks bestowed upon political elites. Except for two former Costa Rican Presidents Miguel Angel Rodriguez and Abel Pacheco, who received illegal election contributions from Taipei, the Chen Shuibian administration also made an investment of \$4.8 million in Costa Rica in the name of “development and tourism.” These funds were, however, transferred into the personal accounts of thirty four foreign ministry staff.<sup>808</sup>

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<sup>807</sup> Gambia is the first and only country to sever official ties with Taiwan since the implementation of the diplomatic truce policy. Taiwan is highly concerned about this incident. According to *Taiwan Insights*: “The Gambia’s move has posed a huge challenge to the “diplomatic truce” or “flexible diplomacy” of President Ma.” See “The Gambia Severs Diplomatic Ties With Taiwan,” (*Taiwan Insights*, November, 2013).

<sup>808</sup> Emily Alves and Michael Johnson, “Paradise Lost: Costa Rica Falls Victim to Corruption and Clientelism,” (*Council on Hemispheric Affairs*, 2004).; Kevin Casas-Zamora, “Notes on Costa Rica’s Switch from Taipei to Beijing,” (*Brookings*, 2009).; Maria Cecilia Calello and Huey-Rong Chen, “Taiwan,

Immediately after the Costa Rican diplomatic shift in 2007, substantial amounts of money from the Mainland became visible in the form of US\$300 million in government bonds, \$10 million in cash donations, \$130 million in aid (including 20 scholarships per year for Costa Rican students to study in China), \$900 million in credit for the upgrading of an oil refinery,<sup>809</sup> and \$83 million for a national stadium.<sup>810</sup> To further consolidate its influence, Beijing pledged a \$400 million loan for construction and public transportation on President Xi's 2013 visit to San José.<sup>811</sup>

The Costa Rica case reflects the neoliberal argument of Lisa Martin who asserts that "heterogeneity of power and of preference intensities may enhance the probability of cooperation, if states are able to link issues credibly".<sup>812</sup> To illustrate, the Mainland and Taiwan mainly focus on high politics, while the LAC countries are concerned about economic and development gains. Whichever of the rivals offer a more generous deal wins diplomatic recognition. For instance, Taiwan's foreign aid comprises approximately 7% of Honduras's GDP and in Nicaragua the figure is as high as 14.3%.<sup>813</sup> Thus the Chen Shuibian administration maintained stable ties with those countries. To quote Saven Grimm, "The assistance that they were receiving from Taiwan was quite substantial. I don't think they'll get a better deal from China in terms

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China and Central American Allies: A Discourse Analysis of the Costa Rican Diplomatic Shift News Coverage," *Taiwan International Studies Quarterly* 9, no. 1 (2013).pp.139-178

<sup>809</sup> Casas-Zamora, "Notes on Costa Rica's Switch from Taipei to Beijing."

<sup>810</sup> Caitlin Campbell Jonathan Weston, and Katherine Koleski, "China's Foreign Assistance in Review: Implications for the United States," in *U.S.-China Economic and Security Review Commission Staff Research Backgrounder* (Washington: U.S.-China Economic and Security Review Commission, 2011).p.10

<sup>811</sup> Shannon Tiezzi, "Why Taiwan's Allies are Flocking to Beijing," (The Diplomat, November, 2013).

<sup>812</sup> Martin, "Heterogeneity, Linkage and Commons Problems." p.473

<sup>813</sup> Casas-Zamora, "Notes on Costa Rica's Switch from Taipei to Beijing."

of development assistance".<sup>814</sup> Following this logic, it is understandable that Costa Rica, where Taipei's yearly assistance accounted for no more than 3% of its GDP ( and often less than 0.3% when only non-reimbursable grants were reckoned with), switched its recognition to Beijing.<sup>815</sup> According to a Brookings' report, in 2006 and 2007, two cabinet-level Costa Rican missions discreetly visited Beijing to discuss details of the eventual switch. The main issue discussed was whether the Chinese government would replace official Taiwanese aids. Moreover, broad investment and trade goals were discussed, including the prospect of crafting an FTA as soon as possible.<sup>816</sup>

Immediately after Costa Rica announced it would break diplomatic ties with Taiwan, Anette Lu, the Taiwanese Vice President, visited those Latin America states that maintained diplomatic ties with Taiwan, while President Chen Shuibian went to Africa. In Guatemala, Lu promised to offer an additional \$50 million of aid for infrastructure. In Nicaragua, Shuibian confirmed the shipment of a thirty megawatt electrical plant to help solve the country's electric power crisis.<sup>817</sup> In addition, to further consolidate diplomatic ties in this region, Taiwan sought to create FTAs with regional countries, particularly in Central America. Cases in point include the FTA with Panama (in effect from January 2004), Guatemala (in effect from July 2006), Nicaragua (in effect from January 2008) and El Salvador (in effect from March 2008). At present, trade volumes between Taiwan and its Central American FTA partners are much larger than the latter's trade with the Mainland. (See Table 6.3 and 6.4) Costa Rica is somewhat of an outlier,

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<sup>814</sup> Pete Guest, "And Then There Were Three: China's Spending Power Entices Taiwanese Ally," (Forbes, 2013).

<sup>815</sup> Casas-Zamora, "Notes on Costa Rica's Switch from Taipei to Beijing."

<sup>816</sup> Ibid.

<sup>817</sup> Peralta, "Central America Between Two Dragons: Relations with the Two Chinas."pp.176-177

the only member of a regional integration arrangement, the Central American Common Market, while all the other members have FTAs with Taiwan.<sup>818</sup>

**Table 6.3: Central American Exports to the Mainland (\$ millions)**

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
2001	13.8	0.1	0.4	0.5	0.4	3.2
2002	33.4	0.9	4.8	0.5	0.2	2.0
2003	88.6	5.1	3.7	2.5	0.1	12.2
2004	162.7	3.6	19.4	8.1	2.6	10.9
2005	240.7	2.9	36.7	17.0	8.2	10.2
2006	556.9	6.5	29.9	13.6	1.7	13.4
2007	835.1	7.0	58.2	19.4	6.2	68.0
2008	613.0	7.1	31.8	n.a	5.4	49.1
2009	765.5	2.6	30.2	42.2	3.7	20.3
2010	268.8	3.3	34.9	n.a	8.2	36.1
2011	214.9	2.0	27.9	n.a	16.4	40.5
2012	326.7	3.7	34.7	n.a	10.6	n.a

**Table 6.4: Central American Exports to Taiwan (\$ millions)**

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
2001	1705.7	183.0	718.1	209.9	233.0	376.0
2002	1692.3	181.7	395.4	207.7	232.2	371.5
2003	89.7	2.5	1.3	1.1	0.7	7.5
2004	1880.1	203.9	473.2	225.0	262.6	378.8
2005	118.5	7.9	22.6	16.4	7.5	26.8
2006	1391.1	158.5	362.3	185.7	221.7	311.4
2007	252.8	32.9	61.6	60.0	46.4	122.8
2008	126.8	20.0	29.6	37.3	31.6	69.8
2009	998.6	166.6	256.3	111.3	166.6	152.3
2010	228.1	21.8	75.6	28.2	43.6	49.3
2011	295.9	64.3	75.8	35.5	57.0	46.6
2012	395.2	15.8	73.4	38.9	57.6	40.0

*Source:* WITS Comtrade (for China Statistics) and Taiwan Bureau of Foreign Trade (for Taiwan statistics), 2013.

<sup>818</sup> Kotschwar, "China's Economic Influence in Latin America."p.211

Beijing refuses to recognize all existing Taiwan-Latin American FTAs and announced that Taipei's attempt to create "two Chinas" by strengthening economic presence in this region was "doomed to fail".<sup>819</sup> Moreover, when normalizing diplomatic ties with Costa Rica in 2007, Beijing concomitantly initiated the establishment of a bilateral FTA. Costa Rica is far from an ideal FTA partner though: its domestic market is too small for China. Nor does its exporting structure complement the Mainland's, which manufactures and sells significant quantities of integrated circuits too. Further, Costa Rica is not a country rich in natural resources. Nevertheless, to many people's surprise, the CCRFTA was established in a speedy fashion with the shortest negotiating period for all Chinese FTAs. (The first round of negotiations was in January 2009, and the agreement was signed in February 2010) This instance again illustrates Martin's view that when an actor has intense political concerns (China) they are willing to make economic sacrifices, while the other actor has intense interests in economic assistance (Costa Rica) and are thus willing to make political contributions (recognition of China's claims over Taiwan).

In short, this section verifies what some neoliberal scholars have argued – cooperation can be achieved among heterogeneous countries by cautiously manipulating cross issue areas and by constructing trans-governmental institutions and agreements. Thus, it is in Beijing's interests to create a model relationship with Costa Rica and to showcase the CCRFTA. If other LAC countries follow Costa Rica, similar repayment (including bilateral FTAs) could be expected, with the prospect of a domino effect in the region. An FTA would be a win-win for China, further strengthening its legitimacy amongst LAC countries while securing their diplomatic shift. Neoliberalism also explains why

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<sup>819</sup> Liu Wenzong, "Dollar Diplomacy' Doomed to Fail," *China Daily* 2003-11-13.

Ma Yingjiu proposed a “diplomatic truce”. Beijing has a deeper pocket to buy adherents, whose foreign exchange reserve is nine times that of Taiwan.

Moreover, the Mainland has established FTAs with major economies in LAC such as Chile and Peru, but Taipei’s sovereignty supporters and FTA partners are mainly small and developing countries in need of aid assistance. In this fiscal context, Taiwan was likely to lose the last remaining pieces of its diplomatic recognition in this region if Ma had adopted the same expensive checkbook and FTA diplomacy as his predecessor.

Neoliberals, however, fail to adequately explain how Latin America’s recognition of Taiwanese authority posed a severe challenge to the PRC’s “One China” doctrine; the odds against Taipei’s checkbook diplomacy, and why Beijing agreed to a “diplomatic truce” rather than continuing to widen its influence in this region through checkbook diplomacy? And second, some neoliberal analysts presumed that the ‘defection’ of Costa Rica would trigger a domino effect where all Central American countries would forge ties with Beijing within ten years,<sup>820</sup> something that has not occurred. To address these theoretical and explanatory deficiencies, it is necessary to consider the possible impact of a third party, and the whole international structure overall. The remainder of this section, taking a cue from structural realists, now turns to explore the Mainland-Taiwan rivalry in the post-truce era, and in particular, by adding the role of the US through the Mainland-Taiwan-US strategic triangle.

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<sup>820</sup> Daniel P. Erikson, "Conflicting US Perceptions of China's Inroads in Latin America," in *China Engages Latin America: Tracing the Trajectory*, ed. Adrian H Hearn and José Luis León-Manríquez (US: Lynne Rienner Publishers, 2011).p.128

### 6.3.2 The Post-truce era and the Mainland-US-Taiwan strategic triangle

The Mainland-US-Taiwan strategic triangle did not come about overnight but started to take shape after the end of World War II. Taiwan is located at the key juncture of the East China Sea and South China Sea. If the Mainland took control of this island, it could then acquire more maritime power and influence. Consequently, Washington has maintained at all costs an alliance with Taiwan.<sup>821</sup> In the eyes of Beijing, the US remains a serious source of friction over the Cross-Straight issue. Currently the Mainland still lacks adequate power to change the *status quo* but is biding time and waiting for opportunities to change the situation. Today the CCP has evolved what Dittmer describes as a “Romantic Triangle”, consisting of closer or better relationships between one ‘pivot’ and two ‘wing’ players than either has with the other.<sup>822</sup> In this China-US-Taiwan triangle, Washington acts as the ‘pivot’ that enjoys relatively stable relations with both Beijing and Taipei, while the latter two’s relationship involves serious sovereignty disputes and is always under pressure from dramatic dynamics that rely on the pivot’s intervention and mediation. Latin America, a region accounting for half of Taiwan’s sovereignty recognition, has long been a crucial battleground in this triangular relationship.

Washington is in a somewhat embarrassing position in this strategic triangle. The official US position is that other states’ decision regarding diplomatic ties with Taiwan should left to them. In addition, since the US has officially recognized the PRC government and the “One China” doctrine, it has no moral authority to publicly lobby

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<sup>821</sup> See Iskander Rehman, "Why Taiwan Matters: A small island of great strategic importance," *The National Interest*, no. September-October (2014); Nancy Bernkopf Tucker and Bonnie Glaser, "Should the United States Abandon Taiwan?," *The Washington Quarterly* 34, no. 4 (2011).

<sup>822</sup> Lowell Dittmer, "Sino-Australian Relations: A Triangular Perspective," *Australian Journal of Political Science* 47, no. 4 (2012).p. 665



other countries to recognize Taiwan.<sup>823</sup> Nevertheless, the US cannot afford to abandon Taiwan, a crucial chess piece for containing mainland China's geopolitical rise. Worse, failure to keep "protecting" a loyal and independent Taiwan would harm America's international credibility. Washington is well aware that Taipei was fighting a losing battle in LAC before the diplomatic truce, and that once the region's remaining holdouts embraced the Mainland, it would be left even more isolated in its support for Taiwan.<sup>824</sup>

Recognizing that it is hard for Taiwan to acquire *de jure* independence, the US resorted to FTAs as an alternative strategy to maintain Taiwan's *de facto* independence. For example, Washington gives backing to Taipei's efforts to build FTAs as an independent authority, particularly through a bilateral US-Taiwan FTA and a NAFTA-Taiwan agreement.<sup>825</sup> A more recent move is an American Trans-Pacific Partnership (TPP) membership scheme that includes Taiwan but excludes the Mainland. Raymond Burghardt, the Obama administration's top official dealing with Taiwan issues, said in July 2013 that the US would resist any efforts opposing Taiwan joining the TPP.<sup>826</sup> As noted in the previous chapter, Beijing regards the TPP as the US's institutional instrument to curb its ascendancy. Economies joining the trade block would be categorized as being in the US camp, including those that have diplomatic difficulties with Beijing such as Vietnam and the Philippines. Once Taiwan gets TPP membership, it will gain a legitimate platform to strengthen cooperation with the US, along with other TPP members that are not that friendly with Beijing. In this context, the Mainland,

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<sup>823</sup> Erikson, "Conflicting US Perceptions of China's Inroads in Latin America." pp.129-130

<sup>824</sup> Daniel Erikson and Janice Chen, "China, Taiwan, and the Battle for Latin America," *The Fletcher Forum of World Affairs* 31, no. 2 (2007).p.84

<sup>825</sup> Brookings, "Conceptualizing Future United States-China Relations," (The Brookings Institution Center for Northeast Asian Policy Studies and John L. Thornton China Center, 2012).

<sup>826</sup> "Background Briefing Taiwan's Participation in International Organizations," (Formosa Foundation, 2012).

through a *realpolitik*/geopolitical lens, believes that Washington issues the TPP invitation to Taiwan to alienate the Mainland and Taiwan.<sup>827</sup>

In the eyes of Taipei, the LAC plays an important role in maintaining its strategic significance in the Mainland-US-Taiwan triangle. More LAC recognition indicates that Taiwan has allies vis-à-vis the Mainland-Taiwan relationship, and that the US is more likely to support its sovereignty. Conversely, if Taipei lost all diplomatic allies in LAC, its strategic value would decrease in the eyes of Washington. Therefore, the diplomatic truce was not because Mr. Ma Yingjiu does not want to win more supporters, but because he could not bear the geopolitical implications of more defectors.

