

# **RCEP, TPP and China's FTA Strategies**

**Ronglin Li and Yang Hu**



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**Ronglin Li<sup>1</sup> and Yang Hu<sup>2</sup>**

## **Introduction**

Since the 21st century, Chinese government has increasingly realized the importance of the Free Trade Area (FTA) strategies, in the context of stagnation in multilateral cooperation of World Trade Organization (WTO) and dramatic development in integration of regional economies. In 2000 China inked Asian-Pacific Agreement, i.e., Bangkok Agreement, followed by other Free Trade agreements with many other nations and regions. In 2007 "FTA Strategies" was officially mentioned in the report of 17th National Congress of the Communist Party of China, which indicates as a turning point of Chinese government's economic international cooperation policy. Since then, Chinese government has accelerated the process of FTA negotiations, and, in consolidating the cooperation with East Asia and Southeast Asia, has expanded the regional cooperation geographically to other Asian regions, South America and Europe.

However, U.S. government high-profile of "return Asia pacific", and its effortless promotion of "Trans-Pacific Partnership Agreement" (TPP) is challenging the implementation of China's FTA strategies in the same region. With U.S. coordination, TPP includes 12 members so far, of which seven have signed FTA agreements with China, and two are underway<sup>3</sup>. Such U.S. dominated TPP implicitly with the feature of excluding China, whenever effective, it will definitely be harmful for China, by taking more members in Asia-Pacific area and playing a leading role in economic cooperation as a result. The most direct impact on China is the trade diversion losses stemming from the high standard and exclusiveness of TPP, which will weaken its regional influence power; besides it will put any FTA negotiations with China in jeopardy.

In confronting the challenges from TPP, Chinese government has responded actively. Till now China is accelerating negotiations with China-South Korea, China-Japan-South Korea, China-Australia and Regional Comprehensive Economic Partnership (RCEP), as slowing down the process of negotiations with other regions. Meanwhile China promotes the upgraded version of "10+1" FTA. The key purpose of those efforts is to establish the RCEP in a fashion that "10+6" as the core cooperation mode would operate, taking China-South Korea, China-Japan-South Korea, China-Australia and new "10+6" as a breaking-through. It is designed to soften the negative shock that TPP is to generate.

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<sup>3</sup> To this date, TPP has 12 members, including U.S., Canada, Mexico, Chile, Peru, Australia, New Zealand, Brunei, Singapore, Malaysia, Vietnam, and Japan. Among them, China has FTA agreements with New Zealand, Chile, Peru, Brunei, Singapore, Malaysia and Vietnam, those seven nations. The FTA agreements with South Korea and Australia are underway.

Within the Asia-Pacific Economic Cooperation (APEC) framework, either U.S. dominated TPP, or any Asian nation dominated RCEP, finally will lead to the way of "Free Trade Area of Asia-Pacific" (FTAAP). It is undeniable that behind the choice of either two aforementioned options there is fiercest competition among big countries such as China, U.S., Japan, and India. According to current situation, the evolution of either mode, TPP or RCEP, is with difficulties so that there is no chance for replacement between the two. For China, it is the moment to consider how to implement "FTA strategies", precisely and effectively: to undertake RCEP with Asian members as core, or to join in U.S. dominated TPP, or another way out? This is the most vital decision-making problem, which is the thesis of this paper. We suggest that economic motive is fundamental for multilateral cooperation, even though regional economic cooperation in Asia-Pacific appears very political. Therefore the suggested FTA strategies for China in the paper is conducted after (i) comparison of economic foundation in RCEP and TPP, and (ii) analysis of difficulties in China's promotion of RCEP and participation in TPP. Before those, it starts with a brief summary of China's status quo in FTAs.

There are two ways to provide economic arguments for a FTA, the after-analysis based upon the assumption that if it is formed, and before-analyses focusing on the existing trade and investment ties among the potential FTA partners. It is to show in this paper that by either one RCEP is both better and reasonable than TPP for China and most of Asian countries, but vice versa for the United States of America. This result, along with some non-economic considerations, has a strong policy implication for China in making its FTA strategy.

## **2. China's Signed Free Trade Area Agreements**

Table1 illustrates the process of China's FTA negotiations. In April 23rd, 2000, China signed "Bangkok Agreement", which is the first time that China joined in regional trade arrangement. It is considered, therefore, as the prelude of China's FTA negotiation process. Till October 2014, China already has had FTA agreements with Association of Southeast Asian Nations (ASEAN), China Hong Kong, China Macao, Chile, Pakistan, New Zealand, Singapore, Peru, Republic of Costa Rica, Iceland and Switzerland. And China is working closely with Gulf Cooperation Council (GCC), Australia, Norway, South Korea, Japan and S. Korea, and Sri Lanka. Besides this, the "Regional Comprehensive Economic Partnership" (RCEP), an upgraded version of "China-ASEAN FTA" negotiations, is underway. Regional economic cooperation with India and Colombia are under cost-benefit analysis.

With efforts in decades, FTAs with China have scaled up. All share the following common features: first, counterparts in FTAs are geographically around Asia-Pacific area, and most are East and Southeast Asian economies. Exceptions are a few, such as Iceland, Switzerland and Norway. Second, most counterparts are developing economies. Only Japan, Iceland, Switzerland and Norway are developed ones. Third, the main focus of FTAs is merchandise trade, service and investment, and implementation is relatively flexible, which reflects in exceptional provisions in

some sensitive sectors<sup>4</sup>. To track the negotiation process, it is obvious that China's FTAs strategy is "neighbor priority, ease priority, and developing economies priority ". As Table1 indicates, China's recent negotiations with GCC and Norway have no improvements nearly in three years; whereas ones with Australia, S. Korea, Japan and S. Korea FTA, along with RCEP and new "10+1" is working impressively. It is clear that Chinese government encourages faster regional integration in Asia under the competition of TPP, in order to materialize RCEP dominated by an Asian economy.

