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Articles

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Expectations and Adaptation: China's Foreign Policies in a Changing Global Environment

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National University of Ireland, Cork

Abstract

The financial and economic crisis of 2008 has highlighted the changing landscape of international relations and the enormous pressure on the People's Republic of China to redefine its international position. Based on two case studies, China's Africa policy and its response to the global financial and economic crisis, we argue that China's foreign policies are currently characterized by an adaptation of its historical role conception as a "leading developing country" to that of a "responsible caretaker" in international, especially economic affairs. In its own perceptions – developed in constant exchange with external perceptions of China – as well as in its actions, the PRC finds itself drawn faster and further into a complex web of global governance than anticipated by its policy elites. Acknowledging the benefits of a stronger involvement, the PRC steps up its engagement with regional, multilateral and global orders and is actively pursuing their recalibration. Contradictions within the Chinese leadership, conflicting themes in public discourse and incoherent actions highlight the difficulties even for a technocratic one-party elite with a limited – albeit real and important – need to assure domestic support and legitimacy to define the global role of an "emerging great power".

Keywords: *China, foreign policy, China and Africa, China and G20, Global Financial Crisis*

JEL classification: *F51, F55, F59, G01*

1. Introduction[1]

The financial and economic crisis that erupted in the United States in 2008 has highlighted the changing landscape of international relations. The People's Republic of China (PRC) found itself under enormous pressure to redefine its role in and contribution to global problem-solving. Earlier discussions on whether to contain or to engage the emerging superpower in the west (Mills, 1996; Shambaugh, 1996) gave way to analyses of how China's rise would determine the future international political system. More than three decades after the PRC embarked on its policies of economic growth, social change and the effective modernization of its one-party state, China has moved to the centre stage of the new global order (Breslin, 2007; Helleiner and Pagliari, 2010).

On a superficial glance, these changes in external role expectations regarding the Chinese leadership resembles the realization of their long cherished ambition to lead erstwhile leading global civilization back to its former glory. However, on closer inspection, China's leaders find the new situation rather difficult to deal with: the increased international prestige serves the Communist Party's leadership credentials at home, yet it challenges the officially restrictive interpretation of national sovereignty. Domestic and foreign expectations hardly ever match. In this paper, we argue that these divergent role expectations increase the complexity of policy-making in Beijing at a time when the Chinese leadership and society still predominantly views itself as a developing country.

On the international stage, the sometimes open, sometimes implicit negation of democratic norms and practices by the Chinese leadership reinforces views that a "Beijing Consensus" (Ramo, 2004) is undermining the current political, economic, social and cultural norms, values and institutions that support the US-led international economic, political and security order. The combination of "might, money, and minds" (Lampton, 2008) causes anxiety mixed with open hostility about the impact of China's (re-)emergence on the existing global political economy (US Congress, 2008). Based on an analysis predominantly within the framework of a neo-realist, balance of power oriented thinking, many observers in the United States and Europe tend to perceive China's rise as a challenge to an existing world order (Friedberg, 2005; Mitchell, 2009). Research by China-watchers provides a different perspective: a Communist party battling the effects of its reform policies, a party-state ripe with internal groups and factions in need of ongoing crisis-management and negotiations, muddling through on the basis of learning and adaptation.

The motivation behind actions of states is usually derived from interests and preferences or from external constraints. Following earlier works on the strategic-relational model in international relations (Brighi, 2007: 104-110), this paper argues that China's foreign policies are currently characterized by an adaptation of its historical role conception as a "leading developing country" to that of a "responsible caretaker" in international, especially economic affairs as a result of domestic policies as well as a changing global environment. In its own perceptions – developed in constant exchange with external perceptions of China – as well as in its actions, the PRC finds itself drawn faster and further into a complex web of global governance than anticipated by its policy elites. Acknowledging the benefits of a stronger involvement, the PRC steps up its engagement with regional, multilateral and global orders and is actively pursuing their recalibration. Contradictions within the Chinese leadership, conflicting themes in public discourse and incoherent actions highlight the difficulties even for a technocratic one-party elite with a limited – albeit real and important – need to assure domestic support and legitimacy to define the global role of an "emerging great power" (for an earlier version of this argument see Gottwald and Duggan, 2011).

Our line of argument is based on two case studies: China's Africa policy and its response to the global financial and economic crisis. In its Africa policy, the Chinese leadership had to broker ceasefires more than consensus among battling ministerial and super-ministerial bureaucracies at home while meeting increasing external pressure to change its formally non-interventionist no-conditions-attached approach in the face of US and European criticism. A change in its self-definition regarding its role in Africa as well as its cooperation with other powers can be identified. Preserving its clear priority for securing access to resources and building up influence, the Chinese leadership has gradually turned to implement less confrontational, more pro-activist policies.

In the global efforts to handle the financial and economic crisis, China had to give up its traditional role as a bystander to global cooperation. Rising domestic expectations regarding China's new international significance particularly among the politically important young online generation, the Chinese leadership has to strike a balance between increased integration into global governance and preservation of its room for manoeuvre. After some considerations, China seemed to take a pro-active approach in 2009 before a stalemate at the G20 summits in Toronto and Seoul deflated high-flying expectations. China's increased profile and growing influence in global economic governance is only gradually translating into a new order. The jury is still out whether or not China's engagement will actually reinforce US- and EU-based notions of global governance or turn out to be one more cornerstone in establishing a new model for political and economic governance. The strong support shown for the G20 might result more from the non-binding unanimous decision-making in this club-style organization than from a new found acceptance of multilateral institution-building for global governance (Johnston, 2008).

2. China's Rise as a Challenge to Political and Academic Analyses

When the CCP introduced reforms in the late 1970s, it began to infuse elements of a market economy into a socialist state by means of Leninist innovation (Heilmann, 2008). Its phenomenal economic development created an urgent demand for energy (EIA, 2006) and raw materials. The export-based growth model required access to foreign markets. The transformation of its centrally planned economy into a Socialist Market Economy resulted in a loss of control over various aspects of Chinese society (see Yeoh, 2010). Economic success and nationalism became the cornerstones of the CCP legitimacy which created strong societal expectations as to China's rank and status in world politics. This transformation of societal expectations, however, intertwined the Party's identity with China's overall national identity, and economic success. Socialism was thus redefined as good policies to raise the living standards of the people and to facilitate China's return to international "great power" status.

This required a revision of China's foreign policy guidelines. Zheng Bijian (2005) proposed to emphasize "China's Peaceful Rise" (Glaser and Menderos, 2007; Deng and Wang, 2005; Chan, 2005). This was subsequently changed to "China's Peaceful Development" (Luo, 2006) to avoid the supposedly aggressive connotations of the term "rise". "Peaceful development" complements the new interest in Chinese "soft power" addressing global unease with China's growing influence. Both concepts share the premise that good relations with China's neighbours will enhance rather than diminish the comprehensive national power of the PRC (Zheng, 2005). Both concepts resonate well with the long-standing tradition of imperial status-quo policies and the "five principles" (Wen, 2004) of "mutual respect for sovereignty and territorial integrity, mutual non-aggression, non-interference in each others' internal affairs, equality and mutual benefit, and peaceful coexistence" (Liu, 2003).

All the official emphases on the peaceful nature of China's new significance, however, are overshadowed by sensitive issues such as Sino-Taiwanese (Chen, 2005; Henderson, 2006) or Sino-Japanese relations (Johnston, 2006). The cross-cutting role expectations of the resulting rise in nationalism (Hughes, 2006) are a constant threat to gains from Chain's constantly growing participation in the East Asia's regional economy (Liao, 2006). The CCP needs economic growth which requires stable relations with important economic partners, turning China into a "fragile superpower" (Shirk, 2007).

The complexity of the internal and external dynamics of China's emergence is reflected in the diversity of theoretical approaches dealing with it. The majority of analyses recount the aims and calculations of *China* as a state or *Beijing* as a government, thus continuing the tradition of the rational actor model of analysis (Legro, 2008). It dovetails nicely with earlier historical approaches interpreting the PRC as an imperial reincarnation (Fairbanks, 1968; Osterhammel, 1989; Gelber, 2007). Stressing continuity, the "Middle Kingdom" resided on top of a hierarchical world and was the centre of tributary regional relations, claiming the status of the most civilized and greatest power. After the intermezzo of quasi-colonial exploitation between 1860 and 1949, its re-emergence constitutes a return to its traditional, one might argue "normal" position. Accordingly, China limits interactions with the rest of the world and defines terms and conditions. While the policies of opening-up and reform hardly fit into this perspective (Yuan, 2008), they still highlight the relevance of Chinese traditional values and norms in foreign policies. The leadership of the PRC often refers to history when explaining current policies (State Council, 2005). Chinese foreign policies thus become the blend of imperial history and orthodox Marxist-Leninist ideology (Liao, 1986) defined by (the) top Chinese leader(s) (Ming, 2007). In both the historical and the communist view, the key factor for China's foreign behavior is China itself. International forces come second.

The contemporary debate is dominated by (neo-)realist interpretations of China negotiating an anarchic international environment (Callahan, 2005; Goldstein, 2001; Wacker, 2006). Like all rising powers before, the PRC confronts the existing structure of international politics as part of its quest for survival (Morgenthau, 1985; Waltz, 1979). Most foreign and domestic media take a similar approach (Castle, 2008; Rozhnov, 2010). The neo-realist approach downplays the significance of domestic policies and expectations, a view taken by a growing number of China-watchers. Reaping massive benefits from the increased integration into the global economy (Gu, Humphrey and Meissner, 2008) the PRC participates in global governance and multilateralism to maintain that status quo (Chung, 2008; Contessi, 2009; Economy, 2005; Hughes, 2005; Johnston, 2003). All of these perspectives on China's rise have a common feature: they treat China as a unitary actor, either influenced by its own tradition and communist ideology or by some rational calculation as if China were a single individual and able to assess its environment, make decisions, and react accordingly. As a result, a strategy based on China's best interests is executed as foreign policies within a stable pre-set international environment.

Contrary to the predominant neo-realist view, most domestic experts and students of policy-making in the PRC consider social and political stability as a prerequisite for further economic development the number one priority for the Chinese leadership. Thus, all Chinese foreign policy is addressing domestic expectations first.[2] But domestic policies exhibit a growing number of conflicting interests within and around the CCP (Dreyer, 2010; Saich, 2005; Yang, 2005), thus questioning the concept of the PRC as a single unitary actor. Within the Chinese leadership and in the increasingly complex and pluralistic society, groups pursue particular interests, define specific preferences and create different power bases. Group interests in the field of foreign affairs can differ widely leading to sometimes incoherent, sometimes conflicting policy outcomes. For actors pursuing their aims, structures and institutions matter (Breslin, 2006). The PRC's global actions are thus shaped primarily by domestic political structures, secondary level institutions and negotiations between collective actors (Lampton, 2001, Lu, 2000). Different perceptions among Chinese elites affect international actions (Deng, 2008; Yan, 2001, 2006) particularly on issues like Taiwanese independence as do social trends and issues (Buzan, 2010).

Perceptual and institutional approaches look at China's rise in very different ways but they share a very important aspect: they open up the black box of the Chinese state and bring in bureaucratic policies, intra-elite conflict and processes of political bargaining. They complement the state-centric view by bringing in state-controlled and non-state actors like enterprises, regulatory agencies or the nascent civil society. Thus, they link up with the growing literature on global politics as a result of trans-national activity (Helleiner and Pagliari, 2010).

Following this approach, we interpret China's role in this process of joining and redefining global politics as a result of actions by Chinese leaders and non-state actors reacting to domestic and external expectations pursuing individual interests and preferences. We conceptualize China's position in global politics as a national role that is based on both domestic and external expectations regarding "appropriate behaviour". This approach highlights the mutual interdependence between China's policies towards the international order and the impact of the order on China's policies. It enables us to integrate external perceptions of China by state- and non-state actors alike, addressing causal alleys for adaptation and learning. We open up the domestic dimension by referring to the expectations of the domestic audience and, finally, allow for ideas, notions of historical traditions and interests to be integrated through the self-perception of the Chinese leadership regarding its role. Our approach thus identifies early signs of change as a form of partial role adaption taking place within an increasingly challenging global environment defined by the potentially deepest political-and economic crisis since the early 20th century. Linking it to the field of foreign policy change it offers an integration of recent approaches to the study of China's domestic policies discussed as learning or adaptive authoritarianism with current debates in the study of foreign and regional policies.

2.1. China's Changing Role in Africa the Balancing of Expectations

China has played a role in Africa since antiquity and was an actor of note during the cold war where its actions on the continent were heavily influenced by the ideology of socialist internationalism and anti-colonial struggle. Although its influence in Africa declined during the reform era of the 1980s, it has rediscovered its interest in the continent since the turn of the century and has once again become a major actor in the region. China is now Africa's second largest trading partner, a key supplier of development aid and a major source of FDI. A growing number of Chinese citizens have taken up residence in Africa. Summing up, in "the last sixty years, no country has made as big an impact on the political, economic and social fabric of Africa as China has since the turn of the millennium" (Moyo, 2009: 103).

China has become deeply involved with Africa both in terms of economics and culture and encompassing state, semi-state and non-state actors (Raine, 2009: 60). The Chinese state has acknowledged this and launched a new China-Africa Policy in 2006 (Foreign Ministry of the PRC, 2006) accompanied by a number of remarkable China Africa Summits in 2000 (Beijing), 2003 (Addis Ababa), 2006 (Beijing), and 2009 (Sharm el-Sheikh).

The foreign perception of China's role in Africa has frequently been negative, even referring to neo-colonialism. Sighting such actions as the unconditional provision of finance, selling of arms, or the protection of "rogue states" from international sanctions, many critique China for its negative impact on African society and economy. Some observers also accuse the PRC of instrumentalizing its traditional emphasis on sovereignty and non-interference to carve out economic deals (Holslag, 2006).

From an African perspective, China's involvement is regarded a mixed blessing. The PRC seems to use Africa as a resource both in terms of raw materials and international influence. From this point of view, China has damaged many of the rights won through independence e.g. workers right, free press, etc. Here, China has simply replaced the old colonial powers in spite of its claims to be a leader of the developing world, with Sudan being a prominent case in point (Srinivasan, 2008). A different view depicts China as an alternative source for investment and aid to western powers. It has also delivered on needed infrastructure projects which delivered significant improvements to the lives of many people in Africa.

Within China itself, the principal view held describes the PRC as Africa's "All Weather Friend", whose presence creates a win-win situation for both (Xu, 2008). From this perspective, China's role is defined by a number of key principles outlined in the 2006 White Paper, most notably the respect of state sovereignty (cf. Zheng, 2010: 42-45). Due to the complex relationship between state and society in African nations, local elites emphasize the principle of non-interference in the internal affairs of sovereign states by external actors, too (Taylor, 2010). For many African states who have found the restructuring programmes under the Washington Consensus very difficult and for governments who have been marginalized by Western criticism of their human rights records, the PRC's interpretation of sovereignty is particularly attractive. Along with a shared experience of colonialism and imperial oppression, China provides an alternative role model and new legitimacy for African autocratic polities (Sicular *et al.*, 2007).

In contrast to this official definition, many Chinese observers take a less favourable approach. They insist that large foreign aid projects need to benefit the Chinese economy, since these funds could have been used domestically for internal poverty relief. For this reason, development projects must create "win-win" situations in substance and not only in rhetoric. Consequently, Chinese involvement in Guinea decreased in line with the fall of prices for copper and other raw materials highlighting the need for its external involvement not to produce costs at home (Polgreen, 2009). The Chinese government is pressed to publicly protect its interests abroad, including interventions in the domestic affairs of sovereign African states. So-called "soft" interventions were employed on several occasions to protect Chinese MNCs in Africa. In Namibia, the PRC government pushed for the release of a CEO who had been charged with corruption (Grobler, 2010). In Zambia, it threatened to pull out its investment should a candidate, Michael Sata, who was accused of anti-Chinese policies, win the presidential elections (BBC, 2006).

In the case of Chinese involvement in Sudan, Beijing substantially altered its role behavior over the course of the humanitarian crisis in Darfur. The PRC started with an obstructionist role in the Security Council, but eventually dispatched peacekeeping forces under a UN Security Council mandate (Huang, 2008). This policy shift indicated a delicate balance of two conflicting expectations, namely external role expectations on the one hand and the Chinese concept of "peaceful development" on the other hand. China's Africa policy had been based originally on the earlier model as a "leading developing country". On this basis, China in 2004 effectively diluted Washington's sanctions policy in the UN Security Council (UNSC). In January 2005, the PRC began to modify its policy due to the "Comprehensive Peace Agreement" and under heavy criticism from non-governmental groups and the Bush administration. China's abstention on Res. 1593 – which allowed for ICC investigations in Darfur – signaled for the first time that China would not always align with the Sudanese leadership and the Arab League on Darfur. Instead, and despite the establishment of the "China-Arab Cooperation Forum" the preceding year, Beijing even supported UNSC Res. 1679, which strengthened the African Union Mission in Sudan (AMIS), and justified its vote "on the basis of our political support for the AU" (UN-Doc. S/PV.5439, 16.5.06). While Beijing hesitated to embrace the AU position on Darfur, China launched a "Darfur initiative", appointing a Special Representative, pressuring the Bashir government and offering 275 engineers in support of the hybrid AU/UN mission (Evans and Steinberg, 2007).

Daniel Large suggested that China's Africa policy shifted to such an extent that it has led other actors to reconsider their conduct (Large, 2008:

74). First, the intervention by the Chinese President Hu Jintao appeared to have been instrumental in persuading the Sudanese leadership to take on a more constructive role towards the AU/UN mission. Second, the Chinese abandonment of its obstructionist policy in the Security Council arguably added pressure on Arab regimes to moderate their support for Khartoum. Right after China's policy shift 10 Arabian states decided to provide substantial funding for the AMIS operation. The Arab League itself persuaded the Sudanese government to accept the AU/UN force at the AL Summit in March 2007. Subsequently, Qatar, a key member of the AL, voted in favour of UNSC Res. 1769 which mandated the AU/UN mission in Darfur.

Other factors in the context of Sino-Sudanese relations also had their impact. The growing restlessness of the Southern Sudanese Government contributed to China's policy shift. The proposed referendum on independence in Southern Sudan in January 2011 might create a new independent state controlling the vast majority of Sudan's oil reserves (Srinivasan, 2008). Many believe that the growing Chinese engagement in Juba is therefore motivated by two factors: one, to address its acknowledged unpopularity and, two, to gain a more strategic political foothold in the South (Large, 2009). The contribution of the PRC to persuading Khartoum to accept the AU/UN Mission can thus be interpreted as an attempt to present itself to the future government of an oil rich South Sudan as a positive influence in the region.