Yet Taiwan is unwilling to accept defeat - its policy actions in LAC suggest that the truce is virtually a half-truce – it uses the checkbook and FTA diplomacy simultaneously. For instance, although Taiwan's current FTAs (Panama, Guatemala, Nicaragua, El Salvador and Honduras) were all built during Chen Shuibian's 'checkbook' tenure, detailed rules for implementation (i.e. Dispute Settlement Mechanisms, tariff rate quotas, and quota quantities) were completed and ratified under Ma Yingjiu's FTA diplomacy. The American intent to include Taiwan in the TPP gave the island new impetus to manipulate FTA diplomacy. It reinforced extant FTAs with LAC countries on the one hand, and sought to get to the FTA bargaining table with bigger economies (i.e. the EU, Singapore and New Zealand<sup>828</sup>) on the other. Meanwhile, Ma Yingjiu has been proactive in lobbying TPP members to support Taiwan's

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<sup>827</sup> See article published in a state-led Chinese media: Zhou Zhongfei, "Washington Ready to Step Deeper in Straits," (Global Times, 30 July, 2012). See also Vancouver Sun, "China Unhappy Over Taiwan's Push for Wider Trade Partnerships," (Canada.com, 30 January, 2012); Richard C. Bush, "Taiwan and the Trans-Pacific Partnership The Political Dimension," (Brookings Institution, January, 2014).

<sup>828</sup> Taiwan signed an FTA with New Zealand on 10, July 2013, a significant precedent as it's the first-ever FTA with a country without recognizing the island's sovereignty. See Lucy Hornby and Luc Cohen, "No Ties? No Problem as China Courts Taiwan's Remaining Allies," (Reuters, 2013).

participation in the trade bloc. In May 2013, he told Canadian Member of Parliament John Duncan that:

The [Taiwan] government is leaving no stone unturned in striving to create favorable conditions for Taiwan's participation in the TPP ... We are in talks with Singapore and New Zealand on signing economic cooperation agreements and, upon conclusion, hope to join the TPP like Canada.<sup>829</sup>

Beijing's consent to the diplomatic truce is partially due to the US, which plays the role of mediating the 'two wings' of the strategic triangle. Although President Jimmy Carter ceased official ties with Taipei and switched diplomatic recognition to Beijing in 1979, the American Congress simultaneously approved the Taiwan Relations Act authorizing the US to militarily protect the island against any possible attacks from the Mainland. Subsequently, US arm-sales to Taiwan have given Beijing a persistent headache.

Constrained within the triangle (it can be a quadrangle or a pentagon or likewise if we introduce other pertinent countries), Beijing has learnt that arbitrarily cutting off Taipei's remaining LAC support for diplomatic legitimacy – as it did before the “truce” – would only invite big power intervention. Rather than pushing Taipei into the US's embrace and military protection, Beijing prefers the island to maintain *status quo*. Besides, countries varying in size from Paraguay to the city state Vatican, can hardly affect the PRC's international legitimacy. Moreover, among the twenty two countries still recognizing Taiwan, many have an increasing desire to normalize relations with mainland China – it is only a matter of time. Against this backdrop Beijing agreed to the truce – and at the same time rebuffed diplomatic recognition requests from at least five

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<sup>829</sup> "Ma seeks Canada Support for ICAO, TPP bids," (Taiwan Today, 2013-05-07).

countries,<sup>830</sup> indicating that China's diplomatic focus has moved from tiny nations that officially recognize Taiwan to bigger powers that have more complicated unofficial ties with the island.

Maintaining a benign relationship with the Mainland-friendly Ma Yingjiu administration is another reason for Beijing to agree with the diplomatic truce. The CCP's objective since the 2008 truce has been to keep the pro-Mainland GMT in office and prevent the pro-independence DPP from being re-elected. Beijing currently tolerates LAC governments that have diplomatic ties with Taipei, but simultaneously maintains its influence within these countries. If the DPP wins the 2016 election, Beijing can easily pry them from Taiwan's grasp and showcase to Taiwanese voters that the DPP now is diplomatically as incompetent as it was under Chen Shuibian. This policy is widely recognized by politicians and academics. As stated by Zhang Zhexin, a Cross-Straight expert in Shanghai Institute for Institutional Studies, "if it weren't for the desire to support Ma, we would have let them switch already. But now we are not as much in a rush as before".<sup>831</sup> Similarly, as Campbell put it, "While China excludes the states from formal modes of diplomatic cooperation, the CCP, and particularly the CCP's International Department, cultivates informal political ties with these countries. Beijing presumably could leverage these ties should its diplomatic truce with Taipei falter."<sup>832</sup>

To achieve the above objective, Beijing started to promote cooperation with all Latin American countries without differentiating between those that recognized Taiwan and

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<sup>830</sup> Lucy Hornby and Luc Cohen, "No ties? No Problem as China Courts Taiwan's Remaining Allies " (Reuters, August 6, 2013).

<sup>831</sup> Cohen, "No Ties? No Problem as China Courts Taiwan's Remaining Allies."np.

<sup>832</sup> Campbell, "China's Expanding and Evolving Engagement with the Caribbean."p.7

those that did not. In Paraguay, for example, imports from the PRC and Hong Kong accounted for the largest share of its total imports in 2010.<sup>833</sup> In Honduras, the China Harbor Engineering Corp (EHEC) won the contract to construct ports and ten inter-oceanic railway lines, with the bidding price of US\$20 billion.<sup>834</sup> And in Nicaragua, Chinese workers are now building a US\$40 billion canal from the Caribbean to the Pacific Ocean.<sup>835</sup> Such cooperation was impossible before the ‘diplomatic truce’. Taiwan has a tacit understanding of Beijing’s intent behind these projects. Antonio Hsiang, a Taiwanese scholar on Latin American affairs, commented on the Nicaragua canal project as:

This project may also be a signal to Taipei that continued Kuomintang of China (KMT) governance will benefit Taiwanese economic interests. As long as the Democratic Progressive Party is kept from winning next presidential election, Beijing is willing to show more good-will to the governing KMT by allowing Taiwan to join the project.<sup>836</sup>

Beijing also seeks to strengthen its international legitimacy through cultural outreach. For example, in 2013 the University of the West Indies in Trinidad and Tobago announced plans to open a Confucius Institute, and the official Confucius Institute website also lists the Dominican Republic – which recognizes Taiwan, but not the PRC – as hosting a Confucius Institute.<sup>837</sup> Moreover, during Xi Jinping’s 2014 Latin America visit, he announced a \$20 billion plan for a “Regional Development Fund”. This fund,

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<sup>833</sup> Antonio Prado Alicia Bárcena, Osvaldo Rosales, and Ricardo Pérez, "People’s Republic of China and Latin America and the Caribbean: Ushering in a new era in the economic and trade relationship," (Economic Commission for Latin America, United Nations, 2011).p.12

<sup>834</sup> Ibid.p.19

<sup>835</sup> Carlos F. Chamorro, "Will China's Nicaraguan Canal Shift Power In The Western Hemisphere?," (The World Post, August 29, 2014).

<sup>836</sup> Antonio C. Hsiang, "Three Reasons Nicaragua Inked the Mega Canal Project," (Sharnoff's Global Views, 2013).

<sup>837</sup> Campbell, "China's Expanding and Evolving Engagement with the Caribbean."p.8

as Ellis pointed out, indicates that Beijing has clearly taken the game to a new level, compared to the pre-truce era, when it could only “build a cricket stadium or a hospital to convince a small Caribbean nation to change its diplomatic recognition from Taiwan to the PRC”.<sup>838</sup>

To sum up, Beijing’s policy behavior in its diplomatic rivalry with Taiwan is identified as a strange and paradoxical combination of neoliberal-realist fundamentalism, with the 2008 diplomatic truce as a watershed. With respect to the pre-truce era, both the Mainland and Taiwan’s LAC policies seemed to fit the neoliberal framework when they used checkbook diplomacy to buy recognition and influence by manipulating cross-issue levers. In this stage the two parties also sowed the seeds of FTAs by signing free trade treaties - *as many as possible*. This reflects China’s lack of confidence about its own legitimacy, and why it rigorously squeezed Taiwan’s ‘international space’.

With the post-truce era, Beijing softened its stance toward Taipei in part due to its own advantages (a growing economic and military profile and growing confidence over sovereignty issues), and partly because of its disadvantages (a relatively weak position vis-à-vis the US on the Cross-Strait relations). At this stage the “FTA diplomacy” plays a crucial role in the Mainland-US-Taiwan strategic triangle, and creates significant political ramifications in Latin America. As Marc Lanteigne argues, “China’s successes with FTAs in the decade prior to the Taiwan accord demonstrated first that Beijing was growing more accepting of free trade agreements as part of its expanding international economic policies, and was also learning much about how FTAs could serve both its

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<sup>838</sup> Evan Ellis, "China Fills the Vacuum Left by the United States in Latin America," in *Perspectives on the Americas* (Center for Hemispheric Policy, University of Miami, August, 2014).p.2

own diplomatic and economic needs".<sup>839</sup> Subsequently, Beijing's FTA strategy in LAC changed from *as many as possible* to the *best possible*, and was beginning to bear fruit. The two stages should not be considered in isolation, since each of them captures China's gradually shifting diplomatic ideas in accordance with its growing material power.

#### **6.4 To Secure Resource Supply**

China's extraordinary growth is largely based on its immense resource consumption. According to figures released by the Ministry of Commerce, 74.4% of Chinese imports were raw materials (i.e. oil and mineral fuels, metal ores, etc.), which were converted into finished goods and then re-exported.<sup>840</sup> In this respect, Zheng Bijian, a senior advisor to former President Hu Jintao, listed the shortage of raw materials, and energy in particular, as the first of three fundamental challenges to China's great rejuvenation in the 21<sup>st</sup> century.<sup>841</sup> In 2004, it overtook the US as the world's largest consumer of grain, meat, coal and steel; in 2010, it satisfied about 16.7% of its own copper demand, but consumed 40% of the world's copper production and in the same year, it became the biggest energy consumer by consuming 20.3% of global energy.<sup>842</sup> Thus far, the central government has looked abroad to obtain primary products to sustain the high growth

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<sup>839</sup> Lanteigne, "Commercial Diplomacy: Preferential Trade Agreements and Soft Power Projection."pp.86-87

<sup>840</sup> See Statistic Database of Ministry of Commerce of the People's Republic of China, available at <http://www.mofcom.gov.cn/tongjiziliao/tongjiziliao.html?3312943867=316931864>

<sup>841</sup> The other two challenges are respectively that of the eco-system and a whole host of thorny issues as we try to coordinate economic and social development. See Suisheng (Sam) Zhao, "China's National Security Strategy and Diplomatic Engagement," in *China – Latin America Task Force* (University of Miami: Center for Hemispheric Policy, University of Miami, 2006); Zheng Bijian, "China's New Path of a Peaceful Rise and China-US Relations " (Embassy of the People's Republic of China in the United States of America, June 13, 2005).p.3

<sup>842</sup> "China Overtakes USA as Top Energy Consumer as World Demand Grows Strongly, Says BP in 60th Year of Global Energy ", (BP press, 2011-June-08). Available at <http://www.bp.com/extendedgenericarticle.do?categoryId=2012968&contentId=7069439>

rate deemed as the base of its legitimacy. The so-called “going out” strategy explicitly reflected Beijing’s efforts to empower and encourage domestic enterprises to secure access to primary goods globally.<sup>843</sup>

Latin America as a region possesses a wealth of natural resources. With respect to minerals, this region owns a quarter of the world’s estimated silver reserves, 45% of copper reserves, and 30% of tin reserves.<sup>844</sup> Chile is the world’s largest copper producer (5.84 million metric tons in 2012, accounting for 32%)<sup>845</sup> as well as being the leading molybdenum supplier. With respect to oil and gas resources, Venezuela holds the largest oil reserves in the world (if the heavy petroleum deposits are reckoned with).<sup>846</sup> Peru’s newly-found gas field is reported to hold a gas deposit of 1-2 trillion feet.<sup>847</sup> Ever-fiercer competition for natural resources in the international market encourages Latin American governments to use their natural endowments to promote economic development. For example, Perupeto, the Peruvian oil licensing authority, announced a plan to auction off twenty-two oil and gas exploration blocks by the end of 2012.<sup>848</sup> Moreover, many Latin American countries are relatively unindustrialized and authoritarian leaders and/or corrupt oligarchies control a large amount of their resources.<sup>849</sup> This provides an opportunity to resource-starved nations, since “signing

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<sup>843</sup> Freeman Briefing, "China’s “Going Out” Investment Policy," in *Freeman Chair in China Studies* (Center For Strategic & International Studies, May 27, 2008).

<sup>844</sup> Ellis, *China in Latin America: The Whats & Wherefores*.p.12

<sup>845</sup> Gachuz, "Chile's Economic and Political Relationship with China."p.140

<sup>846</sup> Ellis, *China in Latin America: The Whats & Wherefores*.p.12

<sup>847</sup> Jason Fargo, "Repsol announces large gas discovery in Peru," *The Oil Daily*, 2012/09/07/ 2012.

<sup>848</sup> Ibid.

<sup>849</sup> Stephen Johnson, "Balancing China's Growing Influence in Latin America," in *Backgrounder* (Washington: The Heritage Foundation, 2005).p.2



purchase agreements with them [Latin America countries] is much easier than dealing with the panoply of private corporations found in more democratic countries”.<sup>850</sup>

As noted above, Beijing views C-LA FTAs as resource-oriented. This intention was explicitly inked in *China's White Paper on Latin America and the Caribbean (2008)*, where it stated, “the Chinese side wishes to expand and deepen mutually beneficial cooperation with Latin American and Caribbean countries in resources and energy within bilateral cooperation frameworks”.<sup>851</sup> Both realism and neoliberalism are good candidates for explaining how China uses bilateral arrangements as a *means* to secure resource-supply, but with distinct *ends*. Realist theorists usually take a pessimistic view relating to national security and geopolitical considerations, and argue that resources will be utilized both economically and militarily while China has a high propensity to transfer economic utilities into military ones. Conversely, neoliberals are relatively optimistic that C-LA FTAs will be used mainly to help China hedge against uncertainties in the international resource market, and to win permission to exploit natural resources in LAC countries. They generally believe that China will maintain the *status quo* and restrict its activities in America’s “backyard” to within the economic realm. This section endeavours to explore China’s “resource-embedded” FTAs (mainly focusing on the China-Chile FTA and the China-Peru FTA), and concludes that China’s resource-seeking activities mainly aim to feed its domestic development needs and that, at least in the short-medium term, it has no intent to militarily challenge the US’s leading position in LAC.

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<sup>850</sup> Ibid.p.2

<sup>851</sup> Xinhua, "China's Policy Paper on Latin American and the Caribbean," *China Daily* 2008-11-06.p.3

#### 6.4.1 Beijing: resources are for economic development

The CCFTA and the CPFTA were designed to hedge against market uncertainties in the importation of resources. Take copper as an example. While in January of 2005, a pound of copper cost \$143.8 cents, in December of the same year it had climbed to \$207.6 cents per pound.<sup>852</sup> According to an ECORYS's report, resource prices for metals, minerals, fuels, fish, timber and biomass increased by over 300% from 1998 to 2011.<sup>853</sup> Further, commercial deals may encounter *force majeure* such as regime change or political instability. Sellers may then decrease or even cut off resource exports committed to by their predecessors. A rational response would be to set up transnational mechanisms to avoid unpredictability for both sellers and buyers.