The FTA practices have further improved China's trade and investment with its main partners after joining into WTO because most of these FTAs contain new commitments that are much beyond those made in WTO. These new commitments provide freer and facilitated arrangements for trade in goods, trade in services and market access of capital movements. This of course means a generally positive impact on domestic economy regarding the fact that the increase in trade and investment based upon comparative advantage will generate growth and bring national welfare. Furthermore, with increasing number of issues included in the FTA negotiations, China's trade policy becomes more open than before towards a framework that would converge somehow towards that in RCEP and TPP. So they are actually necessary preparation for joining into mega FTAs that will be discussed in the following.

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<sup>4</sup> However, some research show that China's FTA is deepening toward the direction of liberalization. It means the cooperative expansion takes place not only in trade and investment, but also in trade, investment, the rule of origin, custom procedures, technological trade barriers, sanitary and phytosanitary measures, dispute arbitration, trade remedies, intellectual property rights, geographical indications and cooperation, among many others (Dong Yan etc., 2009; Xie Yue etc., 2009).

Table 1: The Process of China's FTAs

<b>Signed FTAs</b>	<b>Date of Signature and Effectiveness</b>
Asia-Pacific Agreement (Bongkok Agreement)	Signed on 4/23/2000, Effect on 1/1/2002
ASEAN	Signed on 11/4/2002, Effect on 7/20/2005, established in 2010
Hong Kong, China	Signed on 6/29/2003, Effect on 1/1/2004
Macao, China	Signed on 10/17/2003, Effect on 1/1/2005
Chile	Signed on 11/18/2005, Effect on 10/1/2006
Pakistan	Signed on 11/24/2006, Effect on 7/1/2006
New Zealand	Signed on 4/4/2008, Effect on 1/1/2008
Singapore	Signed on 10/23/2008, Effect on 1/1/2009
Peru	Signed on 4/28/2009, Effect on 3/1/2010
Costa Rica	Signed on 4/8/2010, Effect on 8/1/2011
Iceland	Signed on 4/15/2013, Effect on 7/1/2014
Switzerland	Signed on 7/6/2013, Effect on 7/1/2014
<b>FTAs under Negotiation</b>	<b>Latest Information</b>
GCC	Initiate in 2004/7, 5th round negotiation till 2009/6
Australia	Initiate in 2005/4, 21st round negotiation till 2014/9
Norway	Initiate 2008/9, 8th round negotiation till 2010/9
South Korea	Initiate in 2012/5, 13th round negotiation till 2014/9
S.Korea and Japan	Initiate in 2013/3, 5th round negotiation till 2014/9
RCEP	Initiate in 2013/5, 3rd round negotiation till 2014/1
Updated version of "10+1"	Initiate in 2014/9
Sri Lanka	Initiate in 2014/9
<b>FTA under Research</b>	<b>Updates</b>
India	Executable research done in 2008/9
Columbia	Initiate executable research in 2012/5

Source: China Free Trade Area Service Web, <http://fta.nofcom.gov.cn>.

### 3. RCEP and TPP: which is better?

It is impossible to have no political games in regional economic cooperation among nations though; it is still not convincing that political interests alone could make economic cooperation happen in Asia-Pacific area. Lucrative economic benefits behind integration are the root for economies to engage in FTAs. Let alone China, other major economies in Asia all face the trade-off between RCEP and TPP. Keeping other factors constant, ongoing trade and investment relations among nations provide benchmark for research in economic foundations of FTA.

Theoretically we usually concentrate on trade and investment effect since regional integration takes the form. Based on that we first investigate possible influence on domestic economy after the FTA agreements are signed, and then craft negotiation strategies. In most cases such research is done by Computable General Equilibrium (CGE) model. However, it turns out, in reality, existing trade and investment connection actually determines regional integration among nations. Lawrence (1999) in his seminal work "Regionalism, Multilateralism, and Deeper Integration" shares the similar perspective, that is, FTAs is the result of trade expansion rather than the cause. In addition, Wonnacott and Lutz (1989), and Krugman (1991) indicate, too, that it is highly possible for those nations with close geographical location as well as substantial volumes of

trade<sup>5</sup>. Even though research in this front did not get much echo, it does leave us an important implication: existing trade and investment connections determine potential benefit of regional integration among nations, which furthermore affect decision-making of each government in this area. We consider existing trade and investment connection as economic foundation of integration. Therefore, in RCEP and TPP strategy-crafting, not only economic influence should be taken into consideration, but also its groundwork in trade and investment.

### 3.1. RCEP and TPP: Weight Ratio in World Trade

The weight ratios of RCEP and TPP in world trade reflect the relative importance. Data in Figure 1 is based on trade statistics provided by IMF between 1990 and 2011. It shows the RCEP and TPP members' foreign trade volume, and their weights in world trade, respectively<sup>6</sup>. From Figure 1, prior to financial crisis in 2009, TPP members' trade weight ratio was greater than that of RCEP members; however, since 2000 the gap between them is narrowing down. The main reason is increasing development in Asian emerging economies' foreign trade activities. It is particularly so after China's entry into WTO. The foreign trade volume of this group, as a result, is skyrocketing. In the aftermath of financial crisis, China and other Asian economies take the leading role in economic recovery, which makes trade volume of RCEP members overtakes that of TPP members. Till 2012 RCEP members' foreign trade totaled \$10.5 trillion, accounting for 29% of the world trade. By contrast, TPP's totaled \$9.62 trillion, 27% of world trade.