This brief analysis of China's Sudan policy shows that a host of factors have contributed to how a country conducts its affairs on the international stage. We can see a shift from a broadly ego-based to a more comprehensive national role conception combining both ego- and alter-expectations. Increasing international pressure moved Africa higher up the policy agenda of the central leadership which beforehand had left much of its Africa policies to the various ministries and bureaucratic units. Positions and conduct were modified to meet the expectation of others, most notably the African Union. Moreover, China's increasingly active position in Africa – veto suspension, appointment of a Special Representative, dispatching peacekeepers – suggests the position has become "firmer" over time and will probably stabilize if counter-roles by significant others (the US, AU, AL) evolve accordingly.

The increase in Sino-African trade as well as in other economic activities has created a more complex relationship. The number of influences which affect how China conducts its activities in Africa has grown, with particular influences becoming more important than others. For example, the international pressure on the PRC to become a more proactive member of the global community, a 'responsible stakeholder' in the promotion of global standards and ethics, is now more influential than the domestic pressure to maintain China's role as an anti-establishment actor which still seems to bear a significant influence on the PRC North Korea policies. The Chinese leadership even qualified its adherence to the core principle of non-interference: President Hu Jintao has pointed out that China is now willing to intervene in other nations' internal affairs to protect its national interests, hinting at an incipient departure from the soft interventionism of the recent past. This move addresses domestic pressure to better protect Chinese interests abroad. At the same time, China has also shown a growing willingness to engage in international conflict-settlement. Its participation in peacekeeping missions indicates the growing awareness of external expectations and willingness to fulfill them – at least as long as they can be sold to its domestic audience as beneficial for China's long-term socioeconomic development.

3. Reluctant Crisis-Manager: China's New Role as a Stabilizer/Initiator of Global Financial Governance

The interplay of external and domestic expectations with the self-perceptions and preferences of the Chinese leadership became almost irritatingly obvious during the current financial crisis. The insolvency of the American investment bank Lehman Brothers in September 2008 triggered a chain-reaction of global financial turmoil. Governments all over the world struggled to prevent a melt-down of their financial systems. Most ended up with majority stakes in one or all of their former national champions. Greece and Ireland needed the support of the IMF and the EU to avoid a sovereign debt default. In Asia, Japan struggled to refinance its debt while in the US the Fed embarked on several rounds of quantitative easing fuelling fears of new speculative bubbles in emerging economies. Most governments agreed that the crisis required a well-coordinated global response. The leadership of the PRC found itself drawn deeper into the efforts of global crisis management than it had envisaged. A new and very substantial role emerged for the PRC and its hesitant government (Godement, 2009: 19).

In the perspective of comparative government, the PRC has been aptly described as a learning, adaptive authoritarian system, with the state dominated by the Leninist party apparatus (Shambaugh, 2008; Naughton, 2008; Niquet, 2009). Learning from its own history, from Western market economies and from the results of extensive experiments, the CCP has managed to strengthen its grip on the Chinese polity while at the same time introducing fundamental economic and social reforms (Brodsgaard and Zheng, 2006; Heilmann, 2008; Pearson, 2001; Zheng, 2010). The global crisis erupting in 2008 threatened the cornerstone of China's export and FDI oriented development. This has put the capabilities for adaptation of the Chinese polity to a severe test as there was no "best international practice" in dealing with this unprecedented event. And time was too short to conduct the usual set of trial-and-error policies. Besides, the crisis challenged and threatened China's preferred role as a benevolent bystander and generally non-committal supporter of multilateral global governance. It took the central leadership in Beijing some time to agree on a political reaction. They had to recognize that the "globalization of the crisis requires a globalized response" (Bergsten, 2008) even if it included a revision of China's traditional role in international relations.

3.1. China's Initial Reaction: Defending Its Role as Benevolent Bystander

China's economy was in particular good shape when the crisis hit (Sheng, 2010). Banking and financial services were government-controlled, partly state-owned and had only limited exposed to global turbulence. The balance sheets of the main banks are regularly propped up by the state coffers[3] and its securities markets offer only limited access to foreign investors while Chinese savers still face hurdles if they wish to keep their deposits outside the Chinese system (Zeihan, 2010). Some of the riskiest instruments were banned inside China. Overall, Chinese banks managed to escape the financial crisis with relatively low losses. Foreign exchange controls, vast foreign exchange reserves and an emerging consumer culture offered strong options for macro-economic countermeasures against the fall-out from the crisis.[4] Finally, the Chinese leaders had gained a reputation for its high-quality policy-making and were safe from electoral pressures. From a Chinese perspective, the financial crisis met an economy which was well-prepared to turn the challenge into an advantage (Sun, 2009).

For all these reasons China initially took its responsible bystander position when first signs of a financial crisis merged in the US in the first half of 2008. The original impression was that the events were an issue for Western capitalism (Warden and Stanway, 2008). Chinese leaders reassured their domestic audience of the strength of their own economy. Even after the global public discussed the events as an economic crisis, Chinese newspapers and magazines kept the official description as a Western *financial* crisis (Zheng, 2008). Only the official investments in US and European financial service companies and in US bonds raised public anger. The situation changed when Chinese exports started to dive. Acknowledging the fundamental threat of the crisis to its export-led growth model, the Chinese leadership finally accepted the need for political action. In a two-tier approach the CCP created a macro-economic stimulus package for the domestic economy and took a more pro-active approach towards reforming global governance for financial services.

Up to the crisis, China has been a rule-taker much more than a rule-maker in the area of financial services. This role dovetailed nicely with China's traditional approach to global governance best described as that of 'a benevolent bystander' to global governance who would adopt international norms and standards *à la carte* (Walter, 2010). In global trade, it was exactly the wish to become part of the rule-makers which pushed the Chinese leadership to achieve membership of the WTO even in the face of substantial domestic opposition (Fewsmith, 1999; Fischer, 2000). China's active participation in the Cancun conference on World Trade, its key support to the multilateral attempt of dealing with North Korea's nuclear weapons programme, China's support for the Chiang Mai Initiative or the founding of the Shanghai Cooperation Organization signalled a more positive perception of multilateralism among the Chinese leadership (Wu and Landsdowne, 2007).

Initially, the Chinese leadership voiced their support for global co-ordination, but refused to become too engaged (Wang, 2008; Zheng, 2008). Only after intensive domestic debate, and bowing to growing external pressure, the government in a first revision of its initial positions announced a 4 trillion renminbi yuan package to boost its domestic demand on Sunday, 9th November 2008 (Xinhua, 2008). The announcement addressed both audiences: the domestic one by reassuring them of government action against the fall-out from dwindling exports, and the foreign one by stressing the willingness of the Chinese leadership to preserve China as a centre for global economic activity (Niquet, 2009). At the same time, the central government loosened constraints on local government investments (Wu, 2010) and ordered the state-controlled banks to facilitate cheap credits (Anderlini and Hughes, 2010; Cavey, 2009; Chan and Chu, 2009). The international reaction was euphoric (Branigan, 2008). Only a few observers raised their concern, pointing at the paucity of information provided on the planned use of the funds. Some asked how much of the package constituted additional spending and how much of it was just a repackaging of already measures which had been planned and budgeted beforehand. China also refused steps to address what many perceived as a gross imbalance of the exchange rate between the managed RMB yuan and the fully convertible US dollar, referring only to the need to tackle global macro-economic issues. It stressed its reluctance to decrease the control of its currency when it announced an increase in exchange rate flexibility shortly before the Toronto summit but then had its large commercial banks buy US dollars in order to limit the appreciation of the renminbi.

The Chinese leadership attempted to declare the stimulus package the key element of China's contribution to the global crisis response. Leading cadres like Hu Jintao and Wen Jiabao reiterated that the measures would keep China growing and that a growing China provided a substantial resource for the more advanced economies in their attempts of reigning in the economic downturn (Xinhua, 2009a). The main points of reference and the by far most important partners for the PRC to develop and to revise their position in the global fight against the fall-out from the financial crisis were the United States and the European Union (Gottwald, 2010).

At the ASEM Summit in Beijing, China and the EU hammered out a joint position for the G20 Summit in Washington in November 2008. Prime Minister Wen Jiabao announced his support for the EU position on regulating global financial markets, highlighting a growing convergence between the two economic superpowers. From an internal perspective, Hu Jintao's speech in Washington defined the official approach of the PRC towards future regulation (FMPRC, 2008). On Wen Jiabao's visit to Europe in January 2009 and during the preparatory meeting of the G20 Ministers of Finance and Governors of Central Banks, China sought actively to coordinate its position with the US and Europe.

The Group of 20 leading industrial and developing countries, the G20, quickly superseded the old G8 to become the focal point for global crisis management.[5] As they reached beyond that contested exclusive club, the G20 became "de facto … the main global grouping of countries that is driving responses to the crisis". (Prasad and Sorkin, 2009) A China that "was very cautious about joining any multilateral or regional arrangements" (Yu, 2005: 5) to avoid any limitation of its sovereignty was proud to be a leading member of the G20 but kept a sceptical attitude towards committing to multilateralism.

3.2. China Reluctantly Adapting Its Role in the G20

For China's role in global crisis management, the London Summit in 2009 became a turning point. The United States, the EU and fellow emerging markets all explicitly called on the Chinese government to take a leading role beyond the stimulus package and "responsible investment" by joining the work of rewriting global governance rules for financial markets. This led to an increased debate in China about its dawning dominance in the new world order.[6]

Deciding on the best policy in these circumstances, however, proved difficult and complex. In theory, the centralized structure of the Chinese one-party-state allows for coordinated decision-making. China's position for the G20 was decided at the highest level of the CCPCC Political Buro. The preparatory documents were prepared under crucial involvement of the political strategy research department of the CCPCC.[7] At a meeting of 50 economists, the acting vice-head of the political strategy research department, Zheng Xinli, confirmed the official view that China's integration into the global economy, including global governance institutions like the WTO, was following the internal imperative of domestic reform and opening up. In this regard, the financial crisis was expected to further strengthen China's reform policies.[8]

Vice-Prime Minister Wang Qishan, the leading executive in the State Council in financial affairs, and even more so the finance ministry were initially sidelined.[9] Positioning China for the meeting of the finance ministers in London in March 2009, Wang stressed that keeping China's economy on a sustainable growth course would constitute a major contribution to global crisis management. Implicitly quoting Hu Jintao's remarks at the Washington Summit, he again underlined China's willingness to join hands with the global community to contain the effects of the downturn (Wang, 2009a). He added that China was now ready to take a more active role within the IMF under the implicit condition of a clear timetable for IMF reform to the benefit of emerging market member states (Wang, 2009b). China raised its profile within the Bretton Woods institutions by delegating and promoting highly-qualified experts. While this is a strong indicator about the growing importance of the IMF for Chinese policies, the exact reform plans are still under discussion. Even the official denunciation of a G2 global order is qualified by open expressions of disappointment regarding the European role which is predominantly perceived as weak and incoherent. The loose structure and non-binding nature of the G20 help to avoid a premature definition of Chinese positions.

For the Chinese foreign ministry, global crisis management was declared number one priority for the 2009. It called for a better structured and fairer global financial order.[10] Together with Brazil, Russia and India it requested a stronger representation of the BRIC countries in the emerging new governance of global financial markets (Mo, 2009). The top candidate for the future secretary-general of the CCP, Xi Jinping, was sent out on a tour to Latin America and Malta that was described in the official Chinese media as a major contribution to defining the Chinese position regarding the global crisis, the limited role of its host countries in the world economy notwithstanding.[11] When Wen Jiaobao expressed his dissatisfaction with the American safeguards for PRC investment in treasury bonds, he triggered a global discussion and a quick response by the Obama administration. In various meetings and phone calls, the new US government promised to protect China's interests.[12] According to Hong Kong media, Wen needed to assuage his domestic constituency who became is increasingly irritated with the high exposure of the PRC to American bonds. Even the top central leadership was supposedly shocked when it was informed about the investments taken by the Chinese state vehicles in US financial institutions.[13] On the other hand, top-down Chinese analysts emphasize the opportunities the crisis offers to improve Chinese investments abroad (Zheng, 2009).[14] In the run-up to the London summit, the central bank stirred up confusion among observers with its call for a replacement of the US dollar as the global lead currency through a reform of the IMF special drawing rights, a little known instrument.

With the London Summit in April 2009, the G20 clearly took over the key role in coordinating the global response and in reforms of global financial governance. It defined steps towards a comprehensive reform of principles and organization guiding the IMF and World Bank, something China had called for long before the crisis. The push by the UK government to set up the G20 as a leading organization, calling the IMF a supporting infrastructure (Norman, 2010) further corresponded with traditional Chinese preferences regarding sovereignty and supranational commitments. The PRC duly strengthened its involvement. The G20 offers the Chinese government its preferred mechanism for decision-making (Garrett, 2010): unanimity, thus providing a de facto veto-power against any measure deemed unacceptable. Committing to a club, rather than to a multilateral organization with supranational elements, allows the leadership to preserve considerable autonomy within the G20 while at the same time selling its new, higher profile to its domestic audience as a symbol of strength and to the international audience as enhanced responsibility.

This policy was reflected both in China's preparations for the G20 summit in Pittsburgh and for Toronto in 2010. In Pittsburgh, Hu Jintao reiterated three main issues: the G20 should continue to coordinate macro-economic stimulus to secure sustainable economic growth, to implement the reform package for global financial regulation agreed at the London summit, and it should also address imbalances in the global economy rooted in the wide gap in development between the North and the South (FMPRC, 2009a). His final point again deflected criticism of China's state-managed exchange rate considered to be one of the causes for the crisis by Western observers. Hu stressed the significance of China's domestic policies and reiterated China's substantial contribution to the global response in spite of its severe domestic challenges. The official English language report did not refer to multilateralism or China's increased role in setting the rules for global governance (FMPRC, 2009b),[15] but the stronger representation within IMF and World Bank and the enhanced influence on the future of global governance for the emerging states was hailed as the major success even as the details of the reform still need further consideration (Xinhua, 2009).

At the G20 meeting of finance ministers and central bank governors before the Pittsburgh summit, the Chinese delegation provoked criticism at home and by foreign media for its refusal to hold press briefings. Instead, key statements were disseminated via official Xinhua news bulletins, very much to the dislike of foreign and Chinese media (Poon, 2009; Zhang, 2009). However, Chinese delegations held press meetings when Hu Jintao participated in meetings. This indicates the strict limits for the ministry of finance and the central bank to produce statement on key economic policy issues; those are reserved to the top echelon of the party state. At the same event, the BRIC countries did not follow their tradition of holding a separate meeting of finance ministers leading to a joint communiqué. Instead, only vice-ministers of finance came together without an official document being produced. This was interpreted as a sign that the rather effective cooperation among the most important emerging economies during the crisis was beginning to fade away (Poon, 2009). China's attempt to position itself as a leading representative of emerging and developing countries suffered from its reluctance to discuss exchange rates which the leadership only changed shortly before the Toronto summit.

After the Pittsburgh summit, optimistic foreign expectations of China's commitment were disappointed. The willingness of the PRC leadership to cooperate was publicly called into question. The IMF complained that a progress report on national stimulus packages was blocked by China. Five heads of government took the unusual step to address the members of the G20 in a joint letter containing hardly disguised criticism of China's vanishing enthusiasm for the G20 and its reluctance to honour its commitments (Giles and Beattie, 2010).

In Toronto, the official Chinese position comprised four proposals: first, that the summit would send out a loud and clear signal to keep the global economy on track for recovery; second, that the summit would come to a shared understanding regarding the reform of global financial governance, strengthening the representation of emerging markets and developing countries; third, to enhance support for the least developed countries; and finally, to come up with a substantial push for the global trade talks to prevent a return to more protectionist trade policies (Zheng, 2009). Strengthening the voice of developing countries in the Bretton Woods organizations was explicitly called one of China's own objectives for the work of the G20. In addition, the BRIC countries including China called for a fairer representation at the highest level of management in IMF and World Bank. The summit itself, however, was dominated by the rift between US and European governments on the phasing-out of loose fiscal policies to sustain economic recovery. In sharp contrast to earlier events, the Chinese position and statements from Chinese leaders hardly figured in international press reports after the summit.

A rapidly inflating property bubble and growing social disparities at home reduced the resources the Chinese leadership had at its disposal for global cooperation. The G20 seem to have dropped down the list of priorities of the central leadership. The government of the PRC is caught between a rock and a hard place: a domestic audience expecting tough actions on social and economic development, including the maximum use of national resources for the development of China's economy on the one side, and increasingly critical American and European audiences pushing for China to tackle issues of market openness, the exchange rate and adherence to international norms and standards.

4. Conclusion

China's national role conception includes, as we have shown, elements of both cooperation and conflict with key international actors. To the extent that China's domestic development and thus the security of the CCP regime is concerned, Beijing's role taking is a function of expectations by a host of different and diverging domestic political actors, both within the government and beyond. This results in a balancing act in China's foreign policy between internal and external forces. This often results in contradicting action by the PRC as polices are adopted to meet these factors. China is in the process of adapting its internal policies to external standards while at the same time pursuing strategies to set new global standards close to its domestic ones.

In its Africa policies, China finds itself in transition between presenting itself as guardian of the developing/third/non-aligned world and becoming a leading member of the club of the most powerful nations. Its power base, however, still lies with the developing and newly emerging world, particularly with the other BRIC countries. China has moved towards meeting some international norms and standards, particularly in the run-up to the Beijing Olympics. This in itself, however, is not necessarily a positive development as it has brought about increasingly open and proactive interventions in other nations' domestic affairs. When protecting the interests of state-owned and state-controlled enterprises, the PRC often fails to live up to its rhetorical commitments on sovereignty.

China's response to the Global Financial Crisis highlights the difficulties for the leadership to deal with its strong involvement in the US economy while at the same time rejecting notions of becoming one half of a G2. A young urban population calls increasingly for a policy of using Chinese resources for the benefit of the PRC and for counteracting a perceived US supremacy. US and European governments, however, pressure and lobby the Chinese leadership to take on a more cooperative and pro-active role in global governance. While China's government clearly sees the advantages of increasing its influence on the reform of global financial markets, it has benefited enormously from the "old" US-backed form of globalization. Defining a coherent strategy of reshaping the global order in finance seems to be beyond Beijing's resources at the moment. Its policy so far rather follows the traditional step-by-step learning-by-doing approach which has been implemented so successfully in domestic reforms over the last three decades.