FTAs are the logical institutional means by which China can withstand both price (by inking bilateral contracts as follow-ups to FTAs<sup>854</sup>) and quotas (by eliminating importing tariffs immediately after FTAs entered into force) shocks. For instance, after Shougang Group obtained the Marcona mining rights from the Peruvian government, it was about \$10 per ton cheaper to import iron ore from Marcona than to import it from Australia.<sup>855</sup> Similarly, in a follow-up contract of the CCFTA, Codelco, the Chilean state cooper giant, agreed to supply 56,750 tons of copper per year until 2015 to Minmetals, a leading Chinese mining company. The Chinese company also made a guarantee deposit of \$550 million for a business worth more than US\$ 2.2 billion over

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<sup>852</sup> Alex E. Fernandez Jilberto, "Neoliberalised South-South Relations: Free Trade Between Chile and China," in *Latin America Facing China: South-South Relations Beyond the Washington Consensus*, ed. Alex E. Fernandez Jilberto and Barbara Hogenboom (United States: Berghahn Books, 2012).p.79

<sup>853</sup> Ecorys, "Mapping Resource Prices: The Past and The Future," (Rotterdam, The Netherlands 2012).

<sup>854</sup> China and Chile, for example, encourage and support intergovernmental protocols as well as association agreements between copper corporations based on the existing Sino-Chile FTA. See China-Chile FTA, chapter XIII, article 113. Available at [http://fta.mofcom.gov.cn/chile/chile\\_xieyiwenben.shtml](http://fta.mofcom.gov.cn/chile/chile_xieyiwenben.shtml) try and get this on page 35

<sup>855</sup> Ruben Gonzalez-Vicente, "Mapping Chinese Mining Investment in Latin America: Politics or Market?," *The China Quarterly* 209(2012).p.51

15 years.<sup>856</sup> These arrangements have not only provided Chinese policy-makers with new evidence that FTAs with resource-rich countries will lock-in supply, but have also convinced them that international regimes are cost-effective tools for reducing market risks.

FTAs also provide an ideal way to legitimize China's trade with LAC countries. For example, the signature of the CCFTA and CPFTA indicates that the Chilean and Peruvian governments officially authorize Chinese companies to buy any commodities and to invest in all sectors covered by FTA clauses. As long as China's commercial behavior complies with the FTA regulations, there is little room to query the resource imports from those two countries. Moreover, both the China-Chile FTA (article 113) and the China-Peru FTA (article 157) contain specific arrangements on "Mining and Industrial Cooperation", whereby the contracting parties agree to strengthen joint-work in various fields including, but not limited to, bio-mining, productivity in mining, mining techniques especially underground mining and congenital metallurgy, industrial robotics for mining, informatics and telecommunication applications for mining, and industrial plant production.<sup>857</sup> As a result, mining trade accounted for the bulk of Chilean and Peruvian exports to China. In 2011, Chile exported US\$ 10.42 billion worth of refined copper and copper alloys (HS7430) to China; and in the same year, Peru exported copper related products worth US\$ 0.64 billion (71,367 tons), and iron ore and concentrates (HS2601) worth more than US\$ 1 billion (9,423,747 tons).

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<sup>856</sup> Juan Diego Montalva, "Chile and China: Building Relations Beyond Trade?," in *China – Latin America Task Force* (Center for Hemispheric Policy, University of Miami: University of Miami, 2006).p.10

<sup>857</sup> See the CCFTA and CPFTA tariff reduction schedule texts at China FTA Network official website, available at <http://fta.mofcom.gov.cn/list/enrelease/1/encateinfo.html>

The other function of Free Trade Agreements is to legitimize a country's economic activities internationally. This is because even if a country is wealthy and strong and able to endure market uncertainties, that does not mean that it has the legitimacy to buy resources simply as it wishes. This point is of particular relevance to a China eager to cultivate a responsible big power image after its experiences in Africa. China learnt some important lessons after Africa where it gained a reputation as a "resource exploiter" and "new colonist".<sup>858</sup> Beijing is now alert to concerns that China is taking up too many raw materials in LAC, and it does not want this region to become 'another Africa'.<sup>859</sup> There are signs that Chinese mining enterprises, at the urging of the Chinese government, are starting to behave in accordance with international rules. To quote Barbara Kotschar *et al*:

Chinese investors are beginning to demonstrate interest in acquiring better knowledge, for example by producing feasibility studies in advance of beginning constructions; taking seriously compliance with local and environmental, labor and land acquisition laws, and supporting local development projects through philanthropic activities. In our interview in Peru, Chinese executives spoke (in excellent Spanish) of the large learning curve confronting Chinese investors when entering a country such as Peru with respect to local practices and mores.<sup>860</sup>

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<sup>858</sup> Thompson Ayodele and Olusegun Sotola1, "China in Africa: An Evaluation of Chinese Investment," in *IPPA Working Paper Series* (Initiative for Public Policy Analysis, 2014).

<sup>859</sup> It is true that some practices undertaken by certain Chinese companies in Africa have to some extent damaged China's image, and the fear of this experience being replicated in Latin America incites caution and wariness. Nevertheless, according to an Inter-American Dialogue working paper, the differences between Africa and LAC, and the fact that civil society (unions and indigenous communities) plays a more active role in LAC countries. These differences will make a similar scenario less likely in the Western Hemisphere. See pp.6-14 and p.22. Teddy Ng, "Xi Aims to Tread Softly in Latin America Visit," *South China Morning Post* 2013-05-31.

<sup>860</sup> Muir, "Chinese Investment in Latin American Resources: The Good, The Bad, and The Ugly."p.14

While trying to cultivate a responsible image, Beijing also seeks to create a peaceful image in Latin America. Chinese leaders have repeatedly stressed that resources purchased from the region are purely for economic development. It is understandable that they would say this. A Pew survey of sixteen states reveals that people welcome the PRC's economic ascendancy but not a military rise; "If China is perceived as mainly an economic actor, that person is likely to both approve China's rise and being pro-U.S. By contrast, if an individual mainly sees China as an increasing military power, then his or her pro-American sentiments will often mean disapproval of China's rise."<sup>861</sup> In this sense, to win over international legitimacy regarding its rising power, the PRC needs to behave in accordance with the mainstream liberal norms and embed its behaviour in the rules of various liberal international institutions. The establishment of the three C-LA FTAs is a good starting point to institutionalize the Sino-Latin America relationship, and to show Beijing's apparent respect for the liberal rationale. To further strengthen its ties with the remote region, the next step is to consolidate current C-LA FTAs whilst seeking opportunities to launch further bilateral/sub-regional FTA negotiations with other Latin American countries.

#### **6.4.2 Washington: resources sow the seeds of war**

For realists, the principles of universal moral behavior cannot be applied to the actions of states. According to Hobbes, "in a world of competition and scarcity, to acquire anything of use is to tempt others to "come prepared with forces united, to dispossess, and deprive him, not only of the fruit of his labor, but also his life, or liberty".<sup>862</sup> In this vein, realism portrays the world as one of anarchy where military force is the ultimate instrument for the security of sovereign states, and here the acquisition of material resources is critical to military power. As Mearsheimer says, "great powers do not

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<sup>861</sup> Cited in Joseph Nye, *The Future of Power* (United States: PublicAffairs, 2011), p.185

<sup>862</sup> Thomas Hobbes, *Leviathan*, ed. C.B. Macpherson (Great Britain: Hazell Watson and Viney Ltd, 1968).Part III. P.423

practice self-denial when they have the wherewithal to shift the balance of power in their favor ... the appetite for power does not decline once states have a lot of it".<sup>863</sup> Thus, the shifting balance of power, national security, and war have been constant features of international relations over the centuries.<sup>864</sup>

Sino-Latin American resource trade represents fertile ground to test the realist argument. At present, Chinese policy-makers face the challenge of how to secure and maintain uninterrupted trade routes from Latin America in an economically efficient way. This challenge can be divided into two parts: (1) transportation from the Latin American coast to the Pacific coast and (2) the movement of commodities from the Pacific coast to China. The former one relates a problem of costs: in the past decade, costs for passing through the Panama Canal have doubled. Moreover, gigantic ships cannot pass through the Panama Canal, as the maximum size ships it can accommodate are only 80,000 tons. Larger ships have to make a more than 10,000 km detour via the southernmost point of South America.<sup>865</sup> In this context, a newly created Chinese company, the Hong Kong Nicaragua Development Group, has started to work on the 278-kilometer-long Nicaragua Canal, which will accommodate ships with a loaded displacement of 400,000 tons.<sup>866</sup> (See Picture 6.1)The latter one has more to do with security than trade. Beijing is well aware of the effects the US naval presence and other maritime factors can have on cargo ships or oil tankers sailing back to China.<sup>867</sup> Therefore, to guarantee its secure access to resources in this region, China may need to

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<sup>863</sup> John J. Mearsheimer, *The Tragedy of Great Power Politics* (New York: Norton, 2011).p.168

<sup>864</sup> Nye, *The Future of Power*.p.17

<sup>865</sup> "A Chinese Company Won the Permission of the Nicaragua Canal, With A Maximum of 100 Years Lease [zhongguo qiye huozhun xiuzhu nijia lagua yunhe, jianghuo zuido 100 nian jingying xukequan]," (Observer [Guanchazhe], June 14, 2014).

<sup>866</sup> Chu Daye, "Billionaire Confident on Future 278-km Canal," (Global Times, August 5, 2014).

<sup>867</sup> Teng, "Hegemony or Partnership: China's Strategy and Diplomacy Toward Latin America."p.101

increase its military presence.<sup>868</sup> At a minimum, “these goals require the ability to project and sustain at least a small number of forces overseas to perform noncombat operations, such as peacekeeping and disaster relief” to “show the flag” in regions where a state has strong trade and investment interests.<sup>869</sup> In reality, China’s peacekeeping actions in Haiti; the PLA’s “Peace Ark” hospital ships that visit five Latin and Central American countries (including Cuba and Costa Rica); as well as the construction of a blue-water navy to secure sea-lanes to protect its resource imports;<sup>870</sup> all these efforts are in accordance with the realist notion of a “noncombat” position.

**Picture 6.1: The Proposed Route of the Nicaragua canal**



Source: Laura Smith-Spark, “Nicaragua Canal: just a pipe dream?” (BBC News), available at <http://news.bbc.co.uk/2/hi/americas/6069022.stm>. Picture accessed on 10 August, 2014.

However, noncombat actions can be easily translated into combat operations if there is a need to do so. When resources become scarce and/or prices become too high, a country may resort to war to attain by military means the resources they could not attain by economic means, as Japan and Germany did in the World War II.<sup>871</sup> After all, even if

<sup>868</sup> Ibid.p.105

<sup>869</sup> Fravel, "Economic Growth, Regime Insecurity, and Military Strategy: Explaining the Rise of Noncombat Operations in China."p.182

<sup>870</sup> The Spectator, "Australians Should Fear the Rise of China," (2010).

<sup>871</sup> Giovanni Arrighi, "Reading Hobbes in Beijing: Great Power Politics and The Challenge of the Peaceful Ascent," in *Routledge Handbook of International Political Economy (IPE): IPE as a Global Conversation*, ed. Mark Blyth (New York: Routledge, 2008). pp.165-166

all resources can be peacefully acquired to sustain domestic development, the accumulated economic strength will, sooner or later, be translated into military might. Following this realist logic, America's China observers seem disinclined to believe that the dragon's appetite for resource is purely commercial. Rather, many realists claim that China cannot rise peacefully, and that a war between China and the US is inevitable.<sup>872</sup> As Martin Jacques states, "rising powers in times invariably use their new found economic strength for wider political, cultural and military ends. That is what being a hegemonic power involves, and China will surely become one".<sup>873</sup>

Of course, realism itself is not unitary, although proponents and opponents always treat it as such. Since the development of international laws has made any attempt to acquire resources by military means illegitimate, there emerges a new realist branch – the post-classical realism, also named geoeconomic realism or mercantile realism. This theory argues that nation-states and their rivalry for markets, raw materials, and the mastery of high-tech "becomes a surrogate for traditional military competition".<sup>874</sup> States can enhance their relative share of economic resources by (1) changing transnational trade patterns; (2) establishing efficient regimes to reduce transaction costs; (3) utilizing economic levers to secure supplies of inexpensive resources and other supplies from weaker states; and (4) developing green technologies and renewable energy to free up resources for economic advancement.<sup>875</sup> These suggestions indeed overlap with neoliberal discussions on resource acquisition. Nevertheless, despite this overlap, post-classical realists and neoliberals produce divergent predictions regarding the likely

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<sup>872</sup> John J. Mearsheimer, "The Gathering Storm: China's Challenge to US Power in Asia," *The Chinese Journal of International Politics* 3(2010).pp.381-396

<sup>873</sup> Martin Jacques, *When China Rules the World: The End of the Western World and the Birth of a New Global Order* (New York: Penguin Group, 2009).p.12

<sup>874</sup> Mastanduno, "A Realist View: Three Images of the Coming International Order."p.23

<sup>875</sup> Brooks, "Dueling Realisms."p.462



actions of a resource-thirsty China. For the former, military action is still the principal strategy whenever it is the most cost-effective means.<sup>876</sup> Therefore the possibility of China behaving as a revisionist country, challenging the status quo and the prevailing order through military action, is still high.

Even though Beijing has reiterated that it has no intention to change the status quo, it is hard to convince all China-watchers, particularly realists in Washington. To again quote Mearsheimer, "...even if one could determine China's intention today, there is no way to know what they will be in the future".<sup>877</sup> What if China continued to purchase enough resources to feed its growth by using only economic might and trade regimes, as it is currently doing under C-LA FTAs? Is this a threat to the *status quo*? Would it be nice for China, on the one hand to win over credit and trust from other countries, particularly those belonging to the Third World, and on the other to let America exhaust itself further in endless fights against terrorism, and non-democracy? Hence, in case China has an ambition to dominant the world, current circumstances have given it more than one option to acquire hegemony without a military confrontation with the US. Anyway, a theory that does not even consider a possibly positive conjuncture of China, in Giovanni Arrighi's words, "may well be worse than no theory at all".<sup>878</sup> As John Aberg points out, "The dichotomous understanding of countries as *either* status quo powers *or* revisionist powers is flawed. Status quo and revisionism are analytically useful in terms of foreign policy orientations that are pursued at certain times, at certain locations, and

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<sup>876</sup> Ibid.p.463

<sup>877</sup> Mearsheimer, "The Gathering Storm: China's Challenge to US Power in Asia."p.383

<sup>878</sup> Arrighi, "Reading Hobbes in Beijing: Great Power Politics and The Challenge of the Peaceful Ascent."p.166

in certain issue areas and functional areas of order.”<sup>879</sup> Realism depicts only one ‘revisionist’ view of the many *possible* interpretations of Sino-LAC resource trade.