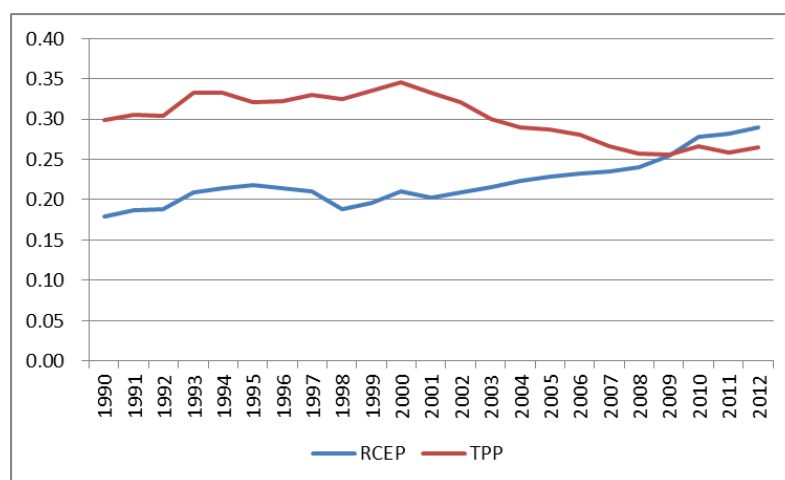


Figure 1. The total trade shares in the world of RCEP and TPP

Therefore, based on trade volume, those of RCEP and TPP, on average, are above 1/4 in world trade. Whoever finalizes FTA agreements, the potential benefit is huge. Alongside with the fact that the gravity of world economy is moving to East Asia, RCEP's foreign trade volume is much likely to continue growing, which widens the gap with TPP. But the precondition is that TPP no longer recruits new Asian economies. In reality, many Asian economies are willing to participate

<sup>5</sup> In those researches, regional integration is taken as an endogenous variable. When benefit of integration overtakes its cost, each authority intends to promote integration. Countries with close location in geography, as well as large volumes of trade, are more likely to generate more trade benefit from FTAs than that from trade transfer, which implies positive benefit.

<sup>6</sup> Statistics in this paper, we take RCEP members as current "10+6" member economies; TPP members are ongoing 12 economies under negotiation.

in TPP negotiations. So simply in trade volume comparison is not significant to tell the difference between RCEP and TPP.

## 3.2. Intensity of Intraregional Trade and Investment

Apparently regional integration is more consolidated if trade and investment is more likely to take place within the FTA region. It is also much easier to deepen the cooperation. Such economic connection can be measured with Intraregional Trade Intensity Index and Intraregional FDI Intensity Index, respectively<sup>7</sup>.

### 3.2.1. Comparison of Trade Intensity Index

Figure 2 shows between 1990 and 2012, the trends of RCEP and TPP intraregional trade intensity index. In it we can see that either RCEP or TPP, its index is greater than 1.5, which means within those two possible FTA, trade connection between members is close. By comparison, RCEP's trade intensity index in most times is greater than that of TPP, which indicates higher interdependence among RCEP members. From trend, however, since 2000, the gap between two is narrowing. Based on the composition of trade intensity index, numerator is intraregional trade share; denominator is the ratio between trade in region and that in the world. Therefore,

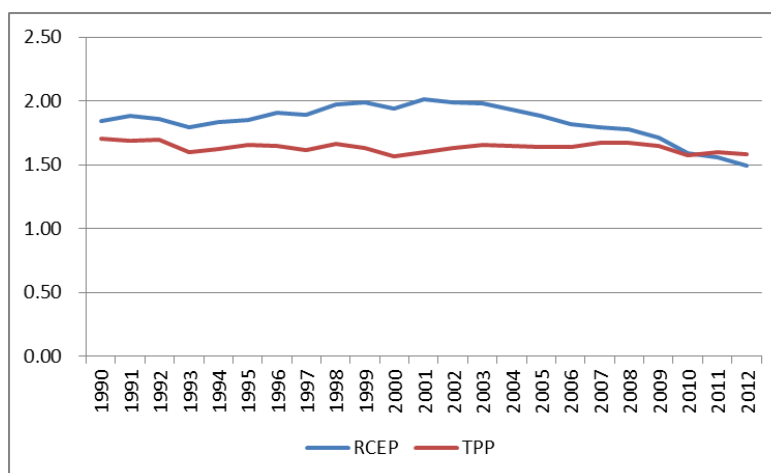


Figure 2. Trade intensity index of RCEP and TPP

regional trade volume in world trade of RCEP is rising during the statistical period, while that of TPP is declining. RCEP's regional trade weight in world trade is rising faster, which causes its index turns south. Suppose we only consider intraregional trade volume and its weight in regional trade, then the interdependence among RCEP members is much more than that of TPP.

<sup>7</sup> Intensity Index greater than unity indicates members have more intension to invest and trade within FTA region; whereas index less than unity indicates otherwise. The formula of trade intensity index is  $\frac{T_{ii}}{T_i} / \frac{T_w}{T_w}$ , where  $T_{ii}$  is exports and imports within region  $i$ ,  $T_i$  is the exports and imports to the whole world,  $T_w$  is exports and imports in the whole world. Investment intensity index formula is similar, which is  $\frac{FDI_{ii}}{FDI_i} / \frac{FDI_w}{FDI_w}$  is FDI inflows and outflows within region  $i$ ,  $FDI_{ii}$  is total investment flows within  $i$ , and  $FDI_i$  is the FDI from region  $i$  to the world, and  $FDI_w$  is the total investment flows of the world.

### 3.2.2. Comparison of Investment Intensity Index

Next, investigate the investment connection between member economies. Figure 3 shows RCEP and TPP intraregional investment index between 2009 and 2012. The time interval is only four years due to the difficult access to bilateral data<sup>8</sup>. Regardless of short-interval data, it is still clear that the average of RCEP investment intensity index, 2.33, is higher than that of TPP, 1.34. It indicates more interdependence among RCEP members in investment. There are many other researches that lead to similar conclusion. As in United Nation's World Investment Report (2006), in FDI inflows into South, East and Southeast Asia, most of them happened within those regions. Hattari and Rajan (2009) investigated bilateral FDI of developing Asia, by data of international trade balance, and concluded 35% of FDI inflows took place within developing Asia. Lispey and Sjöholm (2011) also got the conclusion that a great proportion of FDI inflows into East Asian developing countries came from other developing ones.