Most of the public and considerable parts of the academic debate on China's role in global policies turn around the impact of its rise on the existing world order. Most China watchers would be cautious to project past successes in socioeconomic modernization into the foreseeable future. In the realm of international relations, however, the question only too often seems to be *when* China will be the next superpower, rather than *whether* it will manage to obtain this status. A world ruled by China (Jacques, 2010) is perceived as an explicit departure from Western norms, standards and experience. Using a role model approach provides a different picture. The unitary state PRC with its CCP leadership finds it increasingly difficult to navigate between external and domestic expectations. Demands from domestic audiences quite often do not fit over-optimistic foreign expectations and challenge the decision-making and diplomatic stamina of the Chinese leadership.

In the reform of the global governance of financial markets, the Chinese leadership had to revise its position on several occasions: from flatly referring the crisis to Europe and the US first via creating its own huge stimulus package to rhetorically taking a lead in the reform of IMF and World Bank (while committing only limited financial resources), to significantly tuning down again its cooperative stance after the Pittsburgh summit. While the domestic audience may welcome China's higher profile as a sign of return to superpower status and of the decline of the US, the property bubble, the debt burden of local authorities and growing social imbalances all lead to calls from the domestic audience for a clear focus on China's economy rather than on the reform of global governance. A Chinese specialist put it bluntly: "We do not have the time to care much about G20. Our domestic problems are too demanding."[16] An attempt to balance these conflicting sets of expectations is becoming increasingly difficult for the Chinese leadership. Yet the traditional priority to put domestic issues first has not changed.

Looking ahead, the difficulties to create and execute a coherent set of policies to tackle the challenges of its increasing integration in the global economy, society and polity will grow further. China's CCP increasingly encompasses conflicting social interests and political tendencies. In the run-up to the next National Party Congress in 2012, at least two main groupings have been identified so far, and competing efforts of party leaders to position themselves for future leadership posts have already had an impact on key policy issues. No matter how these personnel and policy issues are going to be resolved, the co-existence of divergent interests within the leadership is going to add further complexity to the challenge of revising China's role in global affairs.

Notes

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2. Interviews in Beijing and Shanghai, 2009; in Beijing, 2010.
3. In February 2009, the government announced plans to transfer US$30 billion to the Agricultural Bank of China. See Ftd online, "China päppelt Bauernbank mit Milliarden" <*http://www.ftd.de/politik/international/:Neues-Konjunkturpaket-China-p%E4ppelt-Bauernbank-mit-Milliarden/468766.html*> [10th February 2009]. According to *The Economist*, from 1998 to 2005, China has propped up the balance sheets of its major banks by US$260 billion.
4. These assets are mostly US-dollar denominated thereby creating, the so-called "dollar-trap", because their value will most likely diminish as the US has to face its growing public deficit.
5. The G20 originated as "an informal forum intended to promote dialog between the industrialized and the developing countries with the aim of global economic stability. Annual meetings of their finance ministers and central bank governors had started in 1999 with their deputies meeting twice annually. Members of the G-20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States" (Fues, 2007: 14; see also Bergsten, 2004).
6. See for example "China Bids for Yuan to Trump US Dollar", in *Caijing*, 28th November 2008.
7. See "Zhongguo Zhongyang Zuzhi Tu" <*http://cpc.people.com.cn/GB/64162/64163/6418742.html*> [20th March 2009].
8. See "Zhonggong Zhongyang Zhengce Yanjiushi Fuzhuren Zheng Xinli Yanjiang" <*http://finance.sina.com.cn/hy/20090216/19575861569.shtml*> [20th March 2009).
9. Interview with Chinese analysts, 19th March 2009.
10. Said Foreign Minister Yang Jiechi at a press conference in Beijing on 7th March 2009. See "Zhongyang Zhengfu Menhu Wangzhan" <*http://www.gov.cn/2009lh/content_1254270.htm*> [10th March 2009].
11. "Vice FM: Chinese VP's Visit Boosts Consensus, Friendship, Co-op", 24th February 2009 <*http://www.gov.cn/misc/2009-02/24/content_1240628.htm*>.

12. According to some experts in China, pressure from Beijing supposedly contributed to the decision to give a state guarantee for the biggest provider of mortgages in the US. Interviews in Beijing and Shanghai, May/June 2009.
13. See "Wen Jiabao yu Hanhua Shengdun" <*http://cn.chinareviewnews.com/crn-webapp/search/allDetail.jsp?id=100919047&sw=20%E5%9B%BD%E9%9B%86%E5%9B%A2*> [20th March 2009].
14. See f.e. Zheng Xinli as quoted in *sohu.com* <*http://news.sohu.com/20090305/n262610819.shtml*> [20th March 2009].
15. The full text in Chinese is available at <*http://www.cnr.cn/09zth/hjtcxlhgxlfh/xinbaodao/200909/t20090926_505487927.html*> [12th April 2010].
16. Interview at the Development Research Centre, Beijing, May 2010.

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Technical Efficiency of Commercial Banks in China: Decomposition into Pure Technical and Scale Efficiency

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Abstract

This study examines the technical efficiency of commercial banks in China during the period 2001-2007 by employing the non-parametric approach, namely, Data Envelopment Analysis (DEA). Technical efficiency is furthered decomposed into pure technical and scale efficiency to determine the sources of inefficiency of the commercial banks in China. Results found that commercial banks in China on average are relatively technically inefficient. In addition, technical inefficiency of the commercial banks in China has its origin in pure technical inefficiency. This means that the commercial banks are facing problem in the allocation of resources between its input and output mix. A significant reduction in technical efficiency is found in foreign-owned commercial banks from 2003 to 2006. This might be due to higher operation costs for employing more factors of production in their expansion process after China entered WTO and the gradual deregulation in the banking system.

Keywords: *commercial banks, technical efficiency, DEA*

JEL classification: *G21, D21, C14*

1. Introduction

Banking industry in the developing countries has long been recognized for its role as a channel of monetary policy transmission due to the under-developed capital market. Firms in these countries depend heavily on bank lending to finance their business activities. Therefore, efficiency of the banking system remains an important issue in developing countries to guarantee the smoothness of the monetary policy transmission process and also to provide better pricing and services to the banking customers.

China's legal and financial systems are not well-developed and lag behind the standard of most developing nations (Berger, Hasan and Zhao, 2009). Hence, the Chinese banking system might be extremely vulnerable in terms of long-term survival especially after China entered the World Trade Organization (WTO) in December 2001. In addition, Cull and Xu (2005) found that the inefficient banking sector together with poor legal and financial infrastructure affected the economic development in China and hence, the banking industry needed to improve its efficiency level so that it could further contribute to the country's economic expansion. Consequently, this study aims to estimate the technical efficiency of the commercial banks in China from 2001 to 2007 by employing a non-parametric approach, namely, the Data Envelopment Analysis (DEA). Hence, this study focuses on the Chinese banking efficiency after China's entry into WTO. Next, the study further decomposes the technical efficiency into pure technical and scale efficiency in order to identify the sources of inefficiency of the commercial banks in China.

Even though China had maintained high growth during the past decades, this might not continue indefinitely without an efficient banking system. According to Berger, Hasan and Zhao (2009), China's high growth rate was mainly due to the excess funds available for investment as a result of high savings rates and trade surpluses. Therefore, efficient allocation of funds is being viewed as unnecessary as compared to the other developing countries that were faced with a shortage of funds. Nevertheless, such imbalances might not lead to the long-term sustainability of economic performance in China. Therefore it is crucial for the country to strive for efficient allocation of resources through an efficient banking system.

In addition, commercial banks in China have been facing intense competition brought by the foreign banks in the recent years as a result of the deregulation of foreign entry under WTO. Therefore, bank managements should carefully plan their banking operations in order to guarantee the long-term survival of the Chinese banks in both domestic and international markets. Thus, this study intends to provide a better understanding to the banks' decision-makers of their status quo in the national banking industry and further assist them in making an appropriate adjustment in managerial policies to improve the banks' efficiency level.

Section 2 provides a brief background of the Chinese banking system while Section 3 reviews the studies of banking efficiency in China. The method employed to estimate the banks' efficiency scores is presented in Section 4, together with the discussion on the variables employed in this study. Section 5 discusses the findings of the study. Section 6 concludes.

2. Background of China's Banking Industry

The Chinese banking system is dominated by four large state-owned banks which accounted for more than half of the banking industry assets in China (Table 1). Besides that, the state-owned banks have been relatively inefficient and characterized by a huge amount of non-performing loans as a result of lending directed by the local authorities. Consequently, the banking sector reform in China is lagging behind reforms in other economic sectors.

Table 1 shows the total assets of banking institutions in China from 2003 to 2007. Table 1 indicates that there is a gradual reduction in the percentage of total assets of the state-owned commercial banks in the Chinese banking industry. In addition, Table 1 also shows an increase in the percentage of total assets of joint-stock commercial banks and foreign-funded banks among the banking institutions over the years. These might be due to the further deregulation process in the Chinese banking system with the lifting of geographic and customer restrictions together with other non-prudential restrictions on foreign banking operation on 11th December 2006 (*Almanac of China's Finance and Banking 2007*). The increments might enhance the competition level of the banking industry and eventually create the awareness of the banks to further improve their operation level for long-term sustainability. This is proven with the reduction of non-performing loan ratio of the major commercial banks from 23.7 per cent at the end of 2002 to 7.5 per cent at the end of 2006 (*ibid*.).

3. Literature Review

Studies on the technical efficiency of the Chinese banking system are limited and were mostly done in the early 2000s. Wei and Wang (2000) studied the technical efficiency of the commercial banks in China and found that on average, the newly founded banks were relatively more technically efficient than the state-owned commercial banks. The result is supported by Zhao, Zhong and Jiang (2001) and Kumbhakar and Wang (2005) who found that the state-owned banks were least efficient as compared to other banking institutions in the country. Besides that, Kumbhakar and Wang (2005) also found that there was a positive relationship between bank efficiency and financial deregulation.

In terms of cost efficiency, Chen, Skully and Brown (2005) compared the cost efficiency of the Big Four state-owned commercial banks with the state-owned joint equity banks in China from 1993 to 2000 using the Data Envelopment Analysis method. Their findings suggest that the Big Four state-owned commercial banks and smaller joint-equity banks were relatively cost-efficient compared to the medium-sized joint-equity banks. Besides that, their results also supported the view of Kumbhakar and Wang (2005) that financial

Table 1 Total Assets of China's Banking Institutions, 2003-2007 (100 million yuan)

	2003		2004		2005		2006		2007	
	Total	%	Total	%	Total	%	Total	%	Total	%
Policy banks	21,247.0	7.68	24,122.5	7.63	29,283.2	7.82	34,732.3	7.90	42,781.0	8.13
State-owned commercial banks	160,511.7	58.03	179,816.7	56.91	210,050.0	56.06	242,363.5	55.15	280,070.9	53.25
Joint stock commercial banks	29,598.6	10.70	36,476.0	11.54	44,654.9	11.92	54,445.9	12.39	72,494.0	13.78
Urban commercial banks	14,621.7	5.29	17,056.3	5.40	20,366.9	5.44	25,937.9	5.90	33,404.8	6.35
Rural commercial banks	384.8	0.14	565.4	0.18	3,028.9	0.81	5,038.1	1.15	6,096.7	1.16
Rural cooperatives banks	–	–	–	–	2,750.4	0.73	4,653.6	1.06	6,459.8	1.23
Urban credit cooperatives	1,468.3	0.53	1,786.8	0.57	2,032.7	0.54	1,830.7	0.42	1,311.7	0.25
Rural credit cooperatives	26,509.2	9.58	30,767.0	9.74	31,426.7	8.39	34,502.8	7.85	43,434.4	8.26
Non-bank financial institutions	9,100.0	3.29	8,726.8	2.76	10,161.9	2.71	10,594.1	2.41	9,717.0	1.85
Postal savings bank	8,984.4	3.25	10,849.6	3.43	13,786.8	3.68	16,122.0	3.67	17,687.5	3.36
Foreign-funded banks	4,159.7	1.50	5,822.9	1.84	7,154.5	1.91	9,278.7	2.11	12,524.7	2.38

Source: *Almanac of Banking and Finance 2007*.

deregulation contributed positively towards bank efficiency especially in the mid-1990s. Similar conclusion was also reached by Fu and Heffernan (2007) who found that cost efficiency of banks was higher during the first phase of bank reforms. However, Fu and Heffernan (2007) found that the joint-equity banks were more cost-efficient than the Big Four state-owned banks. Furthermore, cost efficiency increased with the listing of banks' shares in the stock market.

Ariff and Can (2008) analyzed both cost and profit efficiency of Chinese commercial banks together with the influence of ownership type, size, risk profile, profitability and other key environmental variables on bank efficiency. Using data from 28 commercial banks in China from 1995 to 2004 and employing the DEA techniques, they suggested that Chinese banks were relatively cost-efficient than profit-efficient. Their results were consistent with the findings of Fu and Heffernan (2007) which found the joint-stock banks to be more efficient in both cost and profit as compared to the state-owned banks. This might be due to the fact that joint-equity banks were characterized by better asset quality as compared to the state-owned commercial banks (Yao, Han and Feng, 2008). They also found that the least cost- and profit-efficient banks were more risky, incurred higher operating costs and had more subsidized capital. Fee-based activities were found to have enhanced the efficiency level of the commercial banks in China.

Next, Hu, Su and Chen (2008) examined the cost efficiency of China's nationwide banks by taking into account the effects of the environmental variables. By manipulating the DEA techniques in the estimation of efficiency scores, they found that there was no significant difference of cost efficiency across the banks. They found that nationwide joint-equity commercial banks exhibited higher technical and scale efficiency as compared to the state-owned banks. Their results suggest that the banks' efficiency has declined after the WTO accession and the Asian Financial Crisis in 1997.

Majid, Zulkhibri and Fadzlan (2008) studied the relationship between the efficiency level of China's banking sector and share price performance from 1997 to 2006. The results suggest that ownership structures contributed to the different levels of technical and scale efficiency of commercial banks in China. Besides that, the bank efficiency level depended on bank management quality, size, and bank's diversification towards non-interest income. This is consistent with the findings of Ariff and Can (2008) that fee-based income activities increased the efficiency level of the commercial banks. In addition, the changes in stock return were found to be influenced by the banks' technical efficiency level.

A recent study by Berger, Hasan and Zhao (2009) compared the cost and profit efficiency of the banks in China in relation to different types of ownership structures. By employing data from 38 commercial banks operating in China from 1994 to 2003, they found that foreign banks were more efficient in both cost and profit and this was followed by private domestic banks. Besides that, their results also found that financial reforms which reduced the state-ownership of banks and increased the role of foreign banking had contributed positively towards the increase in the efficiency level of all the banks in China. Even though the state-owned banks were found to be highly cost-efficient, the results suggest that the banks were less effective in their lending activities. Berger, Hasan and Zhao (2009) highlighted that the banks were practicing skimping behaviour in lending which resulted in a huge amount of non-performing loans in the state-owned banks which contributed to lower revenues.

4. Methodology

This study employs the Data Envelopment Analysis (DEA) to estimate the technical efficiency scores of the commercial banks in China. Besides that, the study further decomposes technical efficiency into pure technical and scale efficiency in order to locate the source of inefficiency. DEA was first introduced by Charnes, Cooper and Rhodes (1978), based on the concept of Pareto efficiency. It is a mathematical approach that is used to develop the production frontier to estimate the efficiency of a particular firm (Casu and Molyneux, 2003). The most efficient banks are said to operate on the frontier and banks below the frontier are considered to be relatively inefficient as compared to the benchmark banks. The main advantage of DEA as compared to the econometric approach is that it does not require *a priori* functional specification of the unknown technology (Fukuyama, 1993; Favero and Papi, 1995).

Banker, Charnes and Cooper (1984) further revised the DEA model and introduced the BCC model which allows for further decomposition of technical efficiency into pure technical and scale efficiency. This study manipulates the input-oriented BCC model with the assumption that a bank chooses to minimize the factors of production given the output level. Equation (1) shows the BCC model for technical efficiency:

$$
\begin{aligned}
&\theta^* = \min \theta \\
&\text{subject to} \\
&\sum_{j=1}^{n} \lambda_j x_{ij} \le \theta x_{io} \qquad i = 1,2,\ldots,m \\
&\sum_{j=1}^{n} \lambda_j y_{rj} \le y_{ro} \qquad r = 1,2,\ldots,s \\
&\sum_{j=1}^{n} \lambda_j = 1 \\
&\lambda_j \ge 0 \qquad\qquad j = 1,2,\ldots,n
\end{aligned}
\tag{1}
$$

where DMU_0 represents one of the *n* DMUs under evaluation, and *x* and *y* are the *i*th input and *r*th output for DMU_0, respectively. λ are unknown weights, and j = 1, 2, … *n* represents the number of DMUs. The optimal value of θ^* represents the distance of the banks from the efficient frontier. Therefore, the most technically efficient banks are said to have $\theta^* = 1$ and the inefficient banks will have a $\theta^* < 1$.

The sample of this study consists of the selected commercial banks in China from 2001 to 2007. Therefore, the study focuses on the technical efficiency of commercial banks in China after China entered the WTO.

This study employs the intermediation approach by treating bank deposits as an input for the production of financial outputs. It focuses on the traditional banking activities conducted by commercial banks in China, namely the efficiency of the banks in deposit-taking and lending activities. Therefore, the banks' outputs employed in this study are total loans and total investments. The input vectors employed in this study consist of other non-interest expenses, fixed capital and total deposits. Other non-interest expenses are used as a proxy for personnel costs due to the unavailability of personnel costs in the financial statements of the China's commercial banks. Fixed capital is used as the input for capital. Finally, total deposits are used to represent the financial inputs that produce financial outputs. All the data in the analysis are obtained from the banks' annual reports which can be downloaded from IBCA Bankscope. All outputs and input vectors are in USD million.

5. Results and Discussion

The technical efficiency of commercial banks in China is estimated based on the BCC model and further decomposed into pure technical and scale efficiency. Table 2 presents the summary statistics of the technical, pure technical and scale efficiency of the commercial banks in China estimated from 2001 to 2007.

Table 2 Overall Technical, Pure Technical and Scale Efficiency of Commercial Banks in China, 2001-2007

	Technical Efficiency	Pure Technical Efficiency	Scale Efficiency
Mean	0.3142	0.3789	0.8652
Standard Deviation	0.2281	0.2660	0.1585
Minimum	0.0810	0.0950	0.1700
Maximum	1.0000	1.0000	1.0000

Based on the results in Table 2, commercial banks in China are found to be relatively technically inefficient with a reported average efficiency score of 31.42 per cent. This means that commercial banks in China could further reduce their factor of production by 68.58 per cent by maintaining the same output level. Besides that, the reported standard deviation of 0.2281 shows that there is a large dispersion in terms of technical efficiency among the commercial banks in China from 2001 to 2007.