To conclude, both realist and neoliberal theorists explain why China endeavors to establish FTAs with resource-rich LA countries. This section has shown that Beijing today not only accepts rules and norms in the international market set by neoliberals, but also knows how to utilize them to serve its national interests. Of course economic regimes cannot be fully studied in isolation from high politics. An exploration of two branches of realism – offensive realism and post-classical realism helps to decipher America’s perception of China’s resource-seeking activities, perceptions which Beijing cannot afford to overlook. In theoretical terms, a combination of neoliberalism and realism reveals that the theories indeed share certain common ground regarding the institutional means of obtaining resources, but have different predictions regarding the ends if these means become less cost-effective. Unlike realists, neoliberals, who accept many of the basic premises of realism such as self-help for nation-states and international anarchy, strive for, and believe in, a rationale for building cooperative institutions that would decrease the probability of war.<sup>880</sup> This is why a sophisticated liberalism is, in Keohane’s words, “an antidote to fatalism and a source of hope”.<sup>881</sup> In practical terms, China is desperate to seek raw materials in Latin America, but this aspiration now faces two challenges: (1) how to avoid leaving an image of resource exploitation in Latin America, as well as in other regions; and (2) how to convince other big powers, particularly the US, that China’s resource imports are for commercial use, rather than for building the military means to challenge the incumbent hegemon. How to meet these challenges is a big test for the CCP’s diplomatic skills.

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<sup>879</sup> Muir, "Chinese Investment in Latin American Resources: The Good, The Bad, and The Ugly."

<sup>880</sup> Keohane, "Twenty Years of Institutional Liberalism."p.127

<sup>881</sup> Ibid.p.127

#### 6.4 C-LA FTAs and the China-LAC-US strategic triangle

What upsets many in the US is not only Sino-LAC resource trade, but also China's expanding involvement in the region's integration endeavors.<sup>882</sup> The US factor always looms large over the China-LAC relationships and trade policies. The China-LAC-US relationship forms the second "Romantic Triangle" in this chapter. In contrast to the first, here the LAC assumes the role of pivot, and America and China act as two big wings. In this triangle, the two wings are more competitive than harmonious, and they both need to appeal to the pivot for support regarding regional and international affairs.<sup>883</sup> Strategically, since the 1823 Monroe Doctrine, the US has long referred to LAC as its own "backyard", and any other country's open involvement in this region can be regarded as threatening Washington's "strategic reserve".<sup>884</sup> China's recent emergence in LAC through various cross-regional contracts and trade regimes, have seen China become the region's second biggest trading partner. LAC countries cautiously avoid being entrapped into any agendas that Washington may have vis-à-vis

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<sup>882</sup> Peter Hakim, "China and the U.S. in Latin America: Who Wins?," in *Inter-American Dialogue* (Infolatam, July 30, 2013); Gregory Weeks, "Is the US 'losing' Latin America? ," (ALJAZEERA, September 04, 2014).

<sup>883</sup> The LAC was historically more reliant on the US for economic and political support, but the situation is changing as the region is gradually uniting to voice its own interests. On the other hand, China and the LAC are becoming increasingly interdependent, both economically and politically. The emergence of the China-LAC-US strategic triangle has caused fierce debate both academically and politically, see Economic Commission for Latin America and the Caribbean, "Researchers Analyse Changes in Latin American Middle Class and the "China Effect" on Exports," in *Economic Commission for Latin America and the Caribbean Press Release* (2011-04-19); "Cometh the dragon," *The Economist* (Nov 2010); Detlef Nolte, "The Dragon in the Backyard: US Visions of China's Relations Toward Latin America," in *GIGA Focus International Edition*, ed. Stephan Rosiny Hanspeter Mattes (GIGA Focus, May, 2013); Reg Whitaker, "The Beijing consensus: China has astonished the world, but is the dragon as formidable as it looks?," *Inroads: A Journal of Opinion* (2011).

<sup>884</sup> Greg Grandin, "Is the Monroe Doctrine Really Dead?," (TomDispatch, 2008).

Beijing, while at the same time pursuing their own collective interests by manipulating the two big powers' strategic contest.<sup>885</sup>

There are two contradictory research paradigms that can be used to explain China's engagement in Latin America through FTA efforts. One assumes that conflicts between Beijing and Washington are inevitable, namely the realist Thucydides Trap.<sup>886</sup> John Mearsheimer is a representative of this group of thinking. In his book titled *The Tragedy of Great Power Politics*, Mearsheimer argues that great powers not only strive for hegemonic position in their own region, but also seek to deter the rise of potential hegemonic forces in their relative regions.<sup>887</sup> From the US perspective, no power has posed a challenge to US hegemony in the Western Hemisphere.<sup>888</sup> With its backyard's "free of interference" Washington was able to pay more attention to other regions without fear of an attack from the "rear". Nonetheless, the growing presence of the PRC in Latin America, even if only an economic one, has changed this situation. The US suspects that a rising China could try to build beachheads in its own backyard. This viewpoint is echoed by President Obama who stated that "We've got challenges, for example, with China, where we are borrowing billions of dollars. They now hold a trillion dollars' worth of our debt. And they are active ... in regions like Latin America,

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<sup>885</sup> Brookings, "Conceptualizing Future United States-China Relations."p.12

<sup>886</sup> Thucydides ascribed the cause of the Peloponnesian War in 5<sup>th</sup> Century BC to the rise in power of Athens and the threatened feeling this created in Sparta. Similarly, many historians attribute the underlying cause of the World War I to the ascendancy of Germany and the threatened feeling this created in Britain. Now a rising China also causes some strategists to think about a possible war between China and the US. See Graham Allison, "Thucydides's Trap Has Been Sprung in the Pacific," (Financial Times, August, 2012); James R. Holmes, "Beware the "Thucydides Trap" Trap," in *Beware the "Thucydides Trap" Trap* (The Diplomat, June, 2013); Nye, *The Future of Power*.p.153

<sup>887</sup> Mearsheimer, *The Tragedy of Great Power Politics*

<sup>888</sup> Nolte, "The Dragon in the Backyard: US Visions of China's Relations Toward Latin America."p.2

and Asia, and Africa. The conspicuousness of their presence is only matched by our absence, because we've been focused on Iraq".<sup>889</sup>

The counter-position is founded on the assumption that the Thucydides Trap can be avoided through absorbing the PRC within the framework of liberal international institutions created by the West. This thinking is best represented by John Ikenberry.<sup>890</sup> According to him, in the new scenario of globalization, China does not only face the US; rather, it faces a Western order with global reach. "Compared with previous orders, the current one is much more open, expansive, integrated, and rule-based".<sup>891</sup> Thus, the PRC, which many strategists have described as either a "beneficiary" or a "spoiler" of the liberal order, is becoming one of the most loyal followers of the neoliberal recipe. This is evident in the PRC's embrace of transnational capital and goods, as well its enthusiasm for international institutions.<sup>892</sup> The creation of C-LAC FTAs is evidence that Beijing aspires to participate in current Western regimes and orders. As Marc Lanteigne observes, "In the space of a decade, China has transformed itself from an avowed skeptic, in words and in practice, of liberalized and preferential trade into one of its strongest advocates".<sup>893</sup>

As indicated, the strengthening Sino-Latin America relations can be interpreted through the divergent research paradigms. In order to look more systematically at each player's stance within this "Romantic Triangle", the following analysis will explore respective

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<sup>889</sup> Cited in Erikson, "Conflicting US Perceptions of China's Inroads in Latin America."p.119

<sup>890</sup> See G. John Ikenberry, "The Clash of Ideas in World Politics: Transnational Networks, States, and Regime Change," *Foreign Affairs* 90, no. 1 (2011); G. John Ikenberry and Charles A. Kupchan, "Socialization and Hegemonic Power," *International Organization* 44, no. 3 (1990).pp.283-315

<sup>891</sup> Ikenberry, "America's Challenge: The Rise of China and the Future of Liberal International Order."p.2

<sup>892</sup> John Feffer, "China Nurtures 'Good Neighbour Policy' in Asia," (Asia-America Issues 2006).and Ikenberry, "America's Challenge: The Rise of China and the Future of Liberal International Order."p.8

<sup>893</sup> Lanteigne, "Commercial Diplomacy: Preferential Trade Agreements and Soft Power Projection."p.71

players' diplomacy toward each other. In particular, it seeks to decipher how the quickly ascendant China views its relation with the US. This section concludes that the PRC's diplomacy in the Western Sphere cannot be fully explained by either offensive realism or liberal institutionalism. Only by analyzing eclectically, can we better understand Beijing's real attitude toward Washington and more accurately predict the dynamics of the strategic triangle.

#### **6.4.1 The PRC: C-LA FTAs are bridges to engage in Latin America's economic integration**

Regional economic integration, in terms of free trade agreements in particular, is one of the most prominent global trends since the end of 20<sup>th</sup> century. Latin America is no exception. The Common Market of the South (also named Mercosur), founded in 1991, is a subregional free trade bloc between Argentina, Brazil, Paraguay, Uruguay, Venezuela and Bolivia (with the latter being accepted as a formal member in December 2012). The aim of Mercosur was to harmonize regional currencies and tariffs. In 1993, the Andean Free Trade Agreement (AFTA), constituted by four South American countries (Bolivia, Colombia, Ecuador and Venezuela; Peru joined four years later) entered into force. This FTA now contains five associated regional members (Argentina, Brazil, Paraguay, Uruguay and Chile).<sup>894</sup> On 23 May 2004, the two sub-regional customs unions, the Mercosur and the AFTA, were merged to become the Union of South American Nations (USAN), with the ultimate goal of an EU-like community. In the same year, five Central American countries (Guatemala, El Salvador, Honduras, Costa Rica and Nicaragua) signed the Central American Free Trade Agreement (CAFTA). In December 2011, the Community of Latin America and Caribbean States (CELAC) was established, encompassing thirty-three states in the Americas

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<sup>894</sup> Venezuela withdrew from the AFTA in April 2006. For details see Carlos Malamud, "Venezuela's Withdrawal from the Andean Community of Nations and the Consequences for Regional Integration," (Real Instituto Elcano, November, 2006).

(excluding the US and Canada). CELAC aims to push for a deeper regional integration.<sup>895</sup> The 'Pacific Alliance' trade bloc, with Chile, Colombia, Mexico and Peru as the original members and Costa Rica and Panama as observer countries, was formally established in June 2012. The Alliance, seeking to eliminate all import tariffs and to coordinate rules of origins amongst members, is now the 9<sup>th</sup> largest economic entity in the world and its exports accounted for 55% of Latin America's overall exports.<sup>896</sup> These integrating efforts have greatly improved the region's international status and clout as an economic entity.

In fear of being marginalized in the process of Latin American integration, Beijing has tried hard to gain access to this geographically remote area.<sup>897</sup> These attempts, however, have suffered many frustrations at the initial stage. In 2004 for example, Beijing formally proposed embarking on FTA negotiations with the Mercosur bloc. In that year, China was already the third largest economy in GDP terms (equal to US\$1.65 trillion). Its great market potential and rapidly accumulating foreign exchange reserves were supposed to make it an attractive FTA partner to many countries around the world. Nevertheless, Beijing's Mercosur FTA initiative was deferred due to Argentina's objections - according to Mercosur regulations, any trade negotiation any individual member might undertake would have to be conducted under the umbrella of this regional initiative.<sup>898</sup> This frustration taught Beijing two important lessons. First,

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<sup>895</sup> See the CELAC Summit II official website, available at <http://celac.cubaminrex.cu/en>

<sup>896</sup> Andres Oppenheimer, "New 'Pacific Alliance' Bloc May Have a Chance," *The Miami Herald* 2012-11-06.

<sup>897</sup> Lowell Dittmer, "China and the Developing World," in *China, the Developing World, and the New Global Dynamic*, ed. Lowell Dittmer and George T. Yu (USA: Lynne Rienner, 2010).p.8

<sup>898</sup> The Mercosur was not an inclusive trading bloc until it signed an FTA with Israel on 18 December 2007, signifying Israel as the first non-Latin American country to sign an FTA with the most prominent sub-regional community in this region. Mercosur signed a free trade zone frame agreement with the Gulf Cooperation Council (GCC) countries in May 2005, covering more than 90% of two sides' agricultural

wherewithal does not necessarily open every country's door to negotiation. Second, it was too ambitious to initially try to negotiate an FTA with an entire regional trading bloc – it is more sensible to initially establish some bilateral FTAs as bridges to the whole region.

China's frustrations in participating in the LAC had been relived after Chile and Peru became China's FTA partners – together they form LAC's FTA hub and both of them belong to the USAN. With the support of Chile and Peru, the Chinese government set up consultation mechanisms with Mercosur and the Andean Community respectively, and establishing FTAs with these two organizations was put on the agenda.<sup>899</sup> Costa Rica also played an active role in linking the PRC with the LAC through the China-CELAC Forum. After CR became the rotating president of the CELAC in January 2014, several Costa Rican senior officials, including Foreign Minister Enrique Castillo, flew to Beijing to prepare for the upcoming Forum. In July 2014, in his public address in Costa Rica, Xi Jinping specifically expressed his appreciation to Costa Rica “for vigorously pushing forward the overall cooperation between China and Latin America and conducting a great deal of work for the forthcoming China-Latin America and the Caribbean Summit”.<sup>900</sup> In addition, the “Pacific Alliance” (PA) made a crucial decision to consent to specific types of collaboration and common structures in areas related to commerce with China. It is important to note that Beijing's three LAC FTA partners are

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and industrial products. See Carol Wise and Cintia Quiliconi, "China's Surge in Latin American Markets: Policy Challenges and Responses," *Politics & Policy* 35, no. 3 (2007).pp.432-433.

<sup>899</sup> To better achieve these goals, former Premier Wen Jiabao, during his 2012 visit to Latin America, announced cooperation funding with the first tranche of US\$ 5 billion between China and regional nations, and announced that the Chinese government would offer a soft loan worth US\$ 10 billion to create “favourable conditions for expanding the economic and trade cooperation between the two sides”. See Zhang Kunsheng, "On Strengthening China's Relations with Latin America and Caribbean Countries under New Situation," (China Institute of International Studies, 2012-10-30).

<sup>900</sup> "Xi Jinping Meets with President Ottón Solís of Costa Rica," (The Ministry of Foreign Affairs of the People's Republic of China, July 17, 2014).



all members of PA. Against this background, Colombia, another PA member, also expressed strong interest in a bilateral FTA with China.<sup>901</sup>

This progress would have been very hard to achieve without C-LA FTAs, which “provide institutions and frameworks to make progress on these specific issues achievable”.<sup>902</sup> Thanks to experiences through these FTAs, Chinese decision-makers today are increasingly skilled at managing cross-regional economic relationships. As a result, the PRC’s presence grows ever larger. It is now the region’s largest trading partner and creditor of several major Latin American countries (including Chile, Peru and Brazil) and the region’s second largest investor, behind only the US.<sup>903</sup> With the increasing number of China-LAC institutional bridges, its financial wherewithal is becoming more and more visible. For example, Beijing joined the Inter-American Development Bank (IDB) in 2008, the largest source of development financing for regional countries. In March 2013, Beijing announced a \$2 billion contribution to the IDB’s “China Co-financing Fund for Latin America and the Caribbean”.<sup>904</sup> Over the next six years, the People’s Bank of China will contribute to this fund “to support public and private sector projects that promote sustainable economic growth in the region”.<sup>905</sup> At present China is the fifth biggest donor to the IDB-administrated Multilateral Investment Fund; and is represented on the Board of Executive Directors and has a seat

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<sup>901</sup> Evan Ellis, "Beyond 'Win-Win' and the Menacing Dragon: How China is Transforming Latin America," in *The Impact of Globalization on Latin America Task Force* (Center for Hemispheric Policy, University of Miami, 2013). p.16

<sup>902</sup> World Bank, "Global Economic Prospects 2005: Trade Regionalism and Development," (World Bank, 2005).