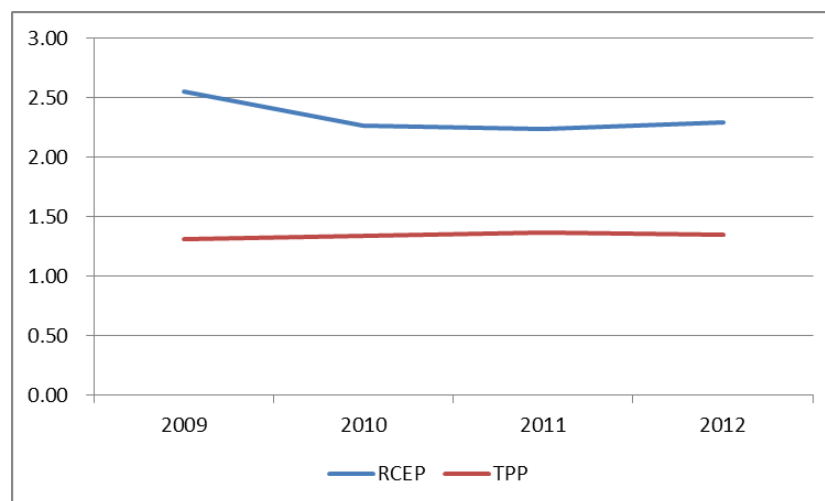


Figure 3. Investment intensity index of RCEP and TPP

As a matter of fact, as the increasing development in Asia's economy, the volume of investment between member countries has been already impressive. Ronglin Li, Yang Hu, and Yingtao Zhang (2013), by using the data of Asian Development Bank (ADB) to investigate FDI in East and Southeast regions, got the conclusion that a complicated "East Asian FDI network" is taking off, which has Japan, China Hong Kong, China Taipei and Singapore as core economies, along with mainland China and ASEAN and other emerging industrialized economies. Econometric results prove the increase in regional integration by investment enhancement. To summarize, from investment perspective, RCEP with Asian countries as members shows more interdependence compared with TPP whose membership has economies that are also part of RCEP. RCEP therefore is more likely to be finalized as FTA.

<sup>8</sup> Data is from Coordinated Direct Investment Survey (CDIS) database, which is high qualified and reliable data provided by IMF. It is cooperatively working with UNCTAD in 2009. The database includes 246 countries and regions, from which it collects individual FDI inflows. Most of the countries provide FDI outflows as well. The database is currently updated in 2012. The database is accessible at <http://cdis.imf.org>.



### 3.2.3. Simulation

In this section, we apply dynamic GTAP model to simulate economic effect of RCEP and TPP. The setup general equilibrium model that contains 19 countries and regions, as well as 15 sectors<sup>9</sup>. It is designed for three scenarios: (1) RCEP and TPP both finalize in 2015; (2) TPP finalizes but RCEP does not; (3) RCEP finalizes but TPP does not. Simulation data is in Appendix.

First, based on scenario one simulation, if both RCEP and TPP complete merchandise trade liberalization, U.S. and RCEP members will all enjoy the benefits. According to the welfare changes, China, Japan and S. Korea are the most winners; welfare effect is \$71.523 billion, \$59.396 billion and \$62.889 billion, respectively. Taking the difference in economic scale into account, small economies will be more beneficiary, such as Vietnam, Malaysia and Thailand. Besides, GDP of Australia and New Zealand will increase by 1% more. That of India will increase by 0.69% regardless of its low openness. The overall welfare improvement for U.S. is \$26.73 billion, lower than any of China, Japan, or S. Korea. Its contribution to GDP growth is only 0.19%. The cause of such small effect is small economic scale in TPP members, except for Japan, which will not contribute much for the U.S. economy.

Second, based on scenario two simulation, if TPP finalizes but RCEP does not, U.S. is the biggest winner. Its welfare improvement is \$66.645 billion. By comparison, China is to have welfare loss of \$21.632 billion. Its GDP growth, exports and imports, and the term of trade will be adversely affected as a result. Much worse, economies that do not join TPP, such as S. Korea, Thailand, Philippines, and India, will all be hit in one way or another.

Third, based on scenario three simulation, if RCEP finalizes but TPP does not, then all RCEP members are winners. China, Japan, and S. Korea will benefit most in terms of welfare, \$87.78 billion, \$51.096 billion, and \$65.769 billion, respectively. Compared with scenario two, Asian members in RCEP will benefit more than those in TPP in terms of welfare improvement. Therefore, from welfare perspective, RCEP should be the priority for Asian countries. In this case, welfare of U.S. is down by \$43.573 billion, and its GDP growth decreases by 0.2%, which is solid evidence that trade liberalization in RCEP will reduce U.S. benefits.

As far as specific sector are concerned, RCEP will have both positive and negative impacts on different industries in China. Based upon our simulation, the output of electronic product, garments and footwear will increase by 5.78% and 4.48% respectively, ranking on the top two, and while mechanical equipment and automobiles will suffer decrease in output by -1.59% and -1.47. The impacts on other industries are relatively moderate.

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<sup>9</sup> There are 57 sectors and 113 regions in standard GTAP model. To concentrate, this paper consolidates 113 regions into 19 countries and regions, which are China, Japan, S. Korea, Australia, New Zealand, India, Indonesia, Malaysia, Philippines, Vietnam, Thailand, Singapore, the United States, Canada, Mexico, Chile, Russia, Brazil and other countries in the world. Categorize 57 sectors into 15, 14 of which are tradable sectors, agriculture, food processing and beverage, mineral fuel, mining, textiles, garment, wood-paper and printings, chemicals, metal products, automobiles, other transport, electronics, mechanical equipment, miscellaneous, and one non-tradable sector, service.

According to those simulations, conclusions are: first, for China, no matter where TPP goes, China should in all effort to push RCEP negotiation, to avoid possible adverse influence; second, for ASEAN, India, Australia and New Zealand, RCEP is dominant strategy, which is good for China as well; third, U.S. will all efforts to make TPP happen, to avoid possible adverse influence.

The simulation results here of course are based upon the currently existing situation in member economies. However, there might be some changes if we take into account the new achievements in negotiation and the increase in membership in TPP. Apparently, TPP would be more attractive if with more membership because that would expand the inner market and provide more opportunity for trade and investment. The economic impacts of high standard on each member country are rather complicated especially in the short run because both the new and crosscutting issues in TPP negotiation have different impacts on different countries in different industry or sectors. In the long run, a general positive conclusion could be made, as it is believed that the deeper liberalization and competition will increase the efficiency and productivity. And this always increases the national welfare of member countries.