Based on the decomposition of technical efficiency into pure technical and scale efficiency, the results show that the major sources of banks efficiency come from scale efficiency with an average efficiency score of 86.52 per cent. This means that banks' efficiency level increases with the scale of operation. A relatively low pure technical efficiency score suggests that commercial banks are pure technically inefficient and faced with misallocation of inputs and outputs in banking operation.

Next, the detailed analysis of technical efficiency according to the types of ownership is presented in Table 3. The average scores of technical, pure technical and scale efficiency of commercial banks in China are further divided into state-, foreign- and private-owned commercial banks.

Results from Table 3 indicate that foreign-owned commercial banks are relatively technically efficient and this is followed by the state-owned banks and finally the private-owned commercial banks. The results hold for the period from 2001 to 2007. Generally, foreign-owned commercial banks reported a higher average pure technical and scale efficiency score as compared to the state-owned banks and private-owned commercial banks in China.

The private-owned commercial banks are relatively least efficient and this is mainly resulted from pure technical inefficiency. This means that private-owned commercial banks in China experienced misallocation of resources between the inputs and outputs. Therefore, the bank management should re-evaluate their management strategies to further improve the banking operations.

Besides that, Table 3 also shows that the state-owned and domestic private-owned commercial banks in China experienced a reduction in technical efficiency during the period from 2001 to 2002. The state-owned commercial banks experienced a reduction in technical efficiency of about 6.44 per cent but started to increase back in the subsequent years.

On the other hand, the foreign-owned banks' technical efficiency increased by 7.70 per cent during the period from 2001 to 2002. However, the reduction in technical efficiency can be seen in the period from 2003 to 2006. Relatively low technical efficiency is found to be a result of lower pure technical efficiency scores in these years due to the mismatch in the production mix. This situation might be due to the further deregulation by

Table 3 Technical, Pure Technical and Scale Efficiency of Commercial Banks in China, 2001-2007

	2001	2002	2003	2004	2005	2006	2007
				Technical Efficiency			
State-owned	0.3753	0.3109	0.3188	0.3323	0.3824	0.3551	0.4452
Foreign	0.5138	0.5908	0.5108	0.4260	0.3912	0.4072	0.5569
Private	0.2738	0.2727	0.2788	0.2831	0.2837	0.2788	0.3104
				Pure Technical Efficiency			
State-owned	0.5757	0.4393	0.4543	0.4936	0.6065	0.5918	0.7163
Foreign	0.6808	0.6625	0.6712	0.5309	0.4279	0.4317	0.6171
Private	0.3140	0.3253	0.3246	0.3240	0.3226	0.3201	0.3592
				Scale Efficiency			
State-owned	0.6710	0.7737	0.7525	0.7241	0.6801	0.6858	0.6572
Foreign	0.8258	0.8565	0.7840	0.8040	0.8966	0.9306	0.9011
Private	0.8809	0.8922	0.8964	0.9010	0.8945	0.8741	0.8845

China's government that had encouraged more foreign banks to set up their subsidiaries and branches in the country. When the foreign banks expand their businesses, it will inevitably result in higher operating costs to employ more factors of production in their expansion process and thus, a reduction in technical efficiency in the short-run is unavoidable. In year 2007, it can be seen that the foreign-owned banks' technical efficiency improved by 14.97 per cent.

6. Conclusions

This study has examined the technical efficiency of commercial banks in China during the period from 2001 to 2007 by employing a non-parametric approach, namely, the Data Envelopment Analysis.

The results show that the commercial banks in China on average are relatively technically inefficient. This might be due to the underdeveloped banking system in the country and as highlighted by Berger, Hasan and Zhao (2009), China's legal and financial systems are not well-developed and not up to the standard of most developing nations.

In addition, the decomposition of technical efficiency into pure technical and scale efficiency shows that on average, the commercial banks in China are having problem in the allocation of resources between their inputs and outputs mix. This is especially true in the case of the private-owned commercial banks. The results here are consistent with the findings of Hu, Su and Chen (2008) that the private-owned joint-equity commercial banks are relatively pure technically inefficient. The misallocation of resources of commercial banking in China might be a result of management complacency in the banking operation because of less intense competition in China's banking industry. Therefore, the opening-up to foreign banking by the authorities might contribute to a more healthy and competitive environment.

A significant reduction in technical efficiency is found in the case of the foreign-owned commercial banks during the period from 2003 to 2006 with the source of inefficiency being pure technical inefficiency. The deregulation of China's banking system has encouraged foreign banks to set up their subsidiaries and branches in the country and thus, it has inevitably resulted in higher operation costs for employing more factors of production in their expansion process. Hence, a reduction in technical efficiency in the short-run cannot be avoided. Nevertheless, technical efficiency of the foreign-owned banks improved by 14.97 per cent in the year 2007. This clearly indicates that foreign-owned banks have gained from operational efficiency after having successfully established their banking operation in China.

Finally, the results of this study are consistent with the existing literature including Zhao, Zhong and Jiang (2001), Kumbhakar and Wang (2005) and

Hu, Su and Chen (2008), in which the foreign-owned commercial banks are found to be relatively technically efficient as compared to the state-owned banks. As stated by Majid, Zulkhibri and Fadzlan (2008), differences in ownership structures contribute to the different levels of technical and scale efficiency of commercial banks in China. Besides that, the results also show that financial deregulation and China's entry into WTO did benefit commercial banking in China as well as provide opportunities for the foreign investors to expand their banking business in China.

Note

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Taiwan-ASEAN Economic Relations in the Context of East Asian Regional Integration

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Abstract

The past years have witnessed a rapid growth of intra-regional trade and intra-regional investment, and a growing number of government-led FTAs in this region. Taiwan has also signed ECFA (Economic Cooperation Framework Agreement) with mainland China. However, as East Asian economic integration intensifies and China's role becomes more central, Taiwan increasingly feels that there is a double danger for it to be overly dependent on the mainland. Taiwan therefore has the intention to more diversify its economic relations and reduce its economic reliance on the mainland. Taiwan will play a more active and positive role in regional integration beyond ECFA. To further develop its cooperation with Southeast Asia is part of this strategy.

Keywords: *Economic integration, Taiwan, ASEAN, FTA, cross-Strait relations*

JEL classification: *F13, F15, F21, F53*

1. Introduction

The financial crisis of 2008-2009 badly hit the global economy, but East Asian economies maintained high growth rates. As China and some other emerging economies keep growing, East Asian regional economic integration has been accelerating these years. China has become a great engine for regional economic growth and integration in East Asia. Trade statistics show a declining dependence of East Asia's exports on the European and U.S. markets, and an increasing dependence on China and other Asian developing countries. Many East Asian economies have leveraged on China's rapid economic growth and deepened their regional economic integration. This trend will further develop as the Chinese government is making endeavours to adjust its development model from an export-led one to a domestic consumption-led model.

In June 2010, Taiwan singed ECFA (Economic Cooperation Framework Agreement) with mainland China. There is no doubt that ECFA will create new momentum for cross-Strait economic cooperation and deepen the bilateral economic interdependence. However, as East Asian economic integration intensifies and China's role becomes more central, Taiwan increasingly feels that there is a double danger for it to be overly dependent on the mainland. Taiwan's opposition party DPP (Democratic Progressive Party) keeps criticizing the Ma Ying-jeou administration's policy as being over-dependent on mainland China.[1] DPP Chairman Tsai Ing-wen insists that "Taiwan should not only develop bilateral exchanges between the two sides. Taiwan should utilize multilateral framework to face the rise of China together with other Asian countries."[2] Taiwan therefore has increasing pressure and intention to diversify its economic relations and play a more active and positive role in regional integration beyond ECFA. To further develop its cooperation with Southeast Asia is part of this strategy.

2. Growing Economic Integration in East Asia

The East Asian economies are very open to trade as their shares of exports in GDP recorded the largest increase from late 1990s to 2008. The past years have witnessed a growing economic integration in this region. This development trend has been reflected in the rapidly growing intra-regional trade, intra-regional investment and the mushrooming of FTAs.

2.1. Intra-regional Trade

Trade statistics show that East Asia is becoming increasingly integrated through merchandise trade. Table 1 shows a declining dependence of East Asia's exports on the European and U.S. markets, and an increasing dependence on China and other developing Asian countries, as mentioned in the introduction. Also observed is the East Asian economies' leveraging on China's rapid economic growth in recent years, as Chinese government's current adjustment of its development model from export- to consumption-led. In other words, China is transforming itself from a "world factory" into a "world market".

Cross-Strait trade has become a driving force for the intra-regional trade development in this region. The bilateral trade value increased from US$40 billion in 2002 to US$105 billion in 2008. Due to the 2008-2009 financial crisis, the bilateral trade decreased from US$105 in 2008 to US$86.5 billion in 2009.[3] As for the whole East Asia, the share of intra-regional trade (import

Table 1 Direction of East Asia's Exports (%)

	U.S.		Europe		Developing Asia		China	
From	2000	2007	2000	2007	2000	2007	2000	2007
China	20.4	16.4	16.1	14.6	32.9	33.1		
Hong Kong	23.0	13.8	15.5	12.8	10.2	10.7	34.1	48.4
Korea	20.9	11.2	13.7	12.6	23.8	21.4	10.2	21.2
Singapore	16.7	9.1	13.5	10.1	44.1	51.2	3.8	9.5
ASEAN	18.2	12.2	14.4	11.1	37.4	41.2	3.7	8.9
India	21.1	13.4	24.1	16.5	19.2	21.2	1.8	8.6

Source: "Regional Trade Policy Cooperation and Architecture in East Asia", ADB Working Paper Series, No. 191, February 2010.

Table 2 Intra-regional Trade in East Asia (%)

	East Asia	NAFTA	EU15
Export			
1987	29.3	45.1	66.6
2007	44.5	48.4	59.5
Import			
1987	41.5	31.8	66.3
2007	62.7	34.1	58.0
Intra-regional trade (export + import)			
1987	34.4	37.3	66.5
2007	52.1	40.4	58.7

Notes: 1. East Asia here includes ASEAN9 (excluding Myanmar), mainland China, Hong Kong, Korea, Taiwan and Japan.
2. This merchandise trade does not include oil and natural gas products (SITC3).
3. EU15 countries before EU enlargement in 2004 included Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, Sweden and United Kingdom.

Source: "Intra-regional Trade in East Asia: the Decoupling Fallacy, Crisis, and Policy Challenges", ADB Working Paper Series, No. 177, December 2009.

and export) in total non-oil trade reached 52 per cent by the year 2007, a share which is higher than that of the NAFTA and is approaching that of the EU15 (Table 2).

2.2. Intra-regional FDI

Intra-regional trade and growing commercial links in East Asia have substantially boosted intra-regional FDI, and the relative weight of the region's FDI sources has shifted. As Table 3 shows, while the U.S. played a leading role in the 1960s and 1970s, followed by Japan in the 1980s, their shares each declined to 8 per cent in 2008, while China's share increased from 0.1 per cent in 1981 to 13.3 per cent in 2008. Intra-regional investment now accounts for over 40 per cent of the total FDI stock of the region.

As new sources and recipients of intra-regional FDI have emerged, more countries and industries have been involved in the upgrading process. In

Table 3 Major Sources of FDI to South, East and Southeast Asia (million of US$; %)

Economies	1981		1991		2001		2008	
	Value	Share	Value	Share	Value	Share	Value	Share
Total	27659	100.0	141547	100.0	1123527	100.0	2305637	100.0
EU	5060	18.3	23131	16.3	143110	12.7	329537	14.3
US	6422	23.2	22046	15.6	112912	10.0	181287	7.9
Japan	5405	19.5	32099	22.7	100021	8.9	185445	8.0
China	29	0.1	575	0.4	125259	11.1	307469	13.3
Hong Kong	3298	11.9	23870	16.9	199974	17.8	328379	14.2
Korea	208	0.8	2539	1.8	18840	1.7	48419	2.1
Singapore	1146	4.1	4448	3.1	44971	4.0	74045	3.2
Taiwan	284	1.0	6729	4.8	43195	3.8	60967	2.6
Others	4567	16.5	20823	14.7	305941	27.2	734285	31.8

Note: The regional totals are based on data covering only 11 countries in 1981, 19 countries in 1991, 16 countries in 2001 and 19 countries in 2008, which account for most of the inward FDI in South, East and Southeast Asia.

Source: UNCTAD, *World Investment Report 2010*, p. 42.

the past years, following in the footsteps of Japanese TNCs (transnational companies), companies from NIEs had relocated their production operations within the region to take advantage of lower costs, thereby enhancing their competitiveness and promoting industrial restructuring. In recent years, while the contribution of Japan as a major driver of intra-regional investment has been declining and the strength of the NIEs as a whole has been relatively weakened by the recent crisis, China has become a main source of global FDI outflows and its role in the region has been expanded. Its total outward FDI in 2009 reached US$56.5 billion.[4]

China is playing a multifaceted role in the current process of industrial restructuring and upgrading in Asia. Within the country, a new round of industrial upgrading is taking place. Some low-end, export-oriented manufacturing activities have been shifting from coastal China to a number of neighbouring countries, while efficiency-seeking FDI in the coastal provinces of China has been upgrading to high-end products, and market-seeking FDI has been increasingly targeting the inland regions. This process has significant implications for the development trajectories of both China and other countries in the region. On the one hand, it continues to be attractive to market-seeking FDI (including the FDI from Taiwan). On the other hand, it has become an important source of capital and technology for the neighbouring and low-income countries in this region. For example, from 2000 to 2009, ASEAN's FDI to China increased from US$2.9 billion to US$4.8 billion, while China's FDI to ASEAN increased from less than US$1 million to US$2.8 billion.[5] China has been carrying out a new round of industrial upgrading. Some labour-intensive manufacturing activities have been shifting from coastal China to a number of Southeast Asian countries. Such relocation of some manufacturing activities from China has provided opportunities for latecomers (such as Vietnam, Cambodia, Laos and Myanmar) to become part of the TNCs' regional production networks. Thus a broader and more complicated pattern of industrial upgrading has been emerging in Southeast and East Asia.

2.3. Proliferation of FTAs

Another indication of the deepening economic integration in East Asia is the proliferation of FTAs in this region. Before 1992, East Asia had no FTAs.[6] The events in the 1997/98 financial crisis promptly highlighted the weaknesses of regional institutions, especially the APEC forum and the ASEAN. The financial crisis also played a crucial role in fostering a stronger regional identity in East Asia. This constituted an ASEAN attempt at widening the scope of cooperation in East Asia by linking the ten ASEAN countries to the larger Northeast Asian economies. Thus the past years have witnessed a

Table 4 FTA status in East Asia by Country, as of January 2010

Country	Implemented	Signed	Under negotiation	Proposed	Total
Singapore	18	1	7	4	30
Korea	6	2	7	13	28
India	11	0	10	5	26
Thailand	10	0	7	6	23
China	8	1	6	7	22
Malaysia	8	1	6	5	20
Japan	11	0	4	4	19
Indonesia	7	1	2	5	15
Philippines	7	0	1	3	11
Vietnam	7	0	2	2	11
Taiwan	4	0	2	1	7
Hong Kong	1	0	1	0	2
Total	98	6	55	55	214

growing number of government-led and competitive integration initiatives in East Asia and beyond (Table 4).

ASEAN accelerated its intraregional trade cooperation initiative by advancing the deadline for the implementation of the ASEAN FTA from 2008 to 2002. In August 2009, China and ASEAN ratified the China-ASEAN Investment Agreement. This, together with the already-signed China-ASEAN agreements of trade in goods and services, completed the negotiation process of CAFTA (China-ASEAN FTA). Implemented in January 2010, CAFTA is comprehensive as it covers trade in goods and services as well as investment. CAFTA opens up new avenues and is expected to boost China-ASEAN trade alongside expanding intra-industry trade and increase investment flow between the two sides.

ASEAN is currently engaged in ASEAN+1 agreement with China, Japan, Korea, India, and Australia-New Zealand, making ASEAN a *de facto* FTA hub (Table 5). Since January this year, ASEAN and China have moved closer to a single free trade market, within which over 90 per cent of the goods traded are granted tariff-free treatment. Japan and South Korea are now in intensive talks with mainland China over FTA, potentially resulting in an even bigger 13-country free trade market.

Table 5 Timeframes for ASEAN and ASEAN Plus Agreements

Group/FTA	Signed	Implementation	Completion date of tariff commitments	
			ASEAN 6	ASEAN 4
ASEAN-AFTA (0-5% tariff target)	1992	January 1993	2003	2006-2010
ASEAN-AFTA (0% tariff target)			2010	2015
ASEAN + China	2004	July 2005	2010	2015
ASEAN + Japan	2008	January 2009†	2012	2017
ASEAN + Korea	2006	Jun 2007‡	2010	
ASEAN + India	2008	March 2010		
ASEAN + Australia/ New Zealand	2009	Pending ratification		

Notes: † Implemented by Brunei, Japan, Laos, Malaysia, Singapore, Myanmar and Vietnam.
‡ Thailand has yet to sign and implement the goods agreement.

The growing number of FTAs in Asia and the Pacific is in part a response to the uncertainty on the progress of multilateral trade liberalization under the auspices of the WTO. There is also a precautionary motive behind them as countries seek to avoid being placed at competitive disadvantage by other regional trading arrangements. Another more fundamental factor behind FTAs is the fact that economies that are geographically close to each other and have established a degree of trade and investment relationships now wish to deepen their economic integration. Properly designed FTAs will further strengthen regional economic integration and boost intraregional FDI flows.

3. Taiwan's External Economic Relations with East Asia

As an export-oriented economy, Taiwan is dependent on external trade to sustain its economic development over the past decades. Taiwan's foreign trade has grown rapidly since the early 1970s. Its foreign trade value came to US$100 billion in 1988, and reached US$400 billion in 2006. With a record trade value of US$496 billion in 2008, Taiwan stood as the 18th leading exporter in the world. Due to the global economic downturn triggered by the 2008 financial tsunami, Taiwan's exports declined to US$378.4 billion in 2009 (Table 6).

Taiwan's trade share in its GDP in 2009 was 99.7 per cent. Over the past decade, Taiwan's major export destinations have shifted to East Asia. Taiwan's growing dependence on regional markets reflects the expansion of manufacturing production chains with its neighbouring economies, where scores of electronics factories assemble Taiwan-made components for onward export to the U.S. and other foreign markets.