<sup>903</sup> Global Development and Environment Institute, "China and Latin America: South-South Investment and Sustainable Development," (Global Development and Environment Institute at Tufts University, 2013).

<sup>904</sup> "China to Provide \$2 billion for Latin America and the Caribbean Co-financing Fund," in *News Releases* (Inter-American Development Bank, March, 2013).

<sup>905</sup> Campbell, "China's Expanding and Evolving Engagement with the Caribbean." p.5

on the Board of Governors of the IDB.<sup>906</sup> These positions enable Beijing to influence the IDB's top decision-making body and further influence the twenty six Latin American member countries.<sup>907</sup>

From an economic perspective, China's engagement in LAC's economic integration is a win-win situation, largely underpinned by various cross-regional institutions. There is, according to Xihua, a Chinese state media, neither a zero-sum game of power rivalry, nor a system of spheres of influence or alliances that places one country in another's "orbit" or reduces one region to some big powers' "backyard".<sup>908</sup> Nevertheless, economics are only one part of international relations. While China claims that the Sino-LAC relationship is purely economic, this is only true if such bilateral relationships are considered in isolation. In reality, there is neither a pure bilateral relationship, nor is a purely economic cooperation. Thus pure economic theory, such as neoliberalism and notions of comparative advantage, "always runs up against political philosophies, leading to trade conflicts, protectionism and all-too-often a zero sum view based on the international relations theory of *realpolitik*: what's good for my adversary must be bad for me."<sup>909</sup> As we shall see in following analysis, in the case of the Sino-LA-US strategic triangle, *realpolitik* leanings are evident in each player's diplomacy toward each other. As a result, the closer Sino-LA relationship, even if just an economic one, has broken the triangle's delicate balance.

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<sup>906</sup> Inter-American Development Bank, "China to join the Inter-American Development Bank," (Inter-American Development Bank, Oct 23, 2008).

<sup>907</sup> Wu and De Wei, "From Financial Assets to Financial Statecraft: the case of China and emerging economies of Africa and Latin America."p.785

<sup>908</sup> Deng Yushan, "Commentary: A Milestone in Shaping a Better World Order," (Xinhuanet, July 25, 2014).

<sup>909</sup> Cynthia Watson, "U.S. Responses to China's Growing Interests in Latin America: Dawning Recognition of a Changing Hemisphere," in *Enter the Dragon? China's Presence in Latin America*, ed. Cynthia Arnson; Mark Mohr; Riordan Roett; Jessica Varat (Woodrow Wilson International Center, 2007),p.69

#### 6.4.2 The Sino-LA-US strategic triangle: a zero sum game?

The linchpin of the realist paradigm is an analogy that Hobbes made in *Leviathan* between individuals in the state of nature and sovereigns who are seen to stand similarly facing one another “in the posture of gladiators ... their weapons pointing and their eyes fixed on one another”.<sup>910</sup> This analogy was made in 1651, but mirrors the contemporary relationship between China, Latin America, and the United States, which reflects the realist notions of power and anarchy in international relations, and the realist solution through self-help, balance of power, and alliances.

##### *The PRC: Washington is seeking to contain China's rise*

America still has incomparable economic and military power in the world and paramount clout within contemporary international institutions. As Ellis put it, “Theoretically it (the US) retains the ability to significantly impair the reemergence of the PRC were a consensus to appear in the United States to deny the PRC access to technology and markets and to use alliance structures and institutions to motivate others to follow suit”.<sup>911</sup> Because of this, some within the PRC leadership see the country's sustained growth and development, and thus the stability of the regime, threatened if Washington seeks to contain China's rise, such as blocking global institutions from supporting Chinese interests.”<sup>912</sup> Beijing often views Washington through a realist lens, fearing that the latter may jeopardize its thirty-five years of economic growth. The only way to allay this fear is to either succumb to the US, or to undermine the US's status as the current world leader. There is considerable evidence that policymakers in Beijing have chosen the latter. As Kissinger noted, “the distinguishing feature of a revolutionary

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<sup>910</sup> Hobbes, *Leviathan*. Cited in Charlotte Epstein, "Theorizing Agency in Hobbes's Wake: The Rational Actor, the Self, or the Speaking Subject?," *International Organization* 67, no. 02 (2013).p.291

<sup>911</sup> Evan Ellis, "The Strategic Dimension of Chinese Engagement With Latin America," in *Perry Paper Series* (William J. Perry Center for Hemispheric Defense Studies, 2013).p.146

<sup>912</sup> Ellis, "Chinese Soft Power in Latin America: a case study."

power is not that it feels threatened – such a feeling is inherent in the nature of international relations based on sovereign states – but that nothing can reassure it”.<sup>913</sup>

During most of Jiang Zemin and Hu Jintao’s time in power, the PRC’s US policy largely fell in line with Deng Xiaoping’s diplomatic principle of “hide one’s capabilities and bide one’s time” (韬光养晦, taoguang yanghui). In Latin America in particular, a region remote from Beijing but close to Washington, the PRC used to behave very cautiously to avoid raising US concerns. A watershed event was Xi Jinping’s Latin American tour (Trinidad, Costa Rica and Mexico) in May 2013, two months after he took office (Xi’s predecessor, Hu Jintao, did not travel to the region until the end of his presidency). This week-long tour, coming so early in his presidency, implies “the rising confidence of the Chinese leadership as it pursues its strategic interests with little concern for U.S. reaction”.<sup>914</sup> Fourteen months later, Xi paid his second visit to Latin America as the Chinese President in June 2014, again demonstrating the new Chinese leadership’s eagerness for engaging into the region. There was another episode that some US strategists regard as China’s bold anti-status quo move: Beijing used to reiterate that Latin America is the US’s backyard, but “you don’t hear any of that from Xi’s team, though you don’t find any threatening rhetoric either”.<sup>915</sup>

China has already moved into the US’s traditional sphere of influence. Its policies toward Latin American countries reflect, to some considerable extent, its own

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<sup>913</sup> Henry Kissinger, *A World Restored: Castlereagh, Metternich, and the Problem of Peace* (Boston: Houghton Mifflin, 1957).

<sup>914</sup> See Joshua Goodman, "Biden Circles Xi as U.S. Duels China for Latin America Ties," (South China Morning Post [International Edition], May 29, 2013); Campbell, "China's Expanding and Evolving Engagement with the Caribbean."p.6

<sup>915</sup> See Goodman, "Biden Circles Xi as U.S. Duels China for Latin America Ties."; Ellis, "China Fills the Vacuum Left by the United States in Latin America."

preferences for world order. As for the three C-LAC FTAs, according to Ellis, “the PRC has leveraged hopes of access to Chinese markets by Chile, Peru and Costa Rica to secure bilateral free trade agreements, whose practical effects is to move Latin America away from a U.S.-dominated trade block (the Free Trade Area of the Americas) in which the PRC would have been disadvantaged”.<sup>916</sup> A more recent case is the newly established dialogue mechanism between China and the Community of Latin American and Caribbean States, namely the China-CELAC Forum.<sup>917</sup> Beijing’s outreach to the CELAC helps highlight some regional ambivalence towards Washington. Established in 2011, the CELAC was designed as an alternative to the US-centered regional institution network. Specifically, this newly found organization encompasses every state in the Western Hemisphere except the US and Canada.<sup>918</sup> Partnering with such an organization reveals that Beijing wants to pursue cooperation with LAC countries to the exclusion of the US, and that Beijing no longer wants to refrain from actions “simply because it might be seen as a threat by some parties within the United States”.<sup>919</sup>

Although official US policy has repeatedly met Chinese activism in the Western Hemisphere with a cautiously welcoming tone, some in journalistic and academic

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<sup>916</sup> Ellis, "Chinese Soft Power in Latin America: a case study."

<sup>917</sup> The C-CELAC Forum was established on 18 July 2014 at the C-CELAC Leadership Summit. Xi Jinping made an address in this summit and proposed to set up a “1+3+6” cooperation framework. The “1” refers to draft the C-CELAC Cooperation Plan (2015-2019); the “3” means three “engines” for economic development (trade, investment and financial cooperation; and the “6” refers to six principle cooperation areas (energy and resources, infrastructure construction, agriculture, manufacturing, scientific and technological innovation, and information technologies). Xi also set a ten years’ goal of achieving \$500 billion in trade and \$250 billion in investment stock between China and the LAC. Moreover, he announced that the Chinese government would provide 6,000 government scholarships to support LAC students studying in China and invite 1,000 LAC party leaders to visit China over the next five years. Information available at <http://cpc.people.com.cn/n/2014/0718/c64094-25300560.html>

<sup>918</sup> Shannon Tiezzi, "China's Push Into 'America's Backyard'," (The Diplomat, February 2014).

<sup>919</sup> See Evan Ellis, "China’s Strategy in Latin America Demonstrates Boldness of President Xi " in *World* (The Manzella Report, February 19, 2014); Evan Ellis, "China’s Advance in Latin America Has more Challenges than Xi’s Visit Suggests " in *World* (The Manzella Report, July 18, 2014 ).

circles urge the government to react to the “dragon in the backyard” and suggest the US “keep China out” of the region.<sup>920</sup> Alan W. Dowd, a senior fellow with the Sagamore Institute, even urges Washington to revive the Monroe Doctrine, namely “Monroe Doctrine 2.0” to signal to China that “there is room for only one great power in the Western Hemisphere”.<sup>921</sup> Perhaps the risks of arousing *realpolitik* in Washington, particularly when the government faces increased frustration in the Middle East, is more than Beijing bargained for when it started to build closer ties with LAC states during the past decade.<sup>922</sup>

### *The US: what’s Beijing’s intent in my backyard?*

What will Beijing do with wealth?<sup>923</sup> Realist scholars, such as David Shambaugh, argue that wealth automatically translates into power and that power, *ipso facto*, buys influence. Pursuing wealth and power, Shambaugh further states, “is deeply embedded in Chinese consciousness ... hence, classic realism is embedded in China’s intellectual DNA”.<sup>924</sup> Assuming such a realist perspective, many in Washington view Beijing’s

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<sup>920</sup> See, for example, Nolte, "The Dragon in the Backyard: US Visions of China’s Relations Toward Latin America."

<sup>921</sup> Alan W. Dowd, "Countering China’s Reach in Latin America," in *Crisis in the Americas* (American Security Council Foundation, February 10, 2012).

<sup>922</sup> Watson, "U.S. Responses to China’s Growing Interests in Latin America: Dawning Recognition of a Changing Hemisphere." p.69

<sup>923</sup> Generally speaking, realists share a common idea that China is a revisionist challenging the world’s liberal order, but with some nuances. Alastair Johnston, for example, argues that the PRC used to respect liberal international institutions during most 1980s and 1990s. But it has since shifted towards a “dissatisfied responsible great power” in recent years. Shambaugh, on the other hand, states that China, although formally and practically involved in the liberal order, “is not normatively integrated” into global society. See Alastair Johnston, "Is China a Status Quo Power?," *International Security* 27, no. 4 (2003); Shaun Breslin, "China and the Global Order: Signaling Threat or Friendship?," *International Affairs* 89, no. 3 (2013); David, *China Goes Global: The Partial Power*.p.7

<sup>924</sup> David Shambaugh, "Chinese Thinking About World Order," in *China and the International System: Becoming a World Power*, ed. Xiaoming Huang and Robert G. Putnam (New York: Routledge, 2013),pp.22-23. This argument is different with Xi Jinping’s declaration in March 2014 that “In Chinese

engagement in Latin America as a threat to their superior position in the region. As noted in the previous section, one of the concerns of some US scholars is that the PRC's commercial appetite for natural resources in LAC will ultimately be transformed into military power. Another concern, perhaps equally dangerous in the eyes of the US, is that China is trying to rise through institutionalizing diplomatic and trade relations within the current liberal world order. As Geoff Dyer *et al.* argues, "China is not seeking a rupture with the international economic system (although some foreign companies are fearful of a technology grab). But it is looking to mold more of the rules, institutions and economic relations that are at the core of the global economy. It is trying to forge post-American globalization."<sup>925</sup> In other words, it is possible that Beijing could use the very institutional tools designed by the US, to challenge the US.

There are already a number of cases that illustrate Beijing's growing institutional power. In fact, it was not long ago when LAC countries (particularly those that had diplomatic ties with Taiwan, such as Guatemala and Costa Rica) acted as a major force to resist China's accession to the World Trade Organization (WTO),<sup>926</sup> but today many of them have to count on China's support to join major international institutions. Costa Rica, for example, has for many years been seeking a non-permanent seat at the United Nations Security Council and admission to APEC. Given China's influence in these two institutions, its ambition "was simply unthinkable in the absence of formal links with

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blood, there is no DNA for aggression or hegemon". Then in Li Keqiang's Britain visit in July 2014, he echoed his argument as "Expansion is not in the Chinese DNA". See Frank Ching, "Does Chinese Blood Really Lack the DNA For Aggression?," (South China Morning Post, July, 2014); Minnie Chan, "President Xi Jinping Vows Peace, as PLA Top Brass Talks Tough and With Vietnam Ablaze," (South China Morning Post, March, 2014).

<sup>925</sup> Geoff Dyer, "A Strategy to Straddle the Planet."

<sup>926</sup> Alex Jilberto and Barbara Hogenboom, "Latin America and China Under Global Neoliberalism," *Journal of Developing Societies* 23, no. 4 (2007), p.488

Beijing”.<sup>927</sup> Therefore, decisions to support Costa Rica’s international claims, as well as to build a bilateral FTA, were packed together as a side-payment to the country’s recognition of the Mainland. As stated by a former Costa Rican Representative to the UN, “By defending Taiwan’s fruitless attempts to gain admission to all the international institutions we were making fools of ourselves”.<sup>928</sup> In this context, some US politicians have started to pressure their government to look south and to pay more attention to the LAC region. In a 2008 Hearing themed “The New Challenge: China in the Western Hemisphere”, Dan Burton, an Indiana Republican Senator of the US Congress of Representatives, declared:

I have strongly promoted free trade agreements with our allies in Latin America in an effort to secure long term trade and investment among our countries. If we do not pursue these markets they will be lost to a country that cares little for the well-being of our hemisphere in favor of the communist model of success. The failure to pass the U.S.-Colombia FTA provides an open door for China’s encroaching influence and is a direct threat to our national security.<sup>929</sup>

*Latin America: the balance between China and the US*

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<sup>927</sup> Casas-Zamora, "Notes on Costa Rica's Switch from Taipei to Beijing."p.4

<sup>928</sup> Ibid.p.5

<sup>929</sup> Committee On Foreign Affairs House of Representatives, "The New Challenge: China in the Western Hemisphere," in *Hearing Before the Subcommittee On the Western Hemisphere* (Committee On Foreign Affairs, 2008).p.27



The development of the Sino-Latin America relationship has not occurred in a vacuum, but rather reflects a gradual shift in Latin America's global relations as regional leaders seek to diversify their economic and political partners. Further, it should be noted that the region is not a unitary actor but comprises a mix of US military allies, new-left governments, and anti-American authorities. As we shall see, although Latin American countries have different characteristics and different relations with the US, a common factor now is that their diplomatic relations with China and the US are based on realpolitik.