But the basic prediction that China will lose and USA will gain does not change at all under the assumed situation of TPP progress and RCEP stagnated. It would reinforce the prediction. The possible changes mainly go to Asian member countries that might gain more in TPP than in RCEP because of the higher standard and broader economic integration. Nevertheless, RCEP might progress both in membership and standards also. We can find the new progress in the scope of RCEP member countries to upgrade or launch the agreement toward some higher standard of comprehensiveness and new issues. This will offset above-mentioned impacts. So the net change will depend on how different components of these agreements progress over time.

The result, however, will be totally different if the results of TPP could dominate markets and overturn the global production chain in East Asia or even in the Asia Pacific region. In general, trade policy embodied in TPP and RCEP are basically aimed at eliminating the impediments for trade and investment that result in some market distortions. But it is never expected to alter the basic market force of comparative advantages that are much more important economic determinants than trade policy. TPP does have very important strategic impacts on emerging new global trade rules, which have been take into account in the following section five discussions.

## **4. Non-Economic Factors on RCEP and TPP**

Economically aforementioned, RCEP has a better trade and investment foundation than TPP and some kind of competition in economic interests exist between US and China because of the mutual exclusiveness with trade diversion effects. However, some non-economic considerations also underlie the future development of TPP and RCEP as well as China's FTA strategy. These include, among many others, the leadership competition inside RCEP and the role of the U.S. in Asia Pacific economic integration.

First of all, let's look at the leadership competition in RCEP. RCEP targets an FTA including Asian countries only. But, it is unlike the TPP in which the U.S. has a unique leading position. There is no

clear leadership taking in Asia regional economic cooperation. Even though in several "10+1" and "10+3" ASEAN is at the core position, it is difficult for her to enforce the negotiation for RCEP based on either her economic influence or comprehensive national power. China and Japan are two biggest economic and political nations in this area, and both have capability to take the leadership. Unfortunately, barriers such as not-reconciled-territorial-disputes in the short run and disagreements in history perspectives, make leadership coalition between two countries impossible. Moreover, China or Japan has intention to undertake sole leadership<sup>10</sup>. Confronting China's fast economic development, taking it as threat, Japan puts China overtaking its leading position as biggest concern. As response, Japan proposed to have India, which is another big country in Asia, Australia and New Zealand into "10+3" framework, together forming up so-called "Comprehensive Economic Partnership in East Asia" (CEPEA) mechanism. The aim of this action is to balance and dilute China's influence with those three economies. Yet, in reality, it creates more complex leadership for East Asia regional economic cooperation. Without strong leadership, it will increase the difficulties to push the RCEP talking ahead and to reach a high standard in the possible agreement.

Secondly, The United States plays an important role in Asia Pacific economic integration. It is the world's only superpower, and has military allies in East and Southeast Asia, such as Japan and South Korea, thus providing military support and security protection. With the status of U.S. ally, some East Asian countries are in attempt to maximize their own interests when they make the choice between RCEP and TPP. Take Japan as example. TPP strengthens its alliance with U.S., in order to remedy the scar in Japan-U.S. relationship caused by Yukio administration. In this way, it is possible to increase its influence in East Asia with ties of U.S. power. Nevertheless, similar industrial structure, both high-tech oriented, puts both countries into fiercer competition. Fully dependent on U.S. in economics and politics cannot help Japan out of its economic recession dilemma. Meanwhile, with the development of emerging economies in East Asia and its possible trend to become the center of gravity of global economy, has led the Japanese government to make a tough choice to turn back and cooperate with East Asian economies. The trade-off between political and economic interests is another element that has to be taken into account for some Asian countries other than Japan.

As far as ASEAN is concerned, it seeks "balance among big countries" strategy in regional economic cooperation. Such strategy avoids one single country taking control of whole regional issues and raises ASEAN political influence. Objectively, this strategy highly succeeds and wins some leadership for ASEAN. However, U.S. dominated TPP will definitely disturb the existing balanced situation in East Asia, putting the region under greater American influence. This is not desired by ASEAN, which will see its own influence weakening. Coincidence with increasing tension with China in South China Sea, some ASEAN countries have intention to fight against "threats" from China, by using TPP as leverage to enhance alliance with U.S. Such choice between

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<sup>10</sup> On the one hand, China is publicly recognized as the leader in "East Asian Civilization Circle". As its fast economic growth and increasing national power, China has the ambition to have more voice in Asia, to restore its leadership as before. On the other, Japan, thanks to easier industrialization, with its developed economy over other Asian countries, had a quick recovery after WWII, winning itself top economy in Asia. Japan's foreign direct investment covers East and Southeast Asia, and leads the Asian economies. It is reasonable for Japan to seek regional leadership as well.

leadership and national security results in action division in ASEAN. Even though ASEAN countries like Singapore, Brunei, Malaysia and Vietnam have already participated in TPP and others such as Thailand and Philippines show interests, ASEAN as a whole is still active in East Asian regional cooperation, for example, recent upgraded "10+1" FTA negotiations with China. The preference over RCEP or TPP for ASEAN depends on its economic and political trade-off in which U.S factor does matter.

## **5. China's Strategic Options**

According to the current situation, it seems impossible for China to join in TPP negotiation and thus it is more willing to promote RCEP. Based on our simulation and analysis, RCEP will definitely bring about substantial economic benefit. However, it is risky to take one simple tactic. Once TPP finalizes but RCEP does not, China will suffer huge economic loss. Therefore engagement in TPP negotiation will offset adverse outcomes. Indeed, cost-and-benefit analysis alone is not enough. If promoting TPP is much more difficult than RCEP, even with impossibility to conclude the negotiations, then it is meaningless to discuss potential benefits, regardless of strategic options. Hence, it is another cornerstone for decision-making to analyze difficulties and challenges in each option.

### **5.1. Difficulties in TPP Entry for China**

On the one hand, that TPP has high standard, restricted requirements in negotiation issues, generally, makes China impossible to meet in the short term. In principle, TPP inclines to cut off all trade restrictions, commence zero custom tariff; it has much more comprehensive tariff cut in trade in goods and higher market access for services and investment. All these broader measures are beyond any FTAs that China has promised in terms of liberalization. In addition, TPP, as the United States' next generation trade and investment standard, contains cross-cutting and new issues that exceed traditional trade issues, which shift focus on social front, beyond border regulations and domestic legislations (including regulation consistency, fair competition and facilitation, intellectual property right, government procurement, small and medium enterprises, state-owned enterprises and development and so forth). Those rules and standards are far beyond acceptability of China's present economic and political framework, resulting in thin chance for China to join in TPP in short term.