Regional market integration in Asia and ASEAN in particular presents great opportunities for Taiwan. Some of these dynamic regional economies have become increasingly important trade partners to Taiwan. For example, from 1985 to 2009, export shares of the U.S. in Taiwan's total exports decreased from 48.1 per cent to 11.6 per cent, while that of ASEAN 6 (Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam) increased from 6 per cent to 14.8 per cent, and that of mainland China rose to 26.6 per cent. In 2009, Taiwan's export dependence on China, ASEAN 6, U.S. and Japan was 26.6 per cent, 14.8 per cent, 11.6 per cent and 7.1 per cent respectively.[7]

Table 6 Development of Taiwan's Exports and Imports (US$ billion)

	Total	Exports	Imports	Balance
1970	3.0	1.48	1.52	–0.043
1975	11.3	5.31	5.95	–0.64
1980	39.5	19.8	19.7	0.078
1985	50.8	30.7	20.1	10.6
1990	121.9	67.2	54.7	12.5
1995	217.4	113.3	104.0	9.3
2000	292.7	152.0	140.7	11.2
2001	234.3	126.3	108.0	18.3
2002	248.6	135.3	113.2	22.1
2003	278.6	150.6	128.0	22.6
2004	351.1	182.4	168.8	13.6
2005	381.0	198.4	182.6	15.8
2006	426.7	224.0	202.7	21.3
2007	465.9	246.7	219.3	27.4
2008	496.1	255.6	240.4	15.2
2009	378.4	203.7	174.4	29.4

Source: Ministry of Finance, Taiwan. <*http://web01.mof.gov.tw/njswww/jspproxy.aspx?sys=100&funid=defjspt2*>

However, over the last decade, Taiwan has been increasingly marginalized and excluded from East Asia's regional integration process. The stagnant pace of WTO Doha Round Negotiation has proliferated bilateral FTAs worldwide as a result of the "Spaghetti Bowl Effect". By January 2010, a total of 98 FTAs had been implemented in East Asia, while Taiwan had inked FTAs with only five Central American countries (Table 3), which constitute a combined 0.187 per cent share of Taiwan's global exports.

The increasing concern is that Taiwan's businesses will be seriously disadvantaged, due to higher import tariffs as well as other trade and business barriers, if it continues to be excluded from any free trade areas in East Asia. This is especially true for some of Taiwan's pillar industries such as petrochemical, machinery and motor industries which accounted for 24 per cent of Taiwan's total exports in 2007. According to a recent report from Taiwan, 110,000 workers may lose their jobs due to the trade diversion brought about by the ASEAN-China FTA, since Taiwan's exports of petrochemical, machinery products and motor vehicles and spare parts to the mainland are subject to 6.49 per cent, 8.23 per cent and 14.92 per cent import tariffs respectively, much higher than those for ASEAN countries under the ASEAN+1 framework.

The situation will only get worse when other FTAs such as those between Korea and the U.S., and the EU and India come into effect between 2010 and 2012, putting Taiwan at a further disadvantage. Recent years have already witnessed a decline in competitiveness of Taiwan's exports and a fall of its world ranking and share of global trade. Although Taiwan advanced to the eighth place in the latest world competitiveness yearbook of the Switzerland-based IMD (International Institute for Management Development) from 23rd last year, it was still ranked 104th in the "market access" sub-index of World Economic Forum's (WEF) 2009-2010 world competitive report. According to *Focus Taiwan*, "the reason Taiwan was given such a low WEF ranking is that it has forged only a limited number of FTA with foreign countries."[8] As shown in Table 7, between 2000 and 2008, Taiwan's share in global exports declined from 2.3 per cent to 1.6 per cent while its share in global imports declined from 1.9 per cent to 1.5 per cent.

4. Taiwan-ASEAN Economic Relations Face Challenges

Taiwan has been an important trade and investment partner of ASEAN. The close economic ties date back to the 1970s when Taiwan first relocated its labour-intensive manufacturing industries in Southeast Asia. Driven by increasing FDI in the region which has helped boost bilateral trade, Southeast Asia has since the late 1990s replaced North America and become Taiwan's most important destination for exports.

Table 7 Taiwan's Share in Global Exports and Imports

	Exports		Imports		Total Ranking
	Ranking	Share	Ranking	Share	
1999	14	2.2	15	1.9	15
2000	14	2.3	15	2.1	14
2001	14	2.0	16	1.7	16
2002	14	2.0	16	1.7	15
2003	15	2.0	16	1.6	15
2004	17	2.0	16	1.8	16
2005	16	1.9	16	1.7	16
2006	16	1.9	16	1.6	17
2007	16	1.8	17	1.5	17
2008	18	1.6	18	1.5	17

Source: Annual WTO International Trade Statistics.

Table 8 Taiwan's Trade with ASEAN (US$100 million)

	Total	Export	Import	Balance
2000	387.1	184.8	203.3	–18.5
2001	314.4	153.9	160.8	–6.9
2002	331.3	164.5	166.7	–2.2
2003	356.7	181.3	175.4	5.9
2004	440.0	240.2	203.8	36.4
2005	485.3	273.6	211.7	61.9
2006	546.0	312.0	234.0	78.0
2007	600.9	363.0	237.9	125.1
2008	646.1	389.3	256.8	132.5
2009	504.2	305.6	198.3	107.3
Jan.-July 2010	401.4	240.1	161.3	78.8

Source: Bureau of Foreign Trade, Taiwan. *<http://cus93.trade.gov.tw/FSC3/FSC3040F>*

During Chen Shui-bian's administration, Taiwan-ASEAN economic relations experienced some fluctuations. Since Ma Ying-jeou took office in May 2008, Taiwan's relations with Southeast Asia have turned a new page. Despite the global financial crisis, Taiwan's total trade with ASEAN amounted to US$50.4 billion in 2009, with exports of US$30.6 billion and imports of US$19.8 billion (Table 8). Taiwan mainly exports electrical machinery and parts to ASEAN countries while importing mineral fuels and electrical machinery and parts, reflecting a significant intra-industrial trade pattern between the two sides.

ASEAN has been a major investment destination for Taiwanese firms since the mid-1980s. Even after mainland China rose to be the top investment destination since the mid-1990s, ASEAN continued to attract steady capital flows from Taiwan, and the favourite investment locations have been switched from Thailand and Malaysia to Vietnam which was viewed as a substitute for China in labour-intensive industries for export purposes (Table 9).

As Taiwan's FDI in ASEAN increased, more and more financial institutions have been established there. By September 2009, there were 35 banks and 97 branches in ASEAN.[9] Since Vietnam and the Philippines have become the major host countries, most of these banks and branches were established in these two countries.

However, as the regional economic integration deepens, Taiwan is facing challenges from China, Japan, South Korea and India in the Southeast Asian markets. Taiwan's export position in some individual ASEAN countries has already been affected to some extent. For example, Taiwan's export to Thailand has been surpassed by South Korea's. In 2002, Taiwan's and South Korea's exports to Thailand were US$2.9 billion and US$2.5 billion respectively; by 2008, however, these figures were US$6.5 billion and US$6.8 billion respectively.[10] Once ASEAN signs an FTA with the U.S. and EU, this trade diversion effect would spread further to other products.

Taiwan has big investment in Indonesia and Vietnam, the two fast growing markets in Southeast Asia with a combined population of 300 million. These two countries have received increasing imports of spare parts and raw materials from Taiwan. Compared to South Korea, however, the growth rates of Taiwan's exports to these two countries paled. For example, from 2002 to 2008, Taiwan's exports to Indonesia increased from US$1,010 million to US$2,850 million (with a 182 per cent growth), while South Korea's increased from US$1,647 million to US$6,926 million (with a rise of 321 per cent).[11] This is because, unlike Japan and South Korea, Taiwan's exports and investment to Indonesia are largely onward-oriented and for re-export to other foreign countries including EU and the U.S. The Southeast Asia-based Taiwan enterprises will need to shift their business models from export-oriented manufacturing to local demand-driven so as to take full advantage of the ASEAN-FTA.

In terms of investment, Taiwan's share in total investment inflows to ASEAN decreased from 13.3 per cent in 2001 to 2.4 per cent in 2008. During the same period, China's share in total investment increased from 0.4 per cent to 2.5 per cent while India's increased from 0.1 per cent to 0.7 per cent.[12] The trend will develop further as the China-ASEAN FTA has already

Table 9 Taiwan's Investment in ASEAN (US$ million)

	Thailand	Malaysia	Philippines	Indonesia	Singapore	Vietnam	Cambodia	Total
1959-1989	2,097.3	1,257.1	349.4	1,384.6	22.7	4.7	0.0	5,115.7
1990	782.7	2,347.8	140.7	618.3	47.6	135.8	0.0	4,072.9
1991	583.5	1,326.2	12.0	1,057.8	12.5	224.2	0.0	3,216.2
1992	289.9	574.7	9.1	563.3	95.1	617.7	0.0	2,149.8
1993	215.4	331.2	5.4	358.9	69.5	745.4	0.0	1,725.8
1994	477.5	1,122.8	199.2	2,484.0	171.2	580.8	0.6	5,036.0
1995	1,803.9	567.8	13.6	567.4	31.7	974.4	10.2	3,968.9
1996	2,785.2	310.4	117.1	534.6	165.0	488.9	163.7	4,564.9
1007	414.3	480.4	80.6	3,419.4	144.0	305.7	44.4	4,888.8
1998	253.6	263.4	30.5	165.2	158.2	251.1	144.3	1,266.2
1999	211.1	70.3	19.2	1,486.1	324.5	225.7	55.4	2,392.2
2000	437.4	241.1	5.4	134.5	219.5	494.2	18.9	1,551.0
2001	158.7	296.6	12.0	83.9	378.3	1,379.6	57.0	2,366.0
2002	62.9	66.3	236.4	83.2	25.8	534.6	6.8	1,016.0
2003	338.8	163.7	47.1	117.5	26.4	623.8	1.3	1,318.7
2004	268.5	109.1	29.5	68.9	751.8	572.8	13.7	1,814.3
2005	417.7	113.6	25.3	133.4	97.7	713.3	12.5	1,513.5
2006	284.3	110.5	38.1	218.6	806.3	383.8	47.7	1,889.2
2007	247.8	118.8	444.9	51.4	1,194.1	1,877.2	39.9	3,974.0
2008	222.8	256.1	29.0	306.2	697.6	8,867.2	21.5	10,400.4
Jan.-Sep. 2009	47.1	188.3	1.9	98.6	49.8	1,336.0	18.9	1,740.6

Source: Department of Investment Services, Ministry of Economic Affairs, Taiwan. <*http://twbusiness.nat.gov.tw/old/xls/inv_3.xls*>

been in practice. Taiwan needs to increase its competitiveness and deepen its economic relations with Southeast Asia.

5. Conclusion: ECFA Will Enhance Taiwan-ASEAN Economic Cooperation

On 29th June 2010, Taiwan and mainland China signed ECFA (Economic Cooperation Framework Agreement). ECFA aims to alleviate disadvantages faced by Taiwanese businesses vis-à-vis those from other economies such as ASEAN and South Korea, by reducing China's import tariffs on Taiwanese products. Although ECFA is not a full FTA, and its early harvest list covers only part of the trading commodity items between the two sides, ECFA is a cross-Strait agreement based on the basic principles of the World Trade Organization (WTO) and adapted by the negotiators to suit cross-Strait relations. Further negotiations on the liberalization of trade in goods and services, and dispute settlement investment agreement will begin later. It heralds a new era in cross-Strait relations and is likely to have an impact on the significant relations between these two and the region.

For ASEAN countries, they will inevitably encounter more intense competition from Taiwan in exporting to China as a result of this agreement. This is especially true for those ASEAN countries with products similar to Taiwan's. For example, over half of Malaysian and the Philippines' exports to China consist of electrical machinery and equipment, sound recorders and television sets. As these are also important export items for Taiwan, competition on these products will increase. Thus, in the long run, as the cross-Strait economic relations deepen, ASEAN countries will need to boost their competitiveness. Deeper intra-ASEAN economic integration is essential in sustaining the bloc's long-term competitiveness.

For Taiwan, the normalization of economic relations across the Strait allows it to engage Southeast Asia more substantially. Since the mainland now accounts for nearly 30 per cent of Taiwan's total exports, and Taiwan has signed ECFA with the mainland, there is no doubt that Taiwan will indirectly benefit from the mainland's FTAs with its trading partners in Southeast Asia and the economic integration in this region.

Taiwan's FDI flows were first focused on Thailand, Malaysia, Indonesia and the Philippines in the 1980s, and then moved on to mainland China in the 1990s, followed by a gradual relocation of certain labour-intensive manufacturing sectors, such as the textile, garment and footwear industries, to Vietnam, Laos and Cambodia. Given the fact that China has become an important outward FDI source now, and Chinese companies in some sectors like textile and automotive industries have also been relocating parts of their production operations to ASEAN countries, such as Cambodia, Indonesia and

Thailand, Taiwan's enterprises can cooperate with mainland's enterprises to enlarge their investment in Southeast Asia.

To further develop economic relations with ASEAN, Taiwan can initiate some specific cooperative projects as a leeway towards FTA and a means to participate in the regional integration process in Southeast Asia. For instance, ASEAN views the food security issue very seriously as its members are struggling to make efficient use of land and natural resources to develop their agriculture. Taiwan is well-known for its rich experience in modern agriculture and expertise in orchid growing and fish farming. The Taiwan government can utilize this industrial advantage to co-develop agriculture with other governments, and strengthen its international competitiveness in agriculture and other related industries. By leveraging on its advantages, Taiwan can speed up its integration with this dynamic region and enhance its competitiveness in the global economy.

Taiwan has a special interest in maintaining and deepening its economic relations with the U.S. and Europe at the same time when it deepens its involvement in intra-Asian integration. Therefore it is natural for Taiwan to take the role of promoting open regionalism in Asia Pacific. By signing ECFA, Taiwan hopes to widen its participation in the economic integration of East Asia and beyond. The prospect of Taiwan pursuing FTA-like agreements, bilateral investment agreements, or other economic arrangements that will help keep pace with the proliferation of bilateral and plurilateral arrangements in Asia has improved since ECFA. Taiwan is in consultation with Singapore toward such ends, and prospects for discussion with the Philippines have been discussed. It therefore will play a more active and positive role in regional integration beyond ECFA.

With the improvement in cross-Strait relations, Taiwan may find more opportunities in joining multilateral activities in the region, for example, as an observer in ASEAN. As Severino (2008) commented, "Taiwan is participating in regional economic arrangements not as a state but as an economy, as it does in its membership in APEC, WTO and the Asian Development Bank. With this made clear, Taiwan and its international partners can conceivably expand the space of Taiwan's involvement in the more practical areas of cooperation among institutions, business firms and people."[13]

Apart from economic cooperation, Taiwan may also have opportunities to cooperate with ASEAN countries on regional affairs, e.g. civil services, legal services, and so on. It could also expand cooperation with ASEAN countries on the management of non-traditional security issues that have become issues of grave concern to most ASEAN countries in recent years, such as environmental protection, transnational crime, drugs and human trafficking, money laundering, and piracy in public seas.

In sum, the new development in cross-Strait economic relations and the signing of ECFA are obviously in line with the interests of ASEAN countries since it will create a more stable and peaceful international environment for economic development in East Asia. This is also conducive to cooperation between Taiwan and Southeast Asia and deepened economic integration in the region.

Notes

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External Sector Development Index: The Case of Chinese and ASEAN Economies

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Abstract

This paper introduces an alternative index to measure the external sector from a different focus. The indicator, called the "external sector development index" (SX_i), is a new analytical tool for studying the external sector behaviour of any country or region. The SX_i has four objectives. The first objective is to measure the vulnerability of the external sector of any country. The second is to evaluate the external sector performance. The third is to analyze the relationship between "the external sector main variable" ES_i and GDP growth rates. The fourth is to evaluate the external sector (SX_i) cycle based on the table of possible combinations between ES_i and GDP. In our case, we apply the SX_i on the Chinese and ASEAN economies.

Keywords: *Econographicology, international trade, trade index*

JEL classification: *F15*

1. Introduction

For many decades, economists and policymakers have been using a variety of analytical tools in the study of external sector behaviour in different countries and regions. The most common analytical tools applied in such studies so far are the terms of trade (ToT)[1] and the openness index (O_i)[2]. This paper introduces a new index to measure the external sector of any country or region from a different analytical perspective. This new index is called the "external sector development index" (SX_i). The SX_i is strongly affiliated with the openness index (O_i). The difference between these two indices is that the measurement of SX_i replaces absolute values with growth rates (or relative values), which in turn are the trade volume growth rate ($\Delta T = \sum$export growth rate plus $\sum$import growth rate), foreign direct investment growth rate (ΔFDI) and gross domestic product growth rate (ΔGDP). The SX_i analysis will also introduce a new variable called "the external sector main variable" (ES_i). The ES_i is equal to the trade volume growth rate (ΔT) plus the foreign direct investment growth rate (ΔFDI) (see Figure 1). However, the three indicators (ToT, O_i and SX_i) have different objectives and analytical foci, but they share something in common – they all aim to evaluate the external sector of any country (see Table 1).

Figure 1 Procedure to Measure the External Sector Development Index (SX_i)

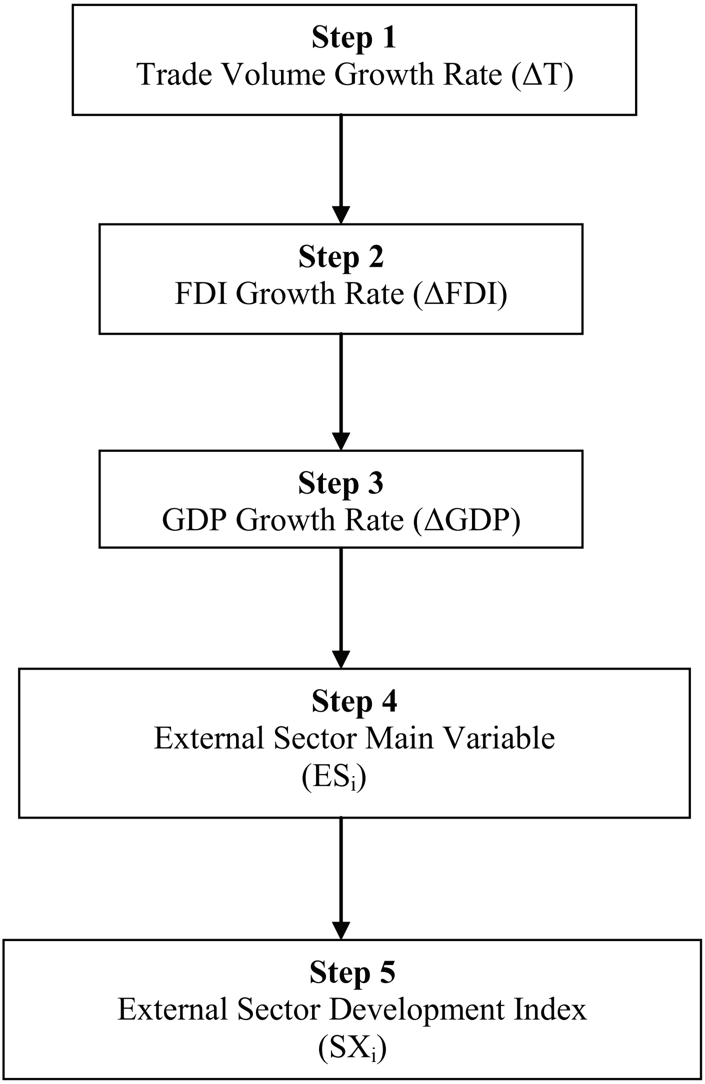


Table 1 Comparison of Terms of Trade, Openness and External Sector Development Index (SX_i)

Concept	Measures	Function	Advantage	Disadvantage
Terms of Trade (ToT)	**X Price/M Price** **X = Export Index Price** **M = Import Index Price**	To study the relationship between export price ratio and import price ratio to find the deteriorating terms of trade among countries	Permits the visualization of the relationship between various international prices in the international market	Difficult to be applied to many countries and goods simultaneously
Openness (O_i)	**TV/GDP x 100%** **TV = X+M**	To measure the level of trade liberalization and the orientation of trade policy	Gives a general idea about how open an economy is in its international trade	Focused on studying how open an economy is from the specific point of view of trade
External Sector Development (SX_i)	**$ES_i/\Delta GDP$ x 100%** **$ES_i = \Delta T + \Delta FDI$**	To measure the level of trade liberalization and investment mobility simultaneously	Observes the trends of the external sector from the perspectives of the international trade sector and the finance sector simultaneously	Difficult to monitor FDI mobility in the short term

2. External Sector Development Index (SX_i)

The objective of the external sector development index (SX_i) is to observe the external sector behaviour of any economy from a new angle of analysis based on three basic variables: trade volume growth rate (ΔT), foreign direct investment growth rate (ΔFDI) and GDP growth rate (ΔGDP).