A shared macroeconomic rationale of the new-left governments in Latin America is to avoid fully adopting "the Washington Consensus style of neoliberalism" and to allow more government intervention, which to some extent overlaps with the so-called Beijing Consensus.<sup>930</sup> Moreover, many of the leftist presidents in the region consider the US as their enemy - they aspire to liberate their countries from the clout of the International Monetary Fund and the World Bank, which have been determining the economic policies in the region ever since the debt crisis of 1982.<sup>931</sup> This is the main reason of why in December 2007, the Bank of the South - the first Latin America-only intergovernmental financial organization - was created by Argentina, Brazil, Paraguay, Uruguay, Ecuador, Bolivia and Venezuela, with an initial capital of US\$ 20 billion.<sup>932</sup>

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<sup>930</sup> See Jilberto, "Neoliberalised South-South Relations: Free Trade Between Chile and China."p.77. See also Fern´andez Jilberto Alex and Hogenboom Barbara, ed. *Latin America Facing China: South-South Relations Beyond the Washington Consensus* (Amsterdam: Berghahn Books, 2010); Yasheng Huang, "Debating China's Economic Growth: The Beijing Consensus or The Washington Consensus," *Academy of Management Perspectives*, no. May (2010); Yasheng Huang, "Rethinking the Beijing Consensus," *Asia Policy* 11, no. January (2011).

<sup>931</sup> See Jilberto, "Neoliberalised South-South Relations: Free Trade Between Chile and China."p.77 and Guillermo I. Martinez, "America Losing Influence Throughout Latin America," (The Sun Sentinel, May 23, 2013); Cynthia J. Arnson and Jose Raul Perales, "The 'New Left' and Democratic Governance in Latin America," in *Latin American Program* (Woodrow Wilson International Center for Scholars, 2007).

<sup>932</sup> See Wikipedia "Bank of the South", available at [http://en.wikipedia.org/wiki/Bank\\_of\\_the\\_South](http://en.wikipedia.org/wiki/Bank_of_the_South)

Beijing's three Latin American FTA partners, Chile, Peru and Costa Rica are all led by new-left governments. A rising China presents as an important factor leading some LAC countries away from the US-oriented Free Trade Area of the Americas.<sup>933</sup> For example, Peru, Chile and Costa Rica were all *demandeurs* that initiated FTA arrangements with China.<sup>934</sup> As noted, Costa Rica even made the signing of an FTA with the Mainland a prerequisite for severing ties with Taiwan. These Latin American states' requests to negotiate a trade deal were underpinned by various motivations, including the PRC's huge market, large foreign exchange reserves, and an "alternative" partner in a world dominated by the US and Western institutions.<sup>935</sup>

Some anti-American nations, such as Venezuela, Ecuador and Bolivia, view establishing rapport with Beijing as signaling their dissatisfaction or displeasure with Washington. The degree to which a "negative" relation with America has propelled them into a "positive" relation with China has increasingly gone beyond symbolism. The late Venezuelan president, Hugo Chávez, for example, painted himself as a leader close to Beijing, with underlying implications for his anti-US stance.<sup>936</sup> In the same vein, US's loyal allies in the region are aware that closer relations with the PRC could damage their strategic ties with the US.<sup>937</sup> For instance, Colombia's special ties with Washington made the government reluctant to procure major military items from

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<sup>933</sup> Ellis, "The Strategic Dimension of Chinese Engagement With Latin America."p.140

<sup>934</sup> Zhang, "China and Latin America's Emerging Economies: Debates, Dynamism, and Dependence."p.21

<sup>935</sup> Evan Ellis, "Latin America's Foreign Policy as the Region Engages China," *Security and Defense Studies Review* 15(2015).p.52

<sup>936</sup> See Gustavo Coronel, "Has Venezuela's Chavez Become a Chinese Puppet in Latin America?," (The Latin American Herald Tribune, October 10, 2011); Teddy Ng, "Chinese Support for Chavez Tempered by Caution," (South China Morning Post, March 07, 2013).

<sup>937</sup> Ellis, "The Strategic Dimension of Chinese Engagement With Latin America."pp.144-145

China.<sup>938</sup> Nevertheless, even the US's cordial allies are quick to negotiate economic deals with China.<sup>939</sup> Both Colombia and Mexico are considering a free trade agreement with the PRC.<sup>940</sup> As former Mexican President Vicente Fox once said, Washington has to bolster ties with Mexico – including recognizing the benefits of migrant labor – or get used to the idea of China setting the international agenda on its own terms.<sup>941</sup> These moves reflect the desire of Latin America leaders to be considered as equal trade partners, rather than US subordinates.<sup>942</sup>

### **6.4.3 The Sino-Latin America-US triangle: how to avoid the Thucydides' trap?**

As noted, China, the US and some Latin American countries all pursue *realpolitik* to maximize gains in the strategic triangle. Even so, it is still overly pessimistic to presume that a Sino-US Thucydides' trap is unavoidable. The remainder of this section argues that offensive realism misinterprets the Chinese challenges from three perspectives: (1) there has been a tendency to exaggerate both the extent of Beijing's influence in LAC and the fears to which this gives rise, particularly among Washington commentators<sup>943</sup>; (2) even if China is powerful enough to overtake the US's world leadership, it will not challenge the current liberal international order; and (3) being anti-America cannot be automatically be presumed to also be pro-China (the anti-US agenda of some LAC

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<sup>938</sup> Ibid.p.144-145

<sup>939</sup> Martinez, "America Losing Influence Throughout Latin America."

<sup>940</sup> Norma Gutierrez, "China Proposes FTA with Mexico," in *Foreign trade and international finance* (Library of Congress, Jan 27, 2012).

<sup>941</sup> Howard Fischer, "Fox Says US-Mexico Ties Deter China's Influence," (Capitol Media Services, September 14, 2012 ).

<sup>942</sup> Robert Valencia, "U.S. and Latin America: Economic Cooperation Without Militarization?," (World Policy, May 23, 2013).

<sup>943</sup> See Rhys Jenkins, "China's Global Expansion and Latin America," *Journal of Latin American Studies* 42, no. 04 (2010).p.809 A Pew survey conducted in US (305 elite experts and 1004 members of the public) showed that most surveyed people perceive China as a competitor to America (66% of the elites and 80% of the public).See also Brookings, "Conceptualizing Future United States-China Relations."p.7

countries emerged long before China's economic rise), nor is China the only alternative partner Latin America has been pursuing.

China's role in Latin America is, above all, based on trade, despite Washington's concerns about China's potential military influence in its backyard.<sup>944</sup> Moreover, the single largest trading partner and investor in Latin America is the US, not China. Compared to the US's military predominance in Western Hemisphere through numerous alliances and military bases, Chinese military projection in LAC is negligible.<sup>945</sup> Nevertheless, China hawks in Washington never seem to stop arguing that the US is losing its military edge over the PRC.<sup>946</sup> This view stems mainly from offensive realist thinking, stressing that (1) each player will try to maximize its own interests, and whenever necessary, at the expense of the other two, China and the LACs; and (2) *perceived* challenges to hegemonic power are no less dangerous than *real* ones.<sup>947</sup> Guided by this logic, US policymakers always prioritize American interests and react as if a perceived challenge really exists, even though neither the C-LA FTAs nor China's commercial assets can constitute substantial threats to the US. Although policymakers in Beijing generally choose to keep silent to prevent aggravating the already fragile Sino-US relationship, academic accounts often refute unjustifiable

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<sup>944</sup> Rodrigo Maciel, "The Economic Relationship between China and Brazil," in *Enter the Dragon? China's Presence in Latin America*, ed. Cynthia Arnson; Mark Mohr; Riordan Roett; Jessica Varat (Woodrow Wilson International Center, 2007).p.34

<sup>945</sup> Ellis, *China in Latin America: The Whats & Wherefores*.

<sup>946</sup> Yochi Dreazen and Dan Lamothe, "China Threat Cited as Pentagon Budget Takes Beating," in *Inside the National Maze* (The Complex, March 5, 2014).

<sup>947</sup> Gonzalo Sebastián Paz, "China, United States and Hegemonic Challenge in Latin America: An Overview and Some Lessons from Previous Instances of Hegemonic Challenge in the Region," *The China Quarterly* 209(2012).p.20

exaggerations of China's military projection in the region.<sup>948</sup> As Ding Gang wrote in the *Global Times*:

In Asia, Washington's marching west across the Pacific has apparently exerted pressure on China. Through intervening in the South China Sea issue and consolidating its military alliance with Japan and the Philippines, the US is aggressively beefing up its dominance in the Asia-Pacific region. Across the Pacific, the two powers' moves toward each other's neighboring region are obviously different. China is neither seeking dominance nor finger-pointing at Latin America, but is engaging in discussions over cooperation as an equal participant ... Beijing certainly has its calculations of interests in developing its relations with Latin American countries. But it's different from brewing military alliances against a target country.<sup>949</sup>

Offensive realists also hold an unwarranted viewpoint that China seeks to topple the world order. As Robert Kagan avers, "The Chinese leadership views the world in much the same way Kaiser Wilhelm II did a century ago ... Chinese leaders chafe at the constraints on them and worry that they must change the rules of the international system before the international system changes them".<sup>950</sup> In essence, however, as one of the major original designers and a long-haul guardian of the current liberal world leader, the US has much more leverage at its disposal than China. Regarding FTAs, the North

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<sup>948</sup> A main strategy that Chinese officials adopt is to try to dilute the political and strategic ramifications created by China's increasing engagement in the region. To quote Qiu Xiaoqi, China's ambassador in Brasilia, "We're not seeking special influence. We have reiterated [to the United States] that our relations with Latin America aren't a threat to anyone". See The Economist, "The dragon in the backyard: Latin America is tilting towards China, Iran and the global "south"—and away from the United States: ," in *Latin American geopolitics* (The Economist, August, 2009).

<sup>949</sup> Ding Gang, "China 'Go East' Move Stress [sic] Equality," (Global Times, July 17, 2014). Moreover, there are already some domestic voices claiming that Beijing should make use of the Latin America card to counter-balance the US' "Asia pivot" strategy. See Deng Yuwen and Jonathan Sullivan, "China's Ties with Latin America Counter the US Rebalance Policy," (South China Morning Post [International Edition], August 5, 2014).

<sup>950</sup> Robert Kagan, "What China Knows That We Don't Know," (Weekly Standard, January 20, 1997).

American Free Trade Agreement (NAFTA) comprising the US, Canada and Mexico, became effective in 1994, and all tariffs and quantitative restrictions were eliminated, on schedule, in 2008. When President George H. W. Bush's plan for a "Free Trade Zone between Tierra del Fuego and Alaska" failed, priority was given to opening regional trade through bilateral FTAs in a US-led hemisphere, with Latin America seen as a reliable and quiet partner.<sup>951</sup> In August 2002, Congress granted the Trade Promotion Authority (TPA, or "fast track" authorization) to President George W. Bush, a vital tool in the creation of additional FTAs within Latin America.<sup>952</sup> In August 2004, an FTA between the US, the Dominican Republic and five Central American nations (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) was signed.<sup>953</sup> Amongst the twenty US bilateral FTAs that have been fully implemented, eleven of them are with Latin America and Caribbean nations, including Chile (2004), Colombia (2012), Costa Rica (2009), Dominican Republic (2007), El Salvador (2006), Guatemala (2006), Honduras (2006), Mexico (1994), Nicaragua (2006), Panama (2012) and Peru (2009).<sup>954</sup>

Thus the United States has surpassed China in terms of establishing FTAs with LAC countries, and elsewhere in the world. Besides, these FTAs are "small" international

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<sup>951</sup> Cynthia A. Watson, "The Obama Administration, Latin America, and the Middle Kingdom," in *China Engages Latin America: Tracing the Trajectory*, ed. Adrian H Hearn and José Luis León-Manríquez (US: Lynne Rienner Publishers, 2011).p.105

<sup>952</sup> See Laura L. Wright, "Trade Promotion Authority: Fast Track for the Twenty-First Century," *William & Mary Bill of Rights Journal* 12, no. 3 (2004).

<sup>953</sup> When former President George W. Bush pushed the US-Central America FTA through Congress, he emphasized that this trade deal would function in both economic and political dimensions - both targeted the PRC. Economically, it will attract investors away from China. Politically, it may prevent Central America from "the intervention of foreign socialist governments". In this sense, the US-Central America FTA and the revived variant of the FTAA would help Washington to "contain China's influence in the Western Hemisphere". See Adrian Hearn, "China and Latin America: Economy and Society," *Latin American Policy* 4, no. 1 (2013).pp.27-28

<sup>954</sup> See the official website of the Office of the United States Trade Representative, available at <http://www.ustr.gov/trade-agreements/free-trade-agreements>

institutions, and the US enjoys a predominant position in the “big” ones - the International Monetary Fund, the World Bank, and the WTO. Against this background, if the PRC wants to become the world’s leader, it has to take over the US’s dominant position in these international institutions. But obviously this is a ‘mission impossible’ for China, at least in the short-term. Mearsheimer argues that “the United States has a profound interest in seeing Chinese economic growth slow considerably in the years ahead”.<sup>955</sup> He also suggests that Washington should reverse course and do what it can to slow the rise of China before it’s too late.<sup>956</sup> But drawing on the above analysis, I argue that it is still too early for the US to worry about a rising China. Realists have a deep-rooted belief that international institutions are essentially arenas for acting out power relations.<sup>957</sup> Apparently, in most of these arenas, China is by far still a new-comer and rule-learner, not a realistic challenger to US leadership. As Joseph Nye says:

By 1900, Germany had already passed Britain in industrial strength. In other words, the United States has more time to deal with China’s growing power than Britain had to deal with Germany’, and the United States does not have to be as fearful. If it were to be too fearful, both sides might overreact. The Chinese, thinking America was in decline, would push too hard, and Americans, worrying about the rise of China, would go too far.<sup>958</sup>

To be sure, if the PRC’s growing momentum continues, it is certainly possible for the ‘Middle Kingdom’ to overtake America in economic size and even political influence. But it would be misleading to equate “US leadership” with “liberal internationalism”. It

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<sup>955</sup> Mearsheimer, *The Tragedy of Great Power Politics* p.402

<sup>956</sup> *Ibid.* p.402

<sup>957</sup> *Ibid.* p.346

<sup>958</sup> Joseph S. Nye, "A Smarter Way to Deal with China The Right U.S. Strategy Includes 'Power With,' Not Just 'Power Over.'," (Los Angeles Times, June 12, 2012).

is understandable that Washington always keeps an eye on Beijing's moves, since China is the only potential candidate to offer an alternative world leadership.<sup>959</sup> Nevertheless, as Ikenberry suggests, "as wealth and power become less concentrated in America's hands ... the deeper foundation of liberal international order will survive and thrive".<sup>960</sup> In other words, China may 'come on as a sub' after the US's decline, as the world lacks an alternative global governing rationale to liberal internationalism and institutionalism. Moreover, given the fact that the PRC is already deeply enmeshed in the international economic society, it would be a grave mistake for China to turn its back on the liberal principles that have served it so well since its open-door policy. If a power transition from China to the US really occurs, Beijing has strong motives to go on utilizing the rules and institutions of the liberal international order to maintain and expand its interests. But before "utilizing" the order, a more imminent challenge for the PRC is to be accepted by the prevailing order. To quote Shambaugh:

China does not like to be seen as an "outlier" and repeated case studies show that China will carefully monitor other major nation's positions on sensitive issues and cling to a dissonant position only as long as others do (e.g. Russia), but will quickly "swing" behind majority opinion when it senses it is being viewed as an outlier or spoiler.<sup>961</sup>

Taking this further, the notions of the Thucydides trap, 'strategic triangle', and 'backyard' have a certain resonance in both Beijing and Washington, but they are more problematic when viewed from the perspective of Latin America. States in the region, arguably, want to pursue their own interests by straddling between the two big powers' strategic contest, while at the same time, they need to cautiously avoid being entrapped

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<sup>959</sup> Ikenberry, "America's Challenge: The Rise of China and the Future of Liberal International Order." p.5

<sup>960</sup> Ibid.p.2

<sup>961</sup> Shambaugh, "Chinese Thinking About World Order." p.23



into any agendas that Washington may have vis-à-vis Beijing.<sup>962</sup> Moreover, the region prefers to see itself as strengthening relationships with multiple extra-regional actors as it projects more extensively into the global arena, rather than being “trapped as one led in a triangle”.<sup>963</sup> The PRC, in many ways, is but one of many partners that Latin America seeks in order to undermine US hegemony. Nor should regional countries’ anti-America sentiment be automatically identified with being pro-China – Latin American countries’ anti-US agenda existed long before China’s economic rise and regional emergence. Unfortunately, the PRC’s arrival in the region coincides with the relative decline of US economic and political eminence in the post-Cold War era.<sup>964</sup> Thus many in the US often portray other countries like China as scapegoats for its own problems.<sup>965</sup> But rather than blaming China’s engagement in Latin America for undermining its regional predominance, it is time for Washington to embark on an introspective examination of its “backyard” policies since the Monroe Doctrine. There are already some scholars that urge the US government to abandon its conservative thinking. Watson, for example, says that “Washington must make a more concerted effort to act as a genuine partner with the region, rather than relegating it to the position of secondary or tertiary thought that assumes absolute U.S. leadership”.<sup>966</sup>

## 6.5 Conclusion

The intensifying relations between China and LAC countries are mostly explained by the emergence of growing economic complementarities and interdependence. A closer look at the CCFTA and CPFTA reveal that natural resources pervade all aspects of

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<sup>962</sup> Brookings, "Conceptualizing Future United States-China Relations."p.12

<sup>963</sup> Ellis, "The United States, Latin America and China: A “Triangular Relationship”?.”p.43

<sup>964</sup> Economist, "The dragon in the backyard: Latin America is tilting towards China, Iran and the global “south”—and away from the United States: ."