On the other hand, the United States, in fact, is unwilling to see China's entry into TPP negotiations, at least before the negotiations are concluded. U.S. never offered any invitation to China for TPP, even though it claims that TPP is Asia-Pacific oriented trade agreement, which has no intension to exclude China. In addition, president Obama made clear in Costa Rica, May 2013, that the current focus of TPP is to close the agreement, instead of having additional new members. This identifies a prevailing unofficial "ABC policy" of the US, which means "anyone but China" in TPP negotiation. Besides, high standards hinder China's intention to engage TPP negotiation, which is the point that U.S., eager to complete TPP, is trying to avoid.

There are controversial points of view about whether China should join in TPP domestically. The opposition comes from the consideration of impossibility and competitiveness between TPP and RCEP backed by the United States and China both economically and politically. However, many of academics and even some of government officials believe that to join in TPP negotiation would bring another new opportunity for China to promote the domestic reform after access to WTO. It is just the domestic reform brought about by openness and liberalization that have provided a great impetus for economic development in the past over 10 years. Many negotiating issues in TPP, including those crosscutting and new issues like regulation, competition policy and so on, will help to break the resistance of interest-groups and promote the new round deep reform. It seems that the government is making the trade-off and taking both the difficulties and opportunities into account. As a matter of fact, China has taken some steps toward TPP. In spite of the effort to up-grade the China ASEAN free trade agreement, China had established Shanghai Free Trade Experiment Zone two years ago, and some new similar zones will be established soon in Tianjin, Guangdong and some other coastal cities. One purpose of the zones is to carry out a more free trade and investment policy inside the area to test their possible impacts and accumulate the experiences in deregulation of the government. These liberalization and facilitation measures are supposed to be copied and extended to the whole economy. It is apparent that, like or not, China would be going beyond the broader measures in free trade practice and become more willing to discuss those used-to sensitive issues in FTA negotiation.

## **5.2. Challenges in RCEP Negotiations for China**

First, "Spaghetti bowl" effect is outstanding within RCEP, especially for FTA integration. There are five "10+1": China, Japan, South Korea, India, Australia and New Zealand all signed bilateral FTAs with ASEAN. Difference in merchandise, services and investment and other areas is recorded in FTAs. Inside ASEAN, members' claims differentiated obligations to liberalization. Therefore, it is a great challenge for further development in trade and investment liberalization about how to integrate already complicated FTAs in East Asia.

Second, the participants confront another barrier due to historical problems, sovereignty claims and lack of political trust. For example, China and Japan have disputes over Diaoyu Island and history issues during WWII, which nearly put a stop in China-Japan-S.Korea FTA negotiation. China has conflicts with Philippines and Vietnam over South China Sea, which is likely to boost nationalism in those nations. As a result, such emotion could finally turn those nations away from China, and seek protection from U.S. by joining TPP. In addition, there are also certain territorial disputes between China and India, and between S. Korea and Japan. How to contain such territorial disputes and to establish political mutual trust would affect the process of RCEP negotiations.

Third, RCEP competes with TPP. If U.S. has more Asian members in TPP, then that it will have a negative influence on RCEP negotiation is obvious. It does squeeze out negotiation resources by implanting new rules from TPP into Asian countries. Once TPP succeeds, RCEP with relatively low openness would be unattractive.

However, we should also aware that TPP and RCEP have been treated as two possible routes towards the final economic integration in Asia Pacific area. FTAAP is the long-term final goal of APEC, TPP and RCEP are two tracks leading to that goal. In the two tracks, RCEP is a real regional arrangement of Asia called as “East-Asia model” regarding to the key role of “10+3”, while TPP is known as “Asia Pacific model” comprising of member economies from both Asia and America. Two tracks are expected to develop simultaneously. Nevertheless, as the host country of the APEC summit held in Beijing this year, China was more willing to push the RCEP track but which is somehow not consistent with the United State effort for TPP. That is why China brought up the Free Trade Area of Asia Pacific (FTAAP) as a compromise.

### **5.3. China's Strategic Options**

Based on previous analysis, we can see that it is much more difficult for China to join in TPP negotiation before its conclusion than to push RCEP, which becomes one of the strategic choice of China in Asia Pacific free trade arrangement. According to the research of this paper, RCEP generates more economic benefits than TPP, due to increasing interdependence in trade and investment among nations in Asia. With huge economic benefits, there is little possibility for Asian countries such as Japan, S. Korea, and ASEAN to join TPP but not RCEP. In addition, the demand for regional leadership makes those countries more prefer RCEP. Hence, RCEP could be a dominant strategy for East Asian countries, regardless of "Spaghetti bowl" effect and territorial disputes. In this context, negative influence of TPP on RCEP should not be overstated.

There are two scenarios that should be taken into account regarding economic benefits. One is the member shifting from RCEP to TPP, and two is its showcase effect of high standards. If some of RCEP member countries withdraw from RCEP and join into TPP, China will suffer greater losses because of the trade and investment diversion. The impacts on shifting countries are unambiguous depending on their trade and investment relation with expanding TPP and shrinking RCEP member economies. They would get better off only if the benefits from joining in TPP were bigger than joining in RCEP. Otherwise, net losses would occur. As we show in the above, RCEP countries has a closer intra-regional trade and investment relationship than TPP. Therefore, generally speaking, it is not a good choice for them to shifting from RCEP to TPP.