The external sector of the SX_i is represented by two specific growth rates: trade volume growth rate (ΔT) and foreign direct investment growth rate (ΔFDI). This part of the research maintains that the trade volume is equal to the sum of exports flow (FOB) plus imports flow (CIF) in US$ per year. On the investment side, it is represented by the variation of the FDI growth rate between two years. The idea to include the FDI growth rate (ΔFDI) and trade volume growth rate (ΔT) together into the study of the external sector is basically to analyze the external sector as a whole. The computation of the SX_i Index requires four preceding steps detailed in Figure 1.

2.1. Step 1: Trade Volume Growth Rate (ΔT)

The trade volume growth rate (ΔT) is the difference between the trade volume of a given year in millions of US$ $(X+M)_{n+1}$ and the trade volume of the previous year in millions of US$ $(X+M)_n$ divided by the trade volume of the previous year in millions of US$ $(X+M)_n$.

$$\Delta T = \frac{(X+M)_{n+1} - (X+M)_n}{(X+M)_n} \tag{1.1}$$

2.2. Step 2: Foreign Direct Investment Growth Rate (ΔFDI)

The foreign direct investment growth rate (ΔFDI) is the difference between the foreign direct investment volume of a given year in millions of US$ $(FDI)_{n+1}$ and the foreign direct investment of the previous year in millions of US$ $(FDI)_n$ divided by the foreign direct investment of the previous year in millions of US$ $(FDI)_n$.

$$\Delta FDI = \frac{(FDI)_{n+1} - (FDI)_n}{(FDI)_n} \tag{1.2}$$

2.3. Step 3: GDP Growth Rate (ΔGDP)

The domestic product growth rate (ΔGDP) is equal to the domestic product growth of a given year in millions of US$ $(GDP)_{n+1}$ minus the domestic product growth of the previous year in millions of US\$ $(GDP)_n$ divided by the domestic product growth of the previous year in millions of US\$ $(GDP)_n$.

$$\Delta GDP = \frac{(GDP)_{n+1} - (GDP)_n}{(GDP)_n} \tag{1.3}$$

2.4. Step 4: External Sector Main Variable (ES_i)

The external sector main variable (ES_i) is equal to the sum of trade volume growth rate (ΔO) and foreign direct investment growth rate (ΔFDI) (see Table 2).

$$ES_i = \Delta T + \Delta FDI \tag{1.4}$$

2.4.1. Possible results

If any value is located within ES_{i+} then this value is included in the category of acceptable performance in the external sector. If any value is located within ES_{i-} or $ES_{i=0}$ then this value is included in the category of weak external sector performance.

Table 2 Possible Combinations of ΔT and ΔFDI to Obtain ES_i

ΔFDI/ΔT	**+ΔT**	**–ΔT**	**ΔT = 0**
+ΔFDI	$\Delta T + \Delta FDI = ES_{i+}$	▲(–ΔT) + ▼ΔFDI = ES_{i-} ▼(–ΔT) + ▲ΔFDI = ES_{i+}	$0 + (\Delta FDI) = ES_{i+}$
–ΔFDI	▲ΔT + ▼(–ΔFDI) = ES_{i+} ▼ΔT + ▲(–ΔFDI) = ES_{i-}	▲(–ΔT) + ▼(–ΔFDI) = ES_{i-} ▼(–ΔT) + ▲(–ΔFDI) = ES_{i-}	$0 + (-\Delta FDI) = ES_{i-}$
ΔFDI = 0	$\Delta T + 0 = ES_{i+}$	$-\Delta T + 0 = ES_{i-}$	$0 + 0 = ES_{i=0}$

Variables: ▲ = High ▼ = Low ΔFDI = Foreign Direct Investment Growth Rate
ΔT = Trade Volume Growth Rate (–) = Negative and (+) = Positive
ES_i = External Sector Main Variable 0 = Zero

2.5. Step 5: External Sector Development Index (SX_i Index)

The external sector development index (SX_i) is equal to the external sector main variable (ES_i) divided by the GDP growth rate (ΔGDP).

$$SX_i = \frac{ES_i}{\Delta GDP} \tag{1.5}$$

2.5.1. Analysis of the SX_i results

High Vulnerability

If the ES_i and ΔGDP are located in these parameters ($+ES_i$ / $+\Delta GDP$) or ($-ES_i$ / $-\Delta GDP$) or ($ES_i = 0$ / $\Delta GDP = 0$), then the SX_i can be classified in the category of high vulnerability (see Table 3). The ES_i and GDP in this category are moving in the same direction, showing the strong connection between these two values (ES_i and GDP).

Normal Vulnerability

If the ES_i and ΔGDP are located in these parameters ($+ES_i$ / $-\Delta GDP$) or ($+ES_i$ / 0), then the SX_i can be classified in the category of normal vulnerability (see Table 3). The category of normal vulnerability shows how the ES_i grows more rapidly than the GDP, and this result will show not only how the external sector depends on the world trade trend, but also that it cannot be affected so greatly under the GDP growth rate.

Low Vulnerability

If the ES_i and GDP are located in these parameters ($-ES_i$ / $+\Delta GDP$) or ($-ES_i$ / 0) or (0 / $+\Delta GDP$) or (0 / $-\Delta GDP$), then the SX_i can be classified in the category of low vulnerability (see Table 3). The category of low vulnerability shows how the ES_i growth is slower than the GDP growth rate; this result will show clearly that the external sector is not a key factor when it comes to affecting the GDP growth rate of any country.

3. Application of External Sector Development Index (SX_i)

The external sector development index (SX_i) will be applied to analyze ASEAN-5's (Indonesia, Malaysia, the Philippines, Singapore, Thailand) and China's external sector performance and vulnerability between 1985 and 2005 respectively. The reason for applying the SX_i is to observe performance, vulnerability and SX_i cycles. The objective for applying the SX_i Index is to observe how trade and investment growth together can affect growth

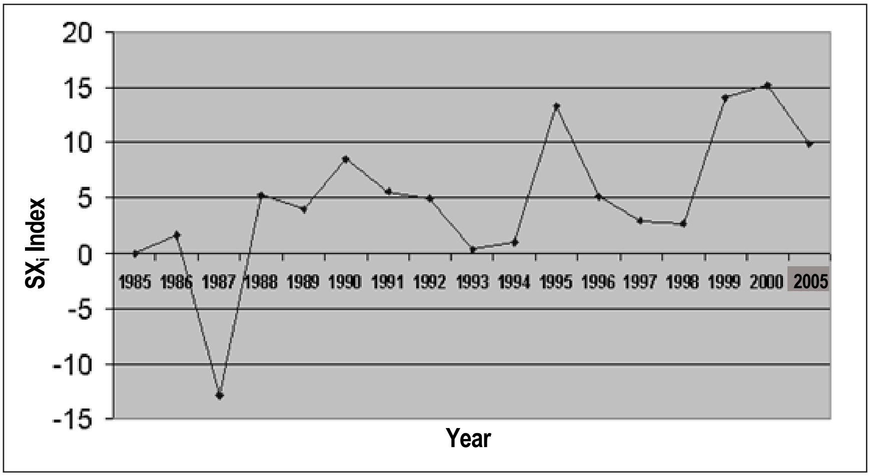
Table 3 SX_i Cycle Levels

ΔGDP / ES_i	**$+\Delta GDP$**	**$-\Delta GDP$**	**$\Delta GDP=0$**
$+ES_i$	**Level 1.1** **High Vulnerability** **$+ES_i$ / $+\Delta GDP = +SX_i$** **Acceptable performance**	**Level 1.2** **Normal Vulnerability** **$+ES_i$ / $-\Delta GDP = -SX_i$** **Weak performance**	**Level 1.3** **Normal Vulnerability** **$+ES_i$ / $0 = SX_i = \infty$** **Acceptable performance**
$-ES_i$	**Level 2.1** **Low Vulnerability** **$-ES_i$ / $+\Delta GDP = -SX_i$** **Weak performance**	**Level 2.2** **High Vulnerability** **$-ES_i$ / $-\Delta GDP = +SX_i$** **Acceptable performance**	**Level 2.3** **Low Vulnerability** **$-ES_i$ / $0 = SX_i = \infty$** **Weak performance**
$ES_{i=0}$	**Level 3.1** **Low Vulnerability** **0 / $+\Delta GDP = SX_i = 0$** **Weak performance**	**Level 3.2** **Low Vulnerability** **0 / $-\Delta GDP = SX_i = 0$** **Weak performance**	**Level 3.3** **High Vulnerability** **$0 / 0 = SX_i = 0$** **Weak performance**

Variables: ▲ = High ▼ = Low ΔGDP = Gross Domestic Product Growth Rate
ES_i = External Sector Main Variable (–) = Negative and (+) = Positive 0 = Zero

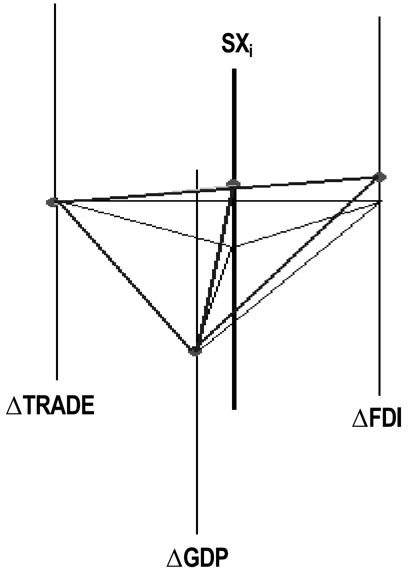
of the GDP. The reason for incorporating FDI growth together with trade volume growth is to observe how both variables can be affected by possible deep international trade or financial crises. Specifically, the SX_i is applied to the ASEAN-5 members, as well as China, to observe the effect of the 1997 financial crisis on these countries. The application of SX_i to the above

Figure 2 SX_i Index: Indonesia, 1985-2005



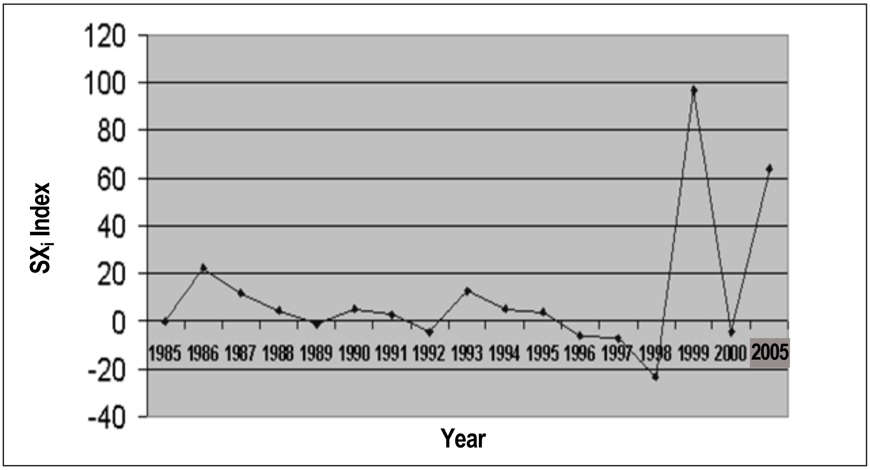
Source: ADB, NBSC WB.

Average SX_i Index: Indonesia, 1985-2005



countries shows that the countries most affected by the 1997 financial crisis were the Philippines $SX_{i\text{-}1998} = -23$ (see Figure 6), Singapore $SX_{i\text{-}1997} = -20$ (see Figure 3), Thailand $SX_{i\text{-}1997} = -6$ (see Figure 5), Malaysia $SX_{i\text{-}1997} = -4$ (see Figure 4), Indonesia $SX_{i\text{-}1997} = -3$ (see Figure 2) and China $SX_{i\text{-}1997} = 0$ (see Figure 7).

Figure 3 SX_i Index: Singapore, 1985-2005



Source: ADB, NBSC WB.

Average SX_i Index: Singapore, 1985-2005

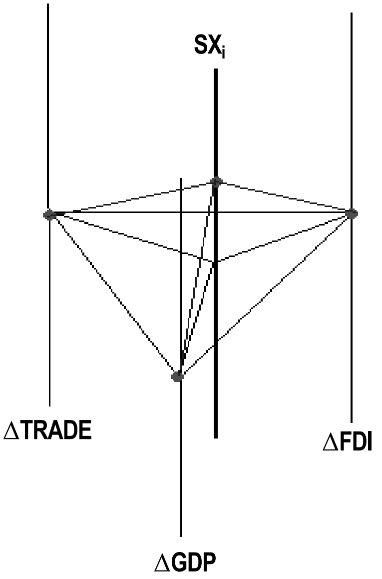
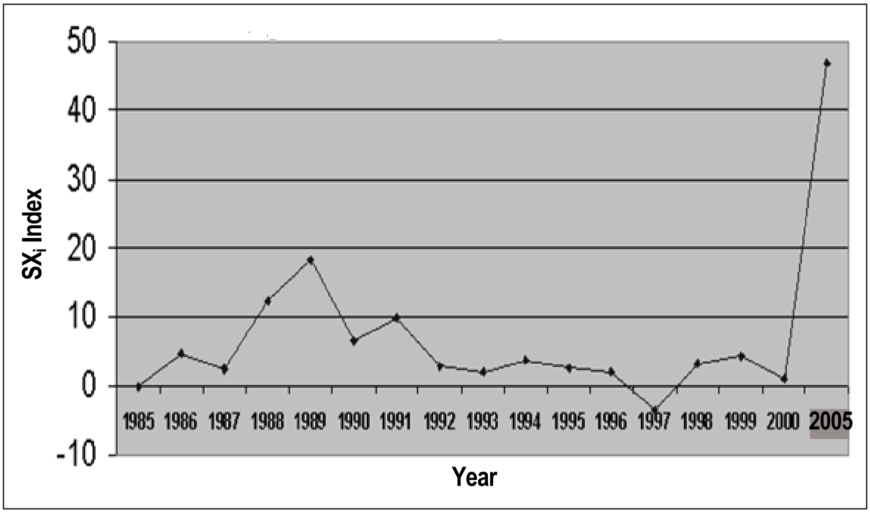


Figure 4 SX_i Index: Malaysia, 1985-2005



Source: ADB, NBSC WB.

Average SX_i Index: Malaysia, 1985-2005

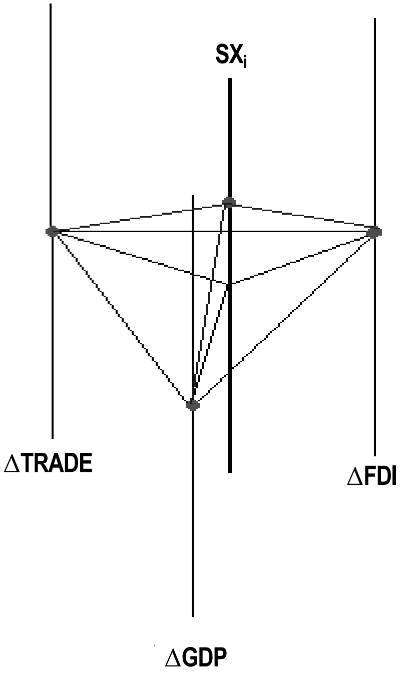
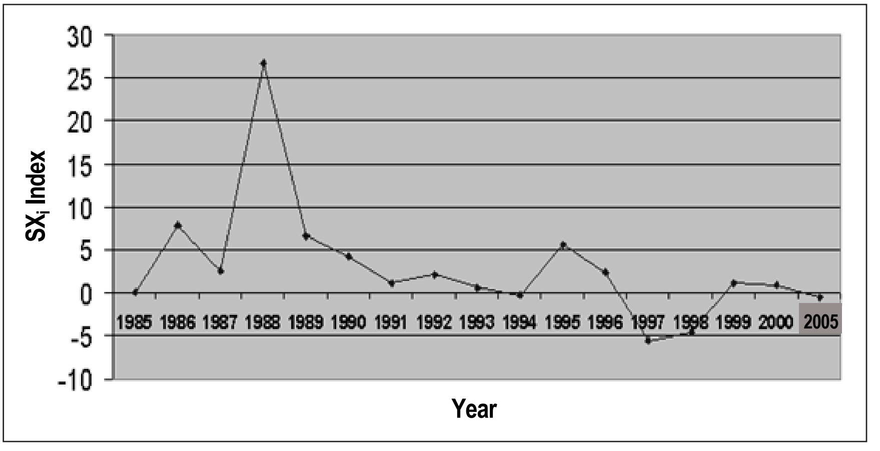


Figure 5 SX_i Index: Thailand, 1985-2005



Source: ADB, NBSC WB.