<sup>965</sup> Ellis, "China Fills the Vacuum Left by the United States in Latin America."

<sup>966</sup> Watson, "U.S. Responses to China’s Growing Interests in Latin America: Dawning Recognition of a Changing Hemisphere."p.74

China's trade with its Latin American FTA partners. Minerals and energy imports account for the bulk of bilateral trade, credit lines for infrastructure are backed by the natural resources, and the largest share of Chinese investment is directed towards the natural resource sector. This chapter shows that Beijing today not only accepts the rules and norms of the international market set by neoliberals, but also knows how to utilize them to serve its own national interests. Yet economic regimes cannot be fully studied in isolation from high politics. An exploration of two branches of realism – offensive realism and post-classical realism - helps to decipher America's perception of China's resource-seeking activities, a perception which Beijing cannot afford to overlook.

After some early mistakes, China's FTA strategy began by engaging in Latin America's regional economic integration. In less than a decade China has managed to carve out a prominent position in the region's economy as its third largest trading partner, an important provider of investment, and an emerging operator in the regions' construction projects. However, there has been a tendency to exaggerate both the extent of China's influence in LAC and the fears to which this gives rise, particularly among realists whose thinking dominates in Washington. For such US realists, China's engagement in LAC, whether peaceful or not, *must* appear threatening.<sup>967</sup>

China's strategy to isolate Taiwan in Latin America changed in 2008 following the diplomatic truce. With respect to the pre-truce era, both the Mainland and Taiwan's LAC policies seemed to fit the neo-liberal framework, when they used checkbook diplomacy to buy recognition and influence by manipulating cross-issue levers. During this stage the two parties also sowed the seeds of FTAs by signing free trade treaties, and *as many as possible*. During the post-truce era, Beijing softened its stance toward

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<sup>967</sup>Barry Buzan, "The Inaugural Kenneth N. Waltz Annual Lecture A World Order Without Superpowers: Deentred Globalism," *International Relations* 25, no. 3 (2011),p.8

Taipei, in part due to its advantages (a growing economic and military profile in absolute terms, and growing confidences over sovereignty affairs), and partly because of its disadvantages (a relatively weak position compared with the US, which loomed large in the Cross-Straight relationship). During this stage Beijing's FTA strategy in LAC changed from *as many as possible* to *the best possible*, and was beginning to reap fruit. The two stages should not be considered in isolation, since each of them capture China's gradually shifting diplomatic ideas in accordance with its growing material power.

In theoretical terms, an eclectic analysis of neo-liberalism and realism provide sound interpretations and predictions for China's policy actions in LAC. China's endeavors to secure resource supply and to engage in Latin America by weaving a cross-regional FTA network demonstrate that Beijing is inclined to embrace liberal norms and rules when making foreign policy, particularly in the economic realm. This inclination however varies in different situations. When it comes to high politics such as the Taiwan issue and Sino-US competition, the zero-sum character of pure realism is still hard to transcend. Therefore, the roles C-LA FTAs play in China's international relations are best understood through a synthesis of the two paradigms.

## Chapter 7 Conclusion

This thesis grows out of the pressing need to understand China's bilateral FTA diplomacy in its totality. I adopt international regime theories to wrestle with how Beijing pursues diplomatic objectives by institutionalizing economic relationships. Specifically, I employ an eclectic approach that encompasses three main research paradigms and domestic and international dimensions to test China's FTA diplomacy. This chapter is divided into two parts, and examines all the FTAs through the theoretical and empirical lenses discussed.

### *Theoretical implications*

China's FTAs are largely shaped by factors that constitute key facets of realist analysis, including anarchy, big power rivalry/balancing, military threat/coercion, etc. From this lens, the PRC's FTA diplomacy has three main features. First, China's FTA is security-embedded. For instance, the CAFTA and the CPFTA are convenient steppingstones toward cooperation with strong strategic implications, which respectively resulted in the initiative of the Maritime Silk Road and the New Silk Road. Second, FTAs signed with developed countries are 'politics-attached', which runs counter to Beijing's self-defined "no strings attached" approach to commercial relations. Previous chapters have shown how China wields the FTA instrument to achieve its political goals such as legitimizing its territorial claims in the South China Sea and isolating Taiwan in Latin America. Third, all investigated cases show that China's FTA is big power-oriented. For example, the Sino-Japan positional rivalry looms large in the CAFTA; the Sino-India competition has a great impact on the CPFTA; the Sino-US contest has greatly affected the C-LA FTAs; and the Sino-Australia negotiation has been considerably shaped the CNZFTA. Taking the three features together, China's FTA diplomacy fits comfortably into the traditional realist research paradigm, which captures very well Beijing's growing assertiveness in international politics, particularly its increasingly uneasy great power relations.

The realist perspective may invite an unwarranted assumption that China is an opportunist or a revisionist seeking to change power configurations in the world. However, it has been of little use in making sense of Beijing' leaning toward liberal institutionalism to broaden and strengthen relationships with FTA partners via reducing transaction costs, enhancing transparency, and diminishing uncertainties. The CNZFTA

is testimony to Beijing's liberal inclination. New Zealand is an ideal training ground for the practice of agricultural liberalization by "bringing-in" while also offering excellent preparation for "going-out". The FTA's "partial" nature thus allows the PRC to stand apart from the neo-liberal world whilst learning and borrowing from it. Even in the strategic arena, such as the South China Sea disputes, Taiwan's sovereignty bid, and the (Maritime) Silk Road building, there is scattered evidence that Beijing tries to use economic leverage to legitimize its claims, rather than conservative secrete diplomacy, checkbook diplomacy, and even military means. These are encouraging signs that reflect, to some degree, China's departure from the purely realist mentality. Liberal institutionalists, who advocate taming China through "institutional integration", may feel vindicated and comforted by these signs. Although it remains unclear whether and to what extent China can be "tamed", we should give China's strategy more time and room, or in David Shambaugh's words, we "should not throw the baby out with the bathwater".<sup>968</sup> He further stated that:

There literally is no alternative but to continue to engage China and integrate it into the institutions, rules, laws, and norms of the international community. It is the best hope for conditioning China's "peaceful rise". ... Institutional integration does have a strong binding and socializing effect on all member states, including China. Beijing has willingly joined this club and benefited enormously from it. And, by and large, it has observed and upheld the rules of the system –although often selectively, partially, and minimally. As President Richard Nixon observed almost a half-century ago, it remains far better to have China in the international system than outside it. Even partial compliance is better than noncompliance.<sup>969</sup>

Throughout all cases studied, this thesis finds that concepts such as norms and identities also shape both the means and ends of China's FTA diplomacy, which rationalists rarely take into account. For example, uncontested norms of economic security are rooted in a contradictory identity of China as a socialist regime with emerging capitalism. This explains why Beijing's endeavors to liberalize the domestic dairy market through the CNZFTA ended with protectionism, and why efforts to foster a stronger Sino-Pak economic relationship were undermined by Chinese companies' reluctance to "follow flags". The identity factor also shows up in the Sino-Japan

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<sup>968</sup> David, *China Goes Global: The Partial Power*.p.314

<sup>969</sup> *Ibid.*,pp.314-315

habitual enmity, which captures the roots of why the two cannot cooperate in Asian FTA building. Previous chapters also show the significance of identity factors such as the Sino-Pak “all-weather friendship” embedded in the CPFTA and the “ASEAN Way” embedded in the CAFTA. In this sense, realist and liberal styles of analysis may leave deeper aspects unexamined, but a norms-based explanation plays an important complementary role in drawing a more complete picture of China’s FTA diplomacy.

Nevertheless, identities cannot exist without material basis. Nor are they fixed and unchangeable. Rather, frequent interactions in or through economic institutions can alter the perceptions players hold of what each can do separately, and what both can accomplish jointly. To quote Katzenstein, “Distinct identities ... can become blurred, leading to subsequent redefinitions of interests as actors discuss joint possibilities that may reflect a redefinition of identities objectives, and strategies.”<sup>970</sup> Previous case studies confirm this argument. Apt examples include China’s changed strategic calculus about gains from cooperation with Japan when the US-led TPP looms large, and the increasingly evident norm-divergence between China and Pakistan since the inception of the CPFTA. In this context, it would be superficial or misleading to confine academic investigations to a single research paradigm. Instead, eclecticism serves as a better explanatory framework to analyze Beijing’s FTA diplomacy.

### *Empirical implications*

This thesis finds that China’s FTA diplomacy is partially-successful. On the one hand, its mega-economy, huge foreign exchange reserves, large domestic market, and the CCP government’s ability to allocate resources, have allowed Beijing to achieve some of its desired outcomes. To illustrate, the CAFTA provides Beijing with a powerful precedent and bargaining chip in subsequent regional FTA negotiations, and prevents ASEAN from speaking in one voice over South China Sea affairs; the CNZFTA helps the PRC to promote domestic dairy reforms, whilst winning over the New Zealand government’s support for its entry into the TPP; the CLAFTA helps China to isolate Taiwan, to secure resource supply, and to engage in Latin America’s regional integration; and the CPFTA strengthens the Sino-Pak strategic cooperation, which in turn enables Beijing to neutralize America and India’s power projection in South Asia.

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<sup>970</sup> Katzenstein Peter, "Introduction: Asian Regionalism in Comparative Perspective," in *Network Power: Japan and Asia*, ed. Peter Katzenstein and Takashi Shiraiishi (Ithaca and London: Cornell University Press, 1996).p.5

Yet when examining across different cases, I find that there are several evident contradictions in China's FTA diplomacy worth highlighting. In the CAFTA case, political considerations such as legitimizing China's CSC claims have been important with respect to trade concessions to ASEAN.. A rationale behind this is that growing economic interdependence will soften the effects of frictions with other SCS claimants. Nevertheless, this move contradicts Beijing's other political aim of allaying ASEAN's concerns about its rapid rise through the CAFTA. As a result, whether Southeast Asian countries are charmed or alarmed by China's FTA diplomacy, their demands for big-power balancing continue to grow – a result Beijing has sought to avoid.

At the same time, the Sino-ASEAN FTA was also premised on China's positional competition with Japan, as can be seen by Beijing's eagerness to use the CAFTA in leveraging its position in regional FTAs. A key reason for China's particular sensitivity to Japan is its contradictory psychology. Surpassing Japan to be the world's second largest economy after the "Century of Humiliation", and the sense of inferiority to Japan after the First Sino-Japanese War of 1894-85, led many Chinese to seek parity with Japan. The dilemma here is that as the US-led TPP looms large, Beijing has no choice but to launch FTA negotiations with Tokyo to lock it into the Asian FTA accords.

In Chapter 4, I find that it was the onset of the 2008 Sanlu Melamine Crisis that stimulated China to ink an FTA with New Zealand. This trade deal was initially regarded as reflecting Beijing's willingness to open up its domestic dairy market to meet New Zealand's exporting demands. The Chinese government also tried to use the CNZFTA to showcase that its rise would be governed by international norms. But when it realized that the trade deal introduced great pressures into its home market, "economic security" became the paramount concern. Domestic political considerations regarding the cultivation of competitive industries and the protection of domestic vested groups triumphed over cultivating international perceptions of China as an international norm taker. Beijing instead fell back on the increasingly lame argument that China was still an undeveloped state and cannot to be expected to do too much regarding openness. Moreover, even as China becomes more integrated into the global market, the essentially protective approach to the CNZFTA only invites more suspicions about its "market economy with Chinese characters".

In Chapter 5, the China-Pakistan FTA represents another example of how China's FTA diplomacy is constrained by domestic political economies. Clearly, the CPFTA was set out to bolster Sino-Pak diplomatic relations in a broader sense. However, although some nascent efforts have been made to "materialize" the trade deal, China's emerging state capitalism has greatly impeded such efforts to move forward. Faced with this challenge, Beijing took direct action to upgrade the FTA by initiating the "New Silk Road" plan, but whether and to what extent can it help China achieve its desired outcomes remains to be seen. Besides, counterbalancing India plays a primary role in the formation of the CPFTA. A challenge facing China is that in the broader international platform, what is more imperative is to cooperate, rather than compete with India. In this sense, how to maintain a subtle balance between India and Pakistan is becoming a new test of Chinese leaders' political wisdom.

The PRC's political considerations are also paramount in the Sino-LAC FTAs, as evidenced by the Chinese strategy to use the FTA toward making others recognize its market economic status, or as a reward to sever diplomatic ties with Taiwan. But these "strings" seem a poor fit with Beijing's "no political strings" promise to differentiate itself from other big powers in building "South-South" relations. In this context, some Latin American scholars have expressed wariness of the PRC's claims to be engaging in the region on equal, developing country terms. To quote Fernando Henrique Cardoso, former president of Brazil, "China for many years cleverly tried to frame the relationship as 'south-south' ... But China's not the south. China is China, with its own set of interests".<sup>971</sup>

The C-LAC FTAs also show that Beijing treats cross-regional FTA partners such as LAC states and Asian countries differently. In Latin America, China behaves very cautiously in order not to raise US concern, and insists that it supports "Americans' America". But in Asia, as exemplified in the CAFTA case, Beijing vigorously seeks to "de-Americanize" to ensure an "Asian only" regional economic community. These are clear signals that China wants to become a paramount power at least in its own region. In addition, across all the cases studied, this thesis finds that the US-led TPP is a crucial explanatory variable in understanding China's FTA diplomacy. The PRC's endeavors to transform its economic clout into political influences through institutionalizing

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<sup>971</sup> Brian Winter and Brian Ellsworth, "Brazil and China: A Young Marriage on the Rocks," (Reuters, February, 2011).



economic relations sometimes succeeds and sometimes fails, but in either case the motivation has generally been found to be Beijing's concerns about Washington and its allies. In this sense, this thesis provides an interesting new window into how China presently views its own relations with the US, as well as the way in which Beijing would like to position itself in the larger context of the international community.