As far as the showcase effect of high standards is concerned, it would bring up greater national welfare by freer trade and investment liberalization. However, regarding to the great differences in economic development and policy regulatory regime, many of RCEP members, especially for developing countries, would encounter big challenges to meet the requirements of high standards in TPP. High standard is good, but at same time it would become difficult to reach a fully comprehensive agreement. The more developing countries to join in, the more difficult it would be. We can see the difficulties and challenges from the hesitation of Japan in TPP negotiation, which is a highly developed country. The reason behind the difficulty is the risk of high adjustment cost, which is a countervailing element to national welfare gains from freer liberalization. If some compromise has to be made to reach the agreement, the benefits resulting

from the high standards would be dampened to some extent. So the showcase effects are a coin with two sides, high standards with high benefits and high standards with high risk. Take this into account, there might be some member shift, but more possible for them is to sit on the fence.

For Chinese government, it is a good option to promote RCEP, and to put TPP on the shelf for a period of time. In addition, China's FTA strategy should not be boxed either in RCEP or in TPP, but could be more flexible to undertake bilateral FTAs as alternative. RCEP should be the strategic goal and bilateral FTA efforts would pave the way to the goal.

First, formalize bilateral FTAs with TPP members or potential ones. That will dissolve and decrease the influence of trade and investment diversion from TPP on China in terms of economic loss. In this perspective, China has had some achievements. As we know, after over 10 years negotiation, China-Australia FTA is expected to close this year or early next year; In the 2014 APEC summit, the leaders proclaimed that China and republic of Korea will finish the bilateral FTA negotiation. This is a symbol that China has speeded up its bilateral strategy in FTA with Asia Pacific countries. With these two FTAs, China has already had free trade and investment arrangement with most of RCEP countries except Japan and India and of TPP except NAFTA three countries. These five left countries are expected to be the next partners of China to talk on possible bilateral or plurilateral FTA. With progress of bilateral FTA strategy, a great part of the trade and investment diversion effects will be avoided and even more so if the standards are similar to TPP in the FTAs with these other countries.

Second, the contents of FTAs do not only need flexibility, but also need to fit in China's economic development and openness. China, as many Asian countries, is still a developing country with huge domestic difficulties in conducting extensive reform and opening-up especially in services sectors and state-owned enterprises dominated industries. Gradually proceeding rather than sudden release has been proven to be a better strategic choice in the past decades. Bilateral FTA strategy fits China's situation. It allows gradual opening-up with some exceptions. This is why flexibility prevails in FTA negotiation among developing countries. However, the competition coming from TPP with showcase effects of high standards enforces China and other developing countries to adopt higher standards in the regional trade arrangement. With this regard, China has taken steps to do so in bilateral strategy. For example, China and ASEAN has started another round talk to upgrade China-ASEAN Free Trade Agreement (CAFTA); It is said that China-Australia and China-Korea FTA are all much more comprehensive and high-standard, which do not only include border issues like tariff reduction and nontariff measures removals but also consist of beyond-border issues such as government procurement and competition policy etc.

Thus, TPP has greatly affected China's FTA policy even though the country is excluded from the negotiation. As a matter of fact, China treats FTA as an outside force to leverage domestic reforms. However, the flexible bilateral FTA strategy will provide more policy room to do so.

Third, compatibility needs to take into consideration in new bilateral FTA agreements to prepare for foundation of integration in the future. In this sense, bilateral FTA agreements serve as transit period towards greater regional cooperation, in which China and increasing number of

economies will finalize integration. According to theory, the “spaghetti effect” is a negative element to offset the gain from trade carried out by FTA, as it will greatly increase the trade diversion effect. From the viewpoint of a country, it will be even worse if the FTAs with different partners are not compatible in the content. In addition, it will become much more difficult to figure out the diversion effect in this situation. As one step toward mega FTA or broader regional trade arrangement, each bilateral FTA should follow a similar format that will make the comparison and conformity possible. For example, RCEP might be formulated finally based upon all the FTAs among RCEP member countries. For China, it means the overall integration of CAFTA, China-Australia FTA, China-New Zealand FTA, China-Korea FTA, China-Japan-Korea FTA (negotiating), and China-India FTA (does not exist). To do so, we can find out all the differences in each clause or section, which will become the marginal issues in the negotiation. However, it will be extremely difficult if there is large incompatibility among these bilateral FTAs. For this purpose, APEC had worked out and provided a suggestive format for FTA negotiation several years ago. Based upon the format, China has paid attention to follow a framework in bilateral negotiation as compatible as possible. To keep compatibility is really another important issue that should be taken into account for China in carrying out the bilateral FTA strategy.

Fourth, for the pecking order of FTA strategies, China-Japan-Korea FTA (CJKFTA) has the priority after closing of China-Australia negotiations. In CJKFTA, China-Japan negotiation remains as the core of the issue regarding the fact of soon coming China-Korea FTA. This might be one of the most difficult parts in the effort toward RCEP. Now Japan has participated in the negotiation of TPP and has had free trade agreement with ASEAN. For many reasons, it seems not eager to promote RCEP, CJKFTA and bilateral talk with China. The same situation exists between China and India. These are great challenges for China in carrying out the bilateral FTA strategy toward RCEP. With any possibility of RCEP negotiations stagnating, China has also some other alternatives. To upgrade Bangkok Agreement, the Shanghai Cooperation Organization (SCO) and BRICS are optional also. It could be followed by possible FTA agreements with other Asia-Pacific members, such as Mexico and Canada. We cannot exclude the possibility to have economic cooperation with U.S and European Union. These developments could minimize the risk of trade and investment diversion under regional integration and also pave the way for China's domestic reform and opening-up requirements, diluting the adverse effects of external shocks.

Another issue that would be of interest is the impact of bilateral investment treaty (BIT) between China and over one hundred other nations on China's bilateral FTA strategy, especially the Investment Agreement being negotiated between China and the US. Trade in good and services as well as investment are three basic parts in a FTA. To have a BIT between two countries is helpful to negotiate on bilateral FTA because it provides a base for market access in negative list and pre-establishment with national treatment in the possible FTA. BIT also has similar impact on the trade in services in the mode of establishing business in another country. However, investment agreement is only one part of FTA, there are still many other trade and investment related issues that have to be solved in a FTA negotiation. If China and US started FTA negotiation, the greater difficulties would come from those crosscutting and new issues related to domestic regulation regime other than trade and investment liberalization itself. It is anticipated that the negative list in BIT between China and US will be greatly shortened. This would mean a high



standard at least in investment agreement of possible US-China FTA.