Average SX_i Index: Thailand, 1985-2005

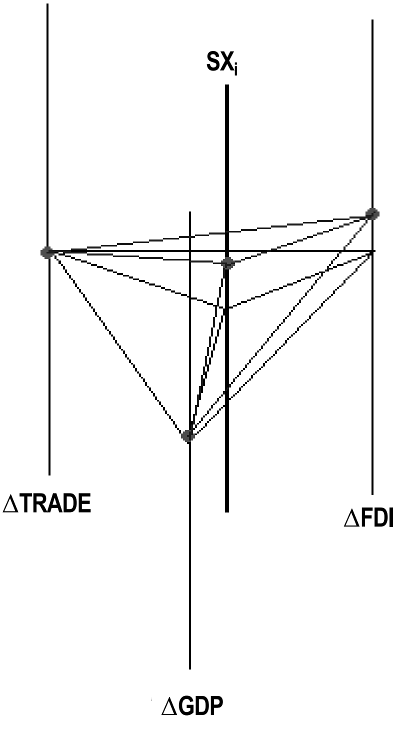
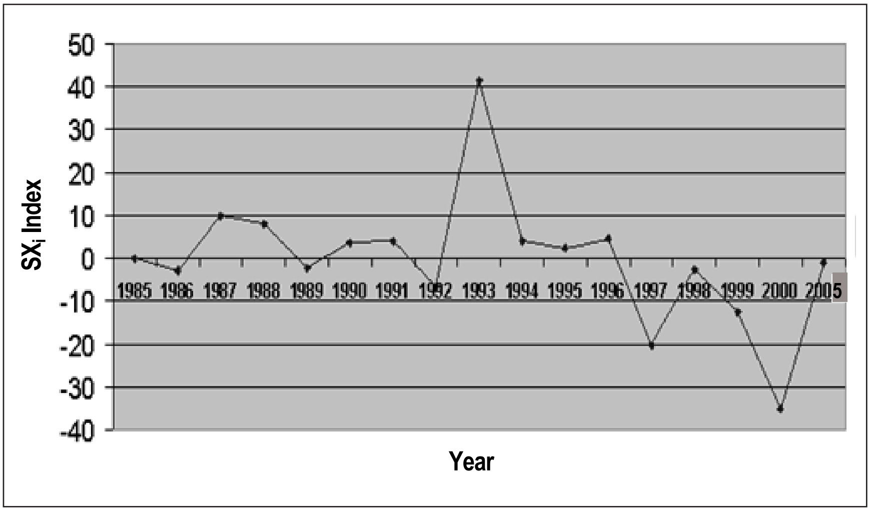


Figure 6 SX_i Index: Philippines, 1985-2005



Source: ADB, NBSC WB.

Average SX_i Index: Philippines, 1985-2005

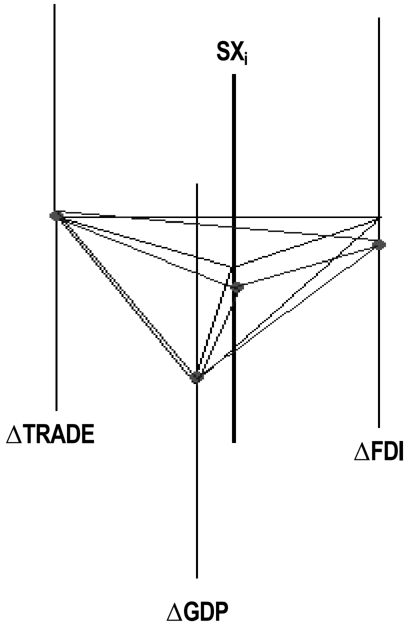
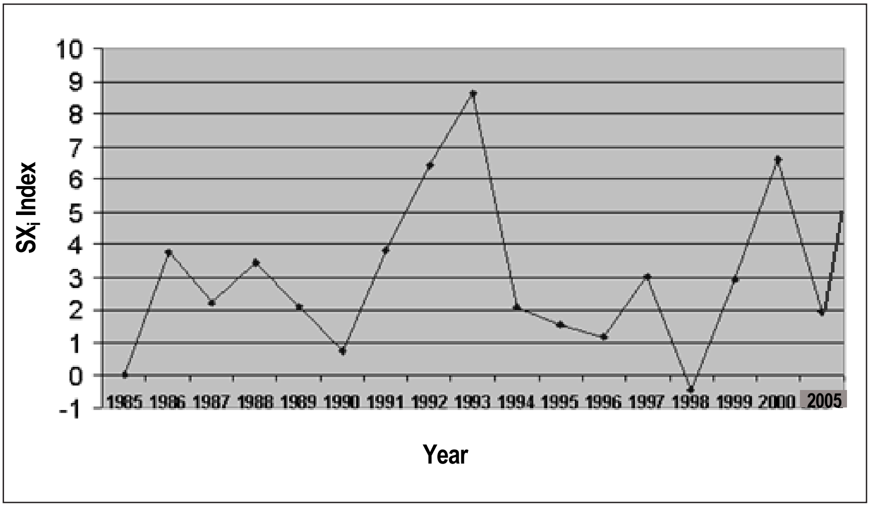
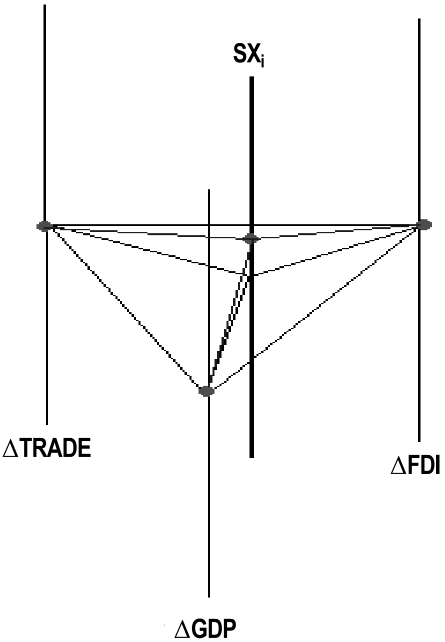


Figure 7 SX_i Index: China, 1985-2005



Source: ADB, NBSC WB.

Average SX_i Index: China, 1985-2005



We can observe clearly that the financial crisis strongly affected the Philippines (1997), Singapore (1997-1998), Thailand (1997-1998), Indonesia (1997) and Malaysia (1997). In the case of China (1998), the country was affected but not at the same level as among the ASEAN-5 members. The results show how strong the dependency is on the external sector of ASEAN-5 members and China; these countries are highly vulnerable to financial and world trade crises. In the period of 1985-2005, the external sector of ASEAN-5 members and China presented an acceptable performance, but irregularities in external sector behaviour between 1985 and 2005 can be detected in two ASEAN-5 members: the Philippines (low participation of the external sector in the world trade) and Singapore (high exposure of the external sector in the world trade). China had the best performance of its external sector compared to many ASEAN-5 members between 1985 and 2005.

On the other hand, this part of this research is also interested in demonstrating whether the ES_i and GDP growth have a correlation. The results show that in China (r = 0.68), Malaysia (r = 0.67) and Indonesia (r = 0.77), there exists a strong correlation between the ES_i and GDP; in the case of Singapore (r = 0.30), Thailand (r = 0.23) and the Philippines (r = -0.23), there is a lower or negative correlation. This shows that China, Malaysia and Indonesia have a high dependency on the performance of its external sector on international trade, together with FDI growth. Thailand and Singapore have been classified in the category of normal vulnerability; the normal vulnerability of Thailand is caused by its lower trade volume and FDI, but in the case of Singapore (low correlation), which also demonstrates normal vulnerability, this is due to the different proportions of growth between trade volume and FDI growth. The Philippines shows a negative correlation between the ES_i and GDP growth; it shows low vulnerability of the external sector, where its trade volume growth and FDI growth are slow and small.

In the SX_i cycles between 1985 and 2005 (20 years) among these ASEAN-5 members and China, we observe that the SX_i cycles have these results: China shows the best performance, it is located in Level 1.1 (15 years) and Level 2.1 (1 year). Among the ASEAN-5 members the SX_i cycles show that Malaysia is in Level 1.1 (12 years), Level 2.2 (3 years) and Level 1.2 (1 year). On the other hand, Indonesia and Thailand show close behaviour in their SX_i cycles: Indonesia has Level 1.1 (11 years), Level 2.2 (4 years) and Level 1.2 (1 year), whereas Thailand is located in Level 1.1 (11 years), Level 2.2 (1 year), Level 2.1 (1 year) and Level 1.2. (3 years). In the specific case of Singapore, this country is located in Level 1.1 (9 years), Level 2.2 (1 year), Level 2.1 (5 years) and Level 1.2 (1 year). The reason why Singapore shows different results in its SX_i cycles is its high dependency on the international markets, especially the United States of America. The Philippines is located in Level 1.1 (8 years), Level 1.2 (5 years) and Level 2.1 (3 years) owing to the low participation of its external sector in the world economy, which is in turn because of its small amount of export products with high added value to the international markets.

4. Concluding Remarks

With the application of the external sector development index (SX_i) to the study of trade liberalization and openness, we observe that trade volume and FDI volume growth need to be joined into a single variable in order to study the external sector of any country or region. This single variable will be called the external sector main variable (ES_i). The external sector development index (SX_i) can thus be used as an alternative index to study trade liberalization cycles effectively. In fact, the SX_i can be considered a complementary analytical tool together with the terms of trade (ToT) and the openness index (O_i).

Notes

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1. The terms of trade (ToT) is considered an analytical tool which can explain the relationship between the ratio of export prices (export index price = IP_x) and the ratio of import prices (import index price = IP_m) to find the deteriorating terms among countries (Balassa, 1985). However, ToT continues to be used by many experts on international trade to explain the behaviour of the external sector of any country.

   $$ToT = IP_x/IP_m \times 100\%$$

2. The openness index (O_i), on the other hand, studies the relationship between the total trade volume (i.e. exports plus imports) and GDP (Edwards, 1998). It measures the level of trade liberalization as well as the orientation of the trade policy of any country. The objective of the O_i is to show how much participation the external sector (export plus imports) has on the GDP as a whole, or how open an economy is to the international markets.

   $$O_i = X+M/GDP \times 100\%$$

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Exploring Financial Cooperation between China and ASEAN Countries under CAFTA

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Abstract

The commencement of CAFTA (China-ASEAN Free Trade Area) has significant implication for the financial cooperation in this region. This paper is to discuss the related issues. Based on the observation on the past financial cooperation between China and ASEAN countries, we could see the generally low-level and unbalanced capital flows among private sectors, and the relatively more achievements in the area of currency cooperation between the state monetary authorities. Hence, to improve the financial cooperation under CAFTA is necessary and helpful for the regional trade and economic development. Meanwhile we should not neglect the influence from changes in the global and regional economic environments. This paper then proceeds to make some recommendations on how to strengthen the financial cooperation between China and the ASEAN countries, as well as discuss about the difficulties and challenges that might be encountered in the way of pushing forward with financial cooperation.

Keywords: *ASEAN, CAFTA, financial cooperation, capital flows, currency cooperation*

JEL classification: *F15, F21, F33, F36*

1. Introduction

On 1st January 2010, China[1]-ASEAN Free Trade Area (CAFTA) was officially launched to promote trade in the region by providing a system of institutional arrangements. ASEAN countries, including Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam, have more than 4 million square kilometres of territory and population of nearly 592 million. CAFTA, by combining China and the ASEAN member countries is thus the world's largest free trade zone with more than one quarter of the population of the whole world. Not only will the people and the economy of the region be influenced significantly, there will also be a profound impact on the world at large.

With the development of trade the cooperation at the financial level also becomes more necessary and important. In fact, in both the private sector and the public sector, China's financial transactions with ASEAN countries have been ongoing and developing gradually. In the private sector, there are foreign direct investments (FDI) or other forms of capital flows; on the official level, there is cooperation conducted mainly by government entities (such as the Ministries of Finance, Central Banks) in the area of regional currency cooperation and other aspects. Especially in the event of financial crisis, there will be a stronger impetus to push forward such cooperation. The 1997-1998 East Asian Financial Crisis and the 2008-2009 Global Financial Crisis are the cases in point.

However, the economic situations in both Southeast Asia and the world at large are constantly evolving. How to implement a more effective cooperation under a new environment so as to benefit the people in both China and ASEAN countries is an issue that requires careful thinking and exploration. It constitutes the focus of this paper.

In the following sections of this paper, we shall begin with an observation on the past financial cooperation between China and ASEAN members, including the status of private sector capital flows and currency cooperation between the state financial and monetary authorities. This is the basis for our further discussion. We shall then analyze the financial cooperation under CAFTA, while considering the changes in global and regional economic environment. This will be followed by some recommendations on how to strengthen the financial cooperation between China and ASEAN countries. Also in this section, we shall discuss the difficulties and challenges that might be encountered in the way of pushing forward the financial cooperation. The final section summarizes and concludes the paper.

2. Observation on Financial Cooperation between China and the ASEAN countries

Since China began the process of reform and opening up in 1978, China's economic transactions with the outside world have been increasing gradually. After over 30 years of development, China has grown to be the world's second largest economy[2]. China also ranks high in foreign trade and in attracting foreign direct investment. In general, however, usually observed are China's economic relations with the United States, Japan and Europe. Less has been focused on regarding the financial cooperation between China and the ASEAN countries in the past.

Financial cooperation is a very broad concept. A rigorous definition is absent in the literature. It can refer to the cooperation in the exchange rate regimes or liquidity arrangement between the national financial or monetary authorities, or it may also include a wider range of capital flows and other related activities. Here in our discussion we use the latter definition. Therefore, the observation on the financial cooperation between China and the ASEAN countries could unfold from both levels.

2.1. Capital Flows among Private Sectors

The Balance of Payments (BoP) presentation records all the economic transactions between the residents in a country and non-residents in the rest of the world in a certain period. The Capital and Financial account, in turn, records transactions involving the capital flows. More specifically, there are two sub-accounts, the Capital Account and the Financial Account, which focus on different types of capital flows respectively. Therefore, we can employ the BoP to observe the capital flows in the private sector.

According to the statistical data, the figures in the Capital Account which are mainly related to the migration activities are relatively small these years[3]. Therefore, we only observe the Financial Account here which includes three items – foreign direct investment (FDI), portfolio investment and other investment.

Table 1 Capital and Financial Account in BoP[†]

II Capital and Financial Account
A. Capital Account
B. Financial Account
1. Direct Investments
2. Portfolio Investments
2.1 Equity Securities
2.2 Debt Securities
3. Other Investments
3.1 Trade Credits
3.2 Loans
3.3 Currency and Deposits
3.4 Other Assets or Liabilities

Note: † Here is an excerpt from China's Balance of Payments. For the purpose of simplifying the analysis some adjustment is made such as removing the two columns of assets and liabilities. Only the basic types are listed.

Source: Official website of the State Administration of Foreign Exchange of China, <*www.safe.gov.cn*>.

Table 2 FDIs to China, 1997-2008 (US$ million)

Year	Singapore, Malaysia, Thailand, Indonesia, Philippines (1)	ASEAN-10 Countries (2)	The five countries/ ASEAN-10 (3) = (1)/(2)	Singapore/ ASEAN-10 (4)	Whole World (5)	ASEAN/ Whole World (6) = (2)/(5)
1997	3417.85	3428.00	99.7%	76.0%	45257.04	7.6%
1998	4198.08	4223.18	99.4%	80.6%	45462.75	9.3%
1999	3274.97	3288.77	99.6%	80.3%	40318.71	8.2%
2000	2836.71	2844.58	99.7%	76.4%	40714.81	7.0%
2001	2969.77	2983.95	99.5%	71.8%	46877.59	6.4%
2002	3200.42	3255.94	98.3%	71.8%	52742.86	6.2%
2003	2853.09	2925.43	97.5%	70.4%	53504.67	5.5%
2004	2909.62	3040.53	95.7%	66.0%	60629.98	5.0%
2005	2937.27	3105.43	94.6%	71.0%	60324.59	5.1%
2006	3033.78	3351.13	90.5%	67.5%	63020.53	5.3%
2007	4001.03	4391.24	91.1%	72.5%	74767.89	5.9%
2008	5105.58	5460.99	93.5%	81.2%	92395.44	5.9%

Source: Official website of the State Bureau of Statistics of China, <*www.stats.gov.cn*>.

2.1.1. Foreign direct investments (FDIs)

China has been rather policy-oriented to attract foreign direct investment for quite a long period. Inward FDIs indeed play a very important role for the economic growth and development in China. Table 2 shows the FDIs to China from 1997 to 2008, including FDIs from ASEAN countries.

As Table 2 shows, in the past decade, ASEAN countries' FDIs into China accounted for a very small proportion in the total FDIs China has acquired, being always less than 10 per cent. This figure even declined in recent years. Among the ten countries in ASEAN, the five countries of Singapore, Malaysia, Thailand, Indonesia and the Philippines are the main sources of FDIs for China. Their FDIs are more than 90 per cent of the total FDIs from ASEAN countries to China. Furthermore, Singapore ranks first among the ten countries, accounting for about 80 per cent of the total investment from the ASEAN countries.

At the same time, there is also foreign direct investment into ASEAN countries from China. Comparatively, however, China has been placing more emphasis on the inward FDIs than the outward FDIs. There are more friendly and encouraging policies upon the inward FDIs and rather strict controls on outward FDIs. For example, the foreign investors are guaranteed various kinds of favourable policies such as tax deduction when they enter China's market, but local investors have to get rather complicated administrative approval for their investments abroad. Nevertheless, as there are more and more foreign exchange reserves accumulating in China, and more solid strength of Chinese enterprises, there are increasing foreign direct investments from China to other countries in recent years.

Table 3 shows China's outward FDIs, based on data from the publications of the National Bureau of Statistics.

Similar to the ASEAN countries' FDIs in China, China's investments in ASEAN countries are also at a relatively very low level, being less than 5

Table 3 China's FDIs Abroad (US$ million)

Year	Total Amount	FDIs to ASEAN	FDIs to ASEAN/Total Amount
2004	5497.99	150.22	2.7%
2005	12261.17	57.71	0.5%
2006	17633.97	248.45	1.4%
2007	26506.09	684.11	2.6%
2008	55907.17	1890.24	3.4%

Source: Official website of the State Bureau of Statistics of China, <*www.stats.gov.cn*>.