To conclude, we have seen through the case studies how China's endeavors to bind the FTA strategy with non-economic issues has met with varying degrees of success. Looking to the future, then, Beijing will continue to pursue FTA diplomacy rife with contradictions, reflecting its diplomatic mentality which remains preoccupied with its own interests and ascendancy. As long as this mentality remains, this thesis, from an eclectic perspective of international regime theories, sees no reason to believe that China can reach optimum FTA diplomacy.

## Appendix

### Appendix 3.1: Agricultural products flows from ASEAN to China and the world

(US\$ billion)

	Flows	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
China	Import	2.03	2.26	1.98	2.32	2.83	3.68	4.00	4.27	5.37	6.80	7.34	7.72
	Export	3.57	5.03	6.24	7.25	10.39	12.83	15.45	13.77	18.96	28.34	26.37	26.42
Deficit		1.54	2.77	4.26	4.93	7.56	9.15	11.45	9.5	13.59	21.54	19.03	18.7
World	Import	25.02	27.07	32.40	35.80	40.056	49.02	64.54	56.14	73.28	94.97	96.22	96.38
	Export	41.95	48.94	56.24	61.87	74.55	93.06	121.40	100.04	131.90	175.30	162.80	161.40
Deficit		16.93	21.87	23.84	26.07	34.494	44.04	56.86	43.9	58.62	80.33	66.58	65.02

Source: WTO database and author's calculation, available at

<http://stat.wto.org/StatisticalProgram/WSDDBViewData.aspx?Language>

### Appendix 3.2: ASEAN's Trade Balance with Selected Trade Partners (US\$ million)

Indicator	Unit/Scale	2000	2005	2009	2010	2011	2012
China	Value	-3,958	-8,882	-15,021	-6,021	-24,953	-35,701
	Exports share	-27.9%	-17.0%	-18.4%	-5.3%	-19.6%	-25.2%
USA	Value	25,322	31,974	15,376	14,260	13,795	16,004
	Exports share	34.3%	34.4%	18.7%	14.2%	13.0%	14.9%
EU-28	Value	24,177	21,370	13,997	21,572	18,848	7,184.5
	Exports share	38.1%	26.4%	15.1%	18.7%	14.9%	5.8%
Republic of Korea	Value	-727	756	-6,187	-8,666	-15,706	-20,970
	Exports share	-5.0%	3.1%	-18.0%	-19.3%	-28.9%	-38.1%
Japan	Value	-15,071	-8,322	-4,746	-831	17,561	-9,870
	Exports share	-29.8%	-11.4%	-6.1%	-0.8%	12.0%	-7.8%
India	Value	3,237	7,096	13,925	16,598	16,831	16,295
	Exports share	50.2%	47.2%	52.5%	46.1%	39.6%	37.0%
Australia	Value	198	8,048	14,235	15,052	15,240	21,949
	Exports share	2.2%	41.0%	49.0%	42.8%	40.7%	48%
New Zealand	Value	179	1,178	897	1,156	909	1,899
	Exports share	14.7%	44.7%	28.6%	27.2%	19.9%	34.1%

Source: WTO database and author's calculation, available at

<http://stat.wto.org/StatisticalProgram/WSDDBViewData.aspx?Language=>

### Appendix 3.3: China and ASEAN Countries' Share of the International Service Market

Reporter	2005	2006	2007	2008	2009	2010	2011	2012	2013
ASEAN	118150	137070	175160	196510	169230	204660	237960	260970	279450
Brunei Darussalam	616	745	813	867	915	1054	1209		
Cambodia	1064	1244	1510	1613	1492	1596	2140	2456	2700
Indonesia	12571	11093	12074	14731	12618	16211	20118	22523	21733
Lao People's Dem. Rep.	184	203	255	359	374	489	526	553	
Malaysia	19463	21572	29375	30283	28727	31713	35760	37532	39834
Myanmar	235	254	282	274	279	331	580		
Philippines	4525	6444	9766	9717	13951	17595	18728	20308	21671
Singapore	55520	66078	84824	99002	75318	94232	109036	117044	122137
Thailand	19740	24382	29848	32709	29893	34086	41280	49306	58584
Viet Nam	4232	5060	6415	6956	5666	7355	8581	9510	10380
China	73909	91427	121654	146444	128526	161210	175670	190440	204718
World	2516190	2845410	3421350	3847060	3488680	3827680	4295420	4397000	4644380
	Share of the world								
Q	4.70%	4.82%	5.12%	5.11%	4.85%	5.35%	5.54%	5.94%	6.02%
Brunei Darussalam	0.02%	0.03%	0.02%	0.02%	0.03%	0.03%	0.03%	0.00%	0.00%
Cambodia	0.04%	0.04%	0.04%	0.04%	0.04%	0.04%	0.05%	0.06%	0.06%
Indonesia	0.50%	0.39%	0.35%	0.38%	0.36%	0.42%	0.47%	0.51%	0.47%
Lao People's Dem. Rep.	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.00%
Malaysia	0.77%	0.76%	0.86%	0.79%	0.82%	0.83%	0.83%	0.85%	0.86%
Myanmar	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.01%	0.00%	0.00%
Philippines	0.18%	0.23%	0.29%	0.25%	0.40%	0.46%	0.44%	0.46%	0.47%
Singapore	2.21%	2.32%	2.48%	2.57%	2.16%	2.46%	2.54%	2.66%	2.63%
Thailand	0.78%	0.86%	0.87%	0.85%	0.86%	0.89%	0.96%	1.12%	1.26%
Viet Nam	0.17%	0.18%	0.19%	0.18%	0.16%	0.19%	0.20%	0.22%	0.22%
China	2.94%	3.21%	3.56%	3.81%	3.68%	4.21%	4.09%	4.33%	4.41%

Source: Source: WTO database and author's calculation, available at

<http://stat.wto.org/StatisticalProgram/WSDDBViewData.aspx?Language=E>

**Appendix 3.4: Ten Major Export Commodities of ASEAN to China by 2-digit HS Code, 2007, 2012**

(US\$ million)

2007				2012			
HS	Commodities	Value	Share	HS	Commodities	Value	Share
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles	22,107.4	28.4	85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles	35,920.2	25.3
84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	12,584.9	16.1	27	Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes	21,601.7	15.2
27	Mineral fuels, mineral oils & products of their distillation; bitumen substances; mineral wax	8,226.5	10.6	84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof Rubber and articles thereof	16,185.3	11.4
40	Rubber and articles thereof	5,221.6	6.7	40	Rubber and articles thereof	12,402.8	8.7
15	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes	4,447.6	5.7	39	Plastics and articles thereof	8,337.7	5.9
29	Organic chemicals	3,618.4	4.6	29	Organic chemicals	7,391.0	5.2
39	Plastics and articles thereof	3,549.0	4.6	15	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes	7,286.2	5.1
74	Copper and articles thereof	1,420.7	1.8	26	Ores, slag and ash	3,731.6	2.6
26	Ores, slag and ash	1,203.3	1.5	90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof	2,766.5	1.9

90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments/ apparatus; parts & accessories	1,013.2	1.3		44	Wood and articles of wood; wood charcoal	2,581.3	1.8
	Ten major commodities	63,392.5	81.3			Ten major commodities	118,204.1	83.3
	Others	14,552.5	18.7			Others	23,687.9	16.7
	Total	77,945.0	100.0			Total	141,892.0	100.0

### Ten Major Import Commodities of ASEAN From China by 2-digit HS Code, 2007, 2012

(US\$ million)

2007				2012			
HS	Commodities	Value	Share	HS	Commodities	Value	Share
85	Electric machinery, equipment and parts; sound equipment; television equipment	27,697.4	29.7	85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles	53,646.3	30.2
84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	20,472.5	22.0	84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	37,347.9	21.0
72	Iron and steel	6,767.1	7.3	72	Iron and steel	8,424.5	4.7
27	Mineral fuels, mineral oils & products of their distillation; bitumen substances; mineral wax	3,913.0	4.2	73	Articles of iron or steel	6,294.4	3.5
73	Articles of iron or steel	2,736.7	2.9	27	Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes	5,714.0	3.2
39	Plastics and articles thereof	1,811.9	1.9	39	Plastics and articles thereof	4,836.3	2.7

90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments/ apparatus; parts & accessories	1,648.9	1.8		29	Organic chemicals	3,704.	2.1
29	Organic chemicals	1,484.9	1.6		90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof	3,325.3	1.9
28	Inorganic chemicals; organic or inorganic compounds of precious metals, of rare-earth metals, of radioactive elements or of isotopes	1,467.5	1.6		87	Vehicles other than railway or tramway rolling- stock, and parts and accessories thereof	3,160.7	1.8
31	Fertilizers	1,189.1	1.3		55	Man-made staple fibres	2,723.1	1.5
	Ten major commodities	69,189.2	74.3			Ten major commodities	129,176.5	72.7
	Others	23,983.5	25.7			Others	48,416.3	27.3
	Total	93,172.7	100.0			Total	177,592.8	100.0

Source: *ASEAN Statistical Yearbook* (2007 and 2013 edition), available

<http://www.asean.org/resources/2012-02-10-08-47-55/statistical-publications>

**Appendix 3.5: Trade growth rate change between China and Vietnam (2008 to July 2014)**

	Vietnam exports to China	Vietnam imports from China	Exports growth	Imports growth	Exports growth change rate	Imports growth change rate
2008	4.54	15.65				
2009	4.91	16.44	0.37	0.79	8.15%	5.05%
2010	7.31	20.19	2.4	3.75	48.88%	22.81%
2011	11.13	24.59	3.82	4.4	18.92%	21.79%
2012	12.39	28.79	1.26	4.2	11.32%	17.08%
2013	13.26	36.95	0.87	8.16	7.02%	28.34%
2014 April	1.55	5.24				
2014MaY	0.99	3.17			-36%	-39%
2014 June	0.98	2.84			-36%	-44%

*Resource:* General Statistics Office of Vietnam and the author's calculation, data available at [\\_\\_\\_\\_\\_](#)



**Appendix 4.1: Visitors from China to New Zealand (Year ended January 2010-14)**

Key Characteristic	Year ended January					Change 2013-14	
	2010	2011	2012	2013	2014	Number	Percent
Total visitor arrivals	97,432	127,837	154,318	192,448	240,288	47,840	24.9
Travel purpose							
Holiday	60,960	85,960	105,797	136,256	179,184	42,928	31.5
Visiting friends & relatives	15,957	19,770	21,920	23,040	30,288	7,248	31.5
Business	10,234	10,834	12,526	15,856	12,576	-3,280	-20.7
Education	3,458	3,162	3,621	3,776	4,784	1,08	26.7
Conferences & conversations	1,339	1,517	1,312	1,840	1,296	-544	-29.6

*Resource: International Visitor Arrivals to New Zealand: January 2014, available at*

[http://www.stats.govt.nz/browse\\_for\\_stats/population/Migration/international-visitor-arrivals-jan-14.aspx](http://www.stats.govt.nz/browse_for_stats/population/Migration/international-visitor-arrivals-jan-14.aspx)

**Appendix 4.2: New Zealand's Inward and Outward Investment <sup>(1)</sup> (NZ\$ million)**

		At 31 March											
		2008		2009		2010		2011		2012		2013	
		New Zealand's total investment abroad										Rank	
Australia		42,065	R	38,889	R	42,460	R	50,463	R	45,686	R	48,177	1
PRC		274	R	495	R	609	R	787	R	1,046	R	1,107	9
Germany		5,331		5,550		3,580		4,904		5,696		4,312	6
Hong Kong		1,357	R	1,297	R	1,524	R	1,254	R	1,568	R	1,953	8
Japan		4,297	R	3,538	R	3,460	R	3,033	R	2,653	R	6,732	4
Netherlands		4,767		4,073		3,820		3,336		4,077		4,880	5
Singapore		1,887	R	1,901	R	2,212	R	3,092	R	2,842	R	2,766	7
Switzerland		1,013	R	681	R	944	R	839	R	1,014	R	742	10
United Kingdom		10,537	R	12,403	R	10,273	R	14,348	R	16,154	R	15,407	3
USA		26,337	R	32,455	R	28,084	R	30,349	R	28,614	R	30,118	2
Total investment abroad		135,121	R	135,836	R	135,965	R	166,771	R	158,412	R	163,942	
		Total foreign investment in New Zealand										Rank	
Australia		92,021	R	104,906	R	109,723	R	113,801	R	112,160	R	110,080	1
PRC		920	R	1,901	R	1,906	R	1,914	R	2,029	R	2,380	10
Hong Kong		3,276	R	3,155	R	4,047	R	3,754	R	3,433	R	3,959	6
Japan		9,542	R	11,120	R	6,529	R	7,273	R	7,174	R	7,784	5
Netherlands		4,933	R	4,449	R	3,797	R	3,520	R	4,160	R	3,582	7
Singapore		8,575	R	6,588	R	3,113	R	4,312	R	5,952	R	7,845	4
Switzerland		1,944		2,455		2,037		1,620		1,759		1,835	9
Taiwan		2,354		2,580		2,519		2,559		2,503		2,488	8
United Kingdom		44,803	R	50,403	R	49,300	R	49,717	R	50,301	R	52,940	2
USA		49,756	R	55,801	R	51,122	R	46,871	R	45,519	R	38,845	3
Total investment in NZ		273,525	R	295,184	R	288,982	R	300,431	R	306,587	R	315,503	

Note: (1) Includes stocks of financial derivatives. R: Revised

Resource: Balance of Payments and International Investment Position: Year ended 31 March 2013 ,  
available at

[http://www.stats.govt.nz/browse\\_for\\_stats/economic\\_indicators/balance\\_of\\_payments/BalanceOfPaymentYearEnded\\_HOTPYe31Mar13.aspx](http://www.stats.govt.nz/browse_for_stats/economic_indicators/balance_of_payments/BalanceOfPaymentYearEnded_HOTPYe31Mar13.aspx)

**Appendix 5.1: China-Pakistan Two-way Trade in Past 13 Years (2001-2013, US\$ billion)**

	China exports to Pakistan	China imports from Pakistan	Trade surplus between China and Pakistan
2001	0.81	0.58	0.23
2002	1.24	0.56	0.68
2003	1.85	0.57	1.28
2004	2.47	0.59	1.87
2005	3.43	0.83	2.59
2006	4.24	1.01	3.23
2007	5.83	1.10	4.73
2008	6.05	1.01	5.04
2009	5.52	1.26	4.25
2010	6.94	1.73	5.21
2011	8.44	2.12	6.32
2012	9.28	3.14	6.14
2013	11.02	3.20	7.82
	To resize chart data range, drag lower right corner of range.		

Source: Author's own calculation based on the UN Comtrade International Statistics Database, available at <http://comtrade.un.org/>

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