## 6. A brief conclusion

In this paper, the economic determinants for RCEP and TPP are investigated after a brief introduction of China's FTA practice based upon the trade and investment ties among member economies. The evidence shows that there exists a closer interdependence relationship in RCEP than in TPP, which provides a reasonable argument for favorable intra Asia economic integration. This is reinforced by the GTAP simulation of a computable general equilibrium model that the national welfare under the scenario of RCEP for Asian countries will be greater than that of TPP. As far as China is concerned, RCEP will bring up net gain and TPP net losses because of the trade and investment creation and diversion effects. The political consideration behind the two mega FTA also affects their future development. The leadership competition inside RCEP, high standard showcase effect from TPP, and exclusiveness from TPP creates some complications for China when participating in the Asia Pacific economic integration, i.e. these condition neither make it possible for China to join in TPP negotiation nor to effectively promote the RCEP. Under this situation, we put forward a bilateral FTA strategy for China. This strategy should be flexible enough to fit the gradual domestic reform and opening-up, more comprehensive to approach TPP high standard, more compatible for future conformity into broader regional economic integration of RCEP and TPP, which are two tracks toward FTAAP.

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## Appendix

In order to focus upon the TPP and RCEP, we established a dynamic model of 15 sectors and 19 countries/regions based upon the standard GTAP model of 57 sectors and 113 countries. In the model, there are one non-tradable services sector and 14 tradable sectors including agriculture, food and beverages, mineral fuels, mining, textile, garments-footwear-and-cap, wood-paper-and-products, chemicals, metal products, automobile, other transportation vehicles, electronic products, machine and equipment, and miscellaneous manufactures. The 19 countries/regions in the model include China, Japan, South Korea, Australia, New Zealand, India, Indonesia, Malaysia, Philippines, Viet Nam, Thailand, Singapore, The United States, Canada, Mexico, Chile, Russia, Brazil, and the rest of the world.

The tariff data come from TRAINS, a tariff database of United Nations. It is calculated and compiled according to the concordance between HS 6 digit code and GTAP sector classification. The average existing tariff rates in each sector of each country are listed in the following Annex table.

In the model, all the assumptions in the standard GTAP model, which include perfect competition, constant return of scale, maximization of utility and minimization of cost, and market clearing in factor and product market, have been kept except the full employment that is absent in many countries in Asia. We assume that the real wage rate, which is adjusted according to the nominal wage rate and CPI, is constant and has imposed impacts on the employment of different labors in each scenario.

Three simulations have been carried out based upon the model: (1) historical simulation from 2005-2013, in which the parameter of productivity is reversely induced by actual economic data; (2) baseline simulation from 2014-2015, in which the data of GDP growth rate come from the prediction made by IMF in World Economic Outlook; that of population, skilled and unskilled labor, and capital stock come from the prediction of World Bank; (3) policy simulation with complete tariff-cut shock. The outcomes are listed in the Annex tables regarding to three different scenarios respectively.

Table A1: Option One Simulation Result

	Changes in Welfare (\$ billion)	Changes in GDP (%)	Changes in Exports (%)	Changes in Imports (%)	Changes in Trade Term (%)
China	715.32	0.93	6.44	8.78	-0.65
Japan	593.96	1.03	5.53	7.22	1.29
S. Korea	628.89	4.64	8.06	13.14	0.53
Singapore	52.49	0.89	2.44	2.87	0.55
Malaysia	174.51	4.95	6.78	10.86	0.23
Thailand	168.63	2.91	-5.71	12.59	1.95
Philippines	32.28	0.87	1.73	4.22	0.27
Indonesia	71.86	0.59	3.57	5.86	0.60
Vietnam	279.71	15.13	17.12	35.80	0.52
Australia	206.00	1.06	5.17	6.31	2.00
New Zealand	34.80	1.14	3.76	5.87	2.22
India	118.64	0.69	7.15	6.99	-0.29
United States	267.30	0.19	3.39	1.35	-0.22

Note: Figures in the table is based on modified GTAP model calculation.

Table A2: Option Two Simulation Result

	Changes in Welfare (\$ billion)	Changes in GDP (%)	Changes in Exports (%)	Changes in Imports (%)	Changes in Trade Term (%)
China	-216.31	-0.13	-0.05	-0.40	-0.17
Japan	173.09	0.33	1.88	1.90	0.19
S. Korea	-45.31	-0.24	0.07	-0.56	-0.25
Singapore	12.26	0.21	0.57	0.64	0.13
Malaysia	89.92	2.94	4.09	6.58	-0.18
Thailand	-22.69	-0.29	1.13	-0.87	-0.43
Philippines	-6.19	-0.10	0.10	-0.30	-0.17
Indonesia	-17.12	-0.13	-0.02	-0.57	-0.19
Vietnam	142.94	6.83	7.19	16.79	1.41
Australia	78.26	0.46	1.93	2.64	0.50
New Zealand	20.08	0.73	2.24	3.93	1.04
India	-31.36	-0.10	0.39	-0.51	-0.27
United States	666.45	0.37	2.99	2.44	0.13

Table A3: Option Three Simulation Result

	Changes in Welfare (\$ billion)	Changes in GDP (%)	Changes in Exports (%)	Changes in Imports (%)	Changes in Trade Term (%)
China	878.80	1.02	6.43	9.06	-0.53
Japan	510.96	0.86	4.13	6.33	1.28
S. Korea	657.69	4.79	7.92	13.48	0.68
Singapore	45.28	0.76	2.07	2.50	0.47
Malaysia	136.72	3.89	5.16	8.41	0.17
Thailand	183.23	3.10	-6.48	13.17	2.24
Philippines	36.42	0.93	1.62	4.43	0.39
Indonesia	82.81	0.68	3.53	6.22	0.71
Vietnam	202.53	11.73	11.90	26.54	-0.47
Australia	193.02	0.97	4.33	5.71	1.98
New Zealand	30.88	1.00	3.10	5.16	1.97
India	143.12	0.77	6.80	7.41	-0.08
United States	-435.73	-0.20	0.47	-1.15	-0.37