Table 4 China’s FDIs to ASEAN Countries, 2000-2008 (US$ million)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008
Brunei	–	–	0.2	0.2	3.0	0.1	4.8	17.2	–
Cambodia	–	2.9	49.2	26.2	33.0	102.8	130.1	164.9	76.9
Indonesia	–2.8	–1.5	0.0	–0.4	294.6	299.5	123.6	117.2	380.2
Laos	9.1	11.8	1.3	1.8	0.1	4.5	5.3	1.7	42.9
Malaysia	0.7	16.9	13.2	1.8	2.0	1.0	–6.7	4.6	56.5
Myanmar	–	0.5	4.8	–	108.1	1.2	1.5	1.7	349.2
Phlippines	0.0	0.1	–	0.0	–0.2	–0.2	2.3	–0.1	–0.2
Singapore	–168.6	91.5	–170.9	131.7	212.6	69.2	616.7	594.2	478.0
Thailand	7.2	–2.5	20.9	23.8	–3.8	11.6	49.9	73.7	69.0
Vietnam	21.0	24.2	9.4	1.5	85.6	48.2	88.7	251.8	44.6
ASEAN-10 (Total)	–133.4	143.9	–71.9	186.6	735.0	537.9	1016.2	1226.9	1497.1

Source: The ASEAN Secretariat, Jakarta, *ASEAN Statistical Yearbook 2008*, July 2009, p. 143, Table VI.14.

per cent of its outward FDIs. In recent years, however, China's investments in ASEAN countries increased rapidly with an average annual growth rate of above 20 per cent[4].

Meanwhile, there is the *ASEAN Statistical Yearbook 2008* issued by the ASEAN Secretariat in July 2009, with more detailed data on FDIs from China, as shown in Table 4.

It could be seen that there are quite many differences between the data presented in Table 4 and the data supplied by China's side. Nevertheless, we could still find the relative status of China's FDIs in each ASEAN member country. Singapore is the ASEAN country which had the largest proportion of all the FDIs to ASEAN from China. Relatively, Indonesia, Cambodia, Vietnam and Myanmar also received rather large amount of FDIs from China. On the contrary, Malaysia, Thailand and the Philippines only received small amount of FDIs from China.

2.1.2. Portfolio investments and other investments

Compared to FDIs, there are stricter controls on the capital flows related to portfolio investments and other investments. In 1996, China has fulfilled the Clause Eight of IMF and realized the complete convertibility of RMB for the transactions under the current account, but China is still working on the process of free capital movement gradually, being concerned with the complexity and the potential shock of capital flows. Regarding statistical data, on the one hand, due to the more stringent controls these types of capital flows have relatively small scale; on the other hand, it is really difficult to find statistical data which are solely about the portfolio and other investments between China and ASEAN countries. Therefore, we can only use some sporadic observational data here.

Among the foreign capital flows into China, some are obtained through the issuance of shares in foreign capital markets. It is a kind of capital flow belonging to the Portfolio Investments. In this respect, Singapore and Malaysia are the more popular destinations for China. Sometimes China's companies went to Thailand, Brunei, Cambodia and the Philippines to raise capital by going to the public.

As can be seen from the Table 5, although China's companies went to Singapore and Malaysia for their capital markets, the total amount of capital inflows can be said to be "insignificant", being less than 1 per cent of the world's total. On the contrary, since the RMB has not yet been fully convertible, and there is strict regulation on China's capital market, capital outflows resulting from the issuance of shares are still quite limited.

In addition to the primary market, there are also capital flows between China and the outside world through the secondary market. Two institutions

Table 5 China's Capital Raised by Issuing Shares Abroad, 1998-2008 (US$ million)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Malaysia	8	2	–	–	–	21	–	531	919	600	1387
Singapore	–	3	41	169	214	142	–	551	35	168	185
World Total	209474	212825	864146	279453	226823	263548	344300	348038	405519	357172	285793
(Malaysia + Singapore)/ World Total	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.0%	0.3%	0.2%	0.2%	0.6%

Source: Official website of the State Bureau of Statistics of China, <*www.stats.gov.cn*>

play important roles in this regard, which were introduced in 2002 and 2006 respectively. The former one is the Qualified Foreign Institutional Investors (QFII) system and the latter one is the Qualified Domestic Institutional Investor (QDII) system. QFII allows the capital to enter the Chinese market for the purpose of investment, and QDII allows the opposite direction of capital flow. As of June 2010, a total of 96 institutions from around the world have become China's QFIIs, of which there are only seven coming from the ASEAN countries – six from Singapore and one from Malaysia. As for QDII, among 601 funds China has issued, only 15 belong to QDII. These funds may seek investment opportunities in the global capital markets; however, it seems that there are few investments in the ASEAN countries.

Moreover, there are also capital flows in various types such as the debt, bonds, loans, etc., between China and the outside world, but existing information shows that the amount of capital flow under these channels between China and the ASEAN countries is still relatively small.

2.2. Financial Cooperation among Financial and Monetary Authorities

In contrast to the financial cooperation in the private sector, it seems that there are more achievements in cooperation between financial and monetary authorities of China and the ASEAN countries. Earlier, it was the occurrence of the Asian financial crisis in 1997-1998 that made these countries in East Asia realize the necessity and importance of regional financial cooperation. Specific exploration was then made to push forward currency cooperation in this region. After one decade's efforts, there are already some significant outcomes in this area (which would be discussed in detail in the following paragraphs). Again, the global financial crisis in 2008-2009 which originated from the sub-prime debt crisis in the USA accelerated the financial cooperation in East Asia, including China and the ASEAN countries. So far, we could observe financial cooperation in the official sector between China and the ASEAN countries in the following aspects.

2.2.1. Chiang Mai Initiative (CMI)

After the 1997-1998 East Asian financial crisis, the financial cooperation among East Asian countries was pushed forward with a direct outcome – the "Chiang Mai Initiative" between the ASEAN countries and China, Japan and Korea in May 2000. The Chiang Mai Initiative aims to create a network of bilateral swap arrangements (BSAs) among the ASEAN+3 countries, with which the short-term liquidity difficulties in the region could be solved to some extent. Meanwhile they could supplement the existing inadequacy of the international financial arrangements.[5]

Since then, there is a meeting of ministers of finance in May each year to discuss about further specific arrangements for this Initiative. The 7th ASEAN+3 Finance Ministers' Meeting set up a review plan on the Initiative for the purpose of exploring more efficient cooperation. The problems such as the amount in swap, the format of help and the relationship with IMF loan were reviewed. Then a more important development was achieved in the following meeting in May 2005. The finance ministers agreed to take some measures to enhance the effectiveness of the CMI, including "(1) integration and enhancement of ASEAN+3 economic surveillance into the CMI framework, (2) clear defining of the swap activation process and the adoption of a collective decision-making mechanism, (3) significant increase in the size of swaps, and (4) improvement of the drawdown mechanism."[6]

At the 10th ASEAN+3 Finance Ministers' Meeting in May 2007 (Kyoto, Japan), the finance ministers unanimously agreed that, in principle, a self-managed reserve pooling arrangement under a single contractual agreement is an appropriate form of CMI multilateralization (CMIM), proceeding with a gradual approach.[7] At the same time, the amount under swap agreement has been increased substantively. As of the end of that year, there were already 17 swap agreements and total amount was US$84 billion.

In the new round of global financial crisis in 2008-2009, China and the ASEAN countries continued to work on liquidity arrangements, with the central banks collaborating on the bilateral liquidity agreements. Till the end of 2008, China and Thailand, the Philippines, Malaysia, Indonesia and other countries signed a total of 230 billion swap agreements. In February 2009, ASEAN and China, Japan and South Korea held a special finance ministers' meeting and introduced the "Asian economic and financial stability plan of action" to address the worldwide financial crisis; at the same time, the reserve pool under the "Chiang Mai Initiative" was increased from US$800 billion to US$120 billion.

The 12th ASEAN+3 Finance Ministers' Meeting, held in the midst of the 2008-2009 global financial crisis, reached agreement on all the main components of the CMIM, and decided to implement the schedule before the end of 2009 (see Appendix).[8] It marked the milestone of CMI in its progress. Till the latest Ministers' Meeting in May 2010, the CMIM was officially announced to come into effect on 24th March 2010. At the same time, there were agreements on all the key elements of the regional macroeconomic surveillance unit of the CMIM, called the ASEAN+3 Macroeconomic Research Office (AMRO).[9]

2.2.2. Economic Review and Policy Dialogue (ERPD)

From the development of the "Chiang Mai Initiative", we can see the importance of inter-regional policy dialogue. In fact, effective economic review and policy dialogue would contribute to the prevention of financial crises. On the one hand, the abnormal phenomena and irregularities could be detected in the earlier stage under effective review; on the other hand, the remedial policy actions could be designed and implemented through policy dialogue more efficiently. All these will lay a solid foundation for providing immediate assistance in the event of a crisis. Out of these considerations, the Economic Review and Policy Dialogue system was established in May 2000. With the existence of this mechanism, ASEAN+3 could conduct meetings at the ministers' level annually and at the deputies' level twice a year to discuss economic and financial developments in the region.

Furthermore, there are similar efforts – the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) – established at the 9th ASEAN+3 Finance Ministers' Meeting in May 2006 (Hyderabad, India) so as to explore the ways for further strengthening surveillance capacity and cooperation within this region.[10]

2.2.3. Asian Bond Markets Initiative (ABMI)

A regional financial market could work for the more efficient allocation of funds within the region. With depth and width, efficiency and liquidity, this kind of market could contribute positively to the development of the economy in the region. Therefore, another exploration of financial cooperation in this area is to first build up a regional bond market.

The EMEAP[11] members made the first step for the Asian Bond Funds in 2003 by investing US$1 billion in bonds denominated in US dollars. In the same year, the Asian Bond Markets Initiative (ABMI) came into being so that an efficient and liquid bond market in Asia could be ultimately founded. With this market the capital resources within Asia would be allocated more efficiently. The ABMI mainly conducts its activities in two areas. One is to make a wider variety of issuers and types of bonds access to the market. Another one is to build up the infrastructure for the unified bond market in Asia.

Along with the effort and progress made under the ABMI since 2003, the Asian bond markets have recorded remarkable growth in terms of size and diversity of issuers. To further develop the Asian bond markets, in 2008 the New ABMI Roadmap was issued, in which there are more strong commitments to the concrete progress of ABMI from each country. Generally, the themes of New Roadmap include promoting issuance of local currency-denominated bonds, facilitating the demand of local currency-denominated bonds, improving regulatory framework, and improving related infrastructure for the bond markets.[12]

In the Boao Forum in April 2009, China promised to set up a China-Asian Investment Fund of US$10 billion. In the latest Ministers' Meeting in 2010, a trust fund with US$700 million was established as the Credit Guarantee and Investment Facility (CGIF) under the Asian Development Bank (ADB). The main objective of the CGIF is to support the issuance of corporate bonds in the region, and thus contribute to the development of the regional bond markets.[13]

From the observation we made on the financial cooperation among the official institutions, we find that there is not only the cooperation between China and the ASEAN countries, but also the cooperation involving two other important economies – Japan and South Korea. In fact, based on the geographical and economic links, it is difficult to conduct financial cooperation without these two important countries in East Asia. As for the cooperation related to China's currency, however, we could focus on the cooperation between China and the ASEAN countries.

2.2.4. Development of transnational settlement of RMB

Although Renminbi is still not a fully convertible international currency, it would be a good try and start if it could first be used in the East Asian region. At the same time, this could provide a good environment for the financial cooperation between China and the ASEAN countries.

On 6th July 2009 China launched an attempt in cross-border trade settlement of RMB. Many domestic banks then began their RMB settlement in the ASEAN countries. On 6th July, the Jakarta branch of the Bank of China and the Shanghai branch handled the first operation in Indonesia successfully. On 29th July, the first business in Singapore was finished by the cooperation between the Shanghai branch of the Bank of China and the Overseas Chinese Bank in Singapore. On 31st July, the Manila branch of the Bank of China introduced the RMB cash business in the Philippines. From August 2010, China began the foreign exchange spot transaction between RMB and the Malaysian ringgit in the inter-bank foreign exchange market. In addition, the central banks of China, Vietnam and Laos signed cooperation agreements of bilateral settlement. These are also substantial steps for regional financial cooperation.

In addition to these aspects of financial cooperation, there are also cooperation in research, such as the 10+3 Research Group, etc., and various forms of financial aids. Collaborative research is helpful in improving national data sharing and information exchange. Financial aids are especially significant for those members which are lagging behind in economic development.

3. Financial Cooperation between China and ASEAN Countries under CAFTA

Since the beginning of China-ASEAN Free Trade Area (CAFTA) on 1st January 2010, the region starts the progress into the zero-tariff era. This will influence the economy and trade of this region substantively. At the same time, the financial cooperation will also enter into a new phase based on the previous development.

The geographic link between China and ASEAN makes CAFTA the trade area with the largest population in the world. Trade between China and ASEAN has become more and more important in their respective foreign trade relations. In the first four months of 2010, ASEAN is China's fourth largest trading partner: China's fourth largest export market and the third largest import market. In the year 2009, China is ASEAN's third largest trading partner: the fourth largest export market of ASEAN and the second largest import market. Along with the initiative of the CAFTA, it could be expected that trade between China and ASEAN would increase continuously. Based on the above observation, however, we can see the rather low level of financial cooperation, especially in the capital flows between private sectors including FDIs.

According to the traditional international trade theory of comparative advantages, trade and capital mobility should be substitutes rather than compliments. The standard Heckscher-Ohlin theory postulates that trade integration invalidates the need for capital to flow to capital-scarce countries. Hence, trade will not result in capital flow, nor will it need capital flow. On the other hand, in a recent paper, Antras and Caballero (2009) showed that in a world with varying degrees of financial development, trade and capital mobility become complements since trade integration increases the return to capital in less financially developed economies.

In addition, two features of the development of financial system require more financial cooperation between countries. First, for a single country, the development of its financial system directly influences the development of its economy. Although the occurrence of the financial crises will soon lead to economic recession, a growing number of theoretical and empirical studies support the view that financial development has a positive impact on economic development. Second, with the development of economic globalization, the financial cooperation between different economies contributes to trade and economic development. Of course, similar to the last point, the sudden reversal of capital, speculative attack and even the financial crisis, will also have a serious impact on economies. To some extent, it is just a sign that the financial cooperation should also be improved.

Therefore, CAFTA creates the space for trade within the region. This potential would be implemented more efficiently with the help resulting from financial cooperation. Financial cooperation could work for the construction of infrastructure, the division of labour and many other aspects. The capital flows between the private sectors could enhance the efficiency of allocating funds and accelerate the deepening of finance markets. The financial and currency cooperation between governments would provide a better regional financial environment. All these will then be helpful for trade and economic development in the region.

Meanwhile, we cannot limit our vision only in the area where the financial cooperation develops. International economic environment is always changing. We must take that into account so as to develop the regional financial cooperation strategically.

One decade after the 1997-1998 East Asian financial crisis there was the sub-prime debt crisis which occurred in the USA in 2007. That crisis finally turned into a global financial crisis in September 2008, impacting the whole world substantively. According to the statistical data, currently many countries have begun to recover from the crisis; however, analyses on this crisis will never stop.

As soon as this global financial crisis took place, there were many kinds of analysis on the reasons of this crisis. Among them, much of the literature attributed the happening of the crisis to the "global imbalance", which means mainly the big current account surplus acquired by China and other Asian countries and the big deficit in other places, particularly in the USA. No matter this kind of accusation is justified or not, we could at least think about this point for the further development of financial cooperation between China and the ASEAN countries.

Table 6 shows the balance of current account status of China and the ASEAN countries in recent years. Except Cambodia and Vietnam, China and the ASEAN countries have large current account surplus, especially Malaysia, Singapore and China. Once the financial crisis occurred, this kind of unbalanced situation became the accused target by trade partners. On the other hand, there was demand from the countries in deficit to have the deficit decreased or adjusted. This made China and most ASEAN countries need to rethink their economic development strategies. The CAFTA could be just considered as a response to this request. External current account surplus is not sustainable in the long term; hence the economy should stimulate the effective demand within the region, and adjust the growth structure. Then, as already mentioned above, trade and in-depth economic development will inevitably require a wider range of financial cooperation.

One direct result of current account surplus is the accumulation of foreign reserves, which is also an important perspective in understanding and developing the financial cooperation.

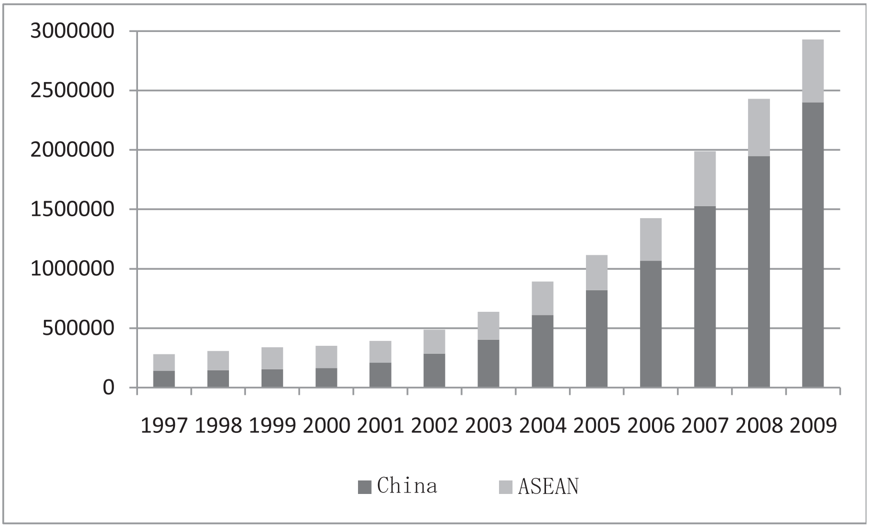
Figure 1 shows a very dramatic change of China's and the ASEAN countries' foreign exchange reserves since the 1997 Asian financial crisis. Particularly, since 2001, foreign exchange reserves of China and the ASEAN countries have been experiencing very high growth rates. ASEAN countries have acquired an average annual growth rate of 14.3 per cent, while China's

Table 6 ASEAN Countries and China's Current Account Balance as a Percentage of GDP, 2000-2007 (%)

Year	2000	2001	2002	2003	2004	2005	2006	2007
Brunei	66.8	67.2	63.5	37.9	35.2	70.5	72.5	13.0
Cambodia	–2.8	–1.1	–1.2	–10.0	–7.4	–4.2	–0.7	–1.5
Indonesia	4.8	4.3	3.7	3.4	0.7	0.1	3.0	2.4
Laos	–0.3	–4.0	0.2	–2.0	–7.5	–6.5	1.2	2.6
Malaysia	9.4	11.7	8.4	12.8	11.9	14.5	16.2	15.6
Philippines	–3.0	–2.4	–0.4	0.4	1.9	2.0	4.6	4.3
Singapore	11.6	12.5	12.7	23.4	17.0	19.1	22.5	22.1
Thailand	7.6	4.4	3.7	3.3	1.7	–4.3	1.1	5.7
Vietnam	–1.1	2.1	–2.5	–4.8	–2.1	–0.9	–0.3	–4.1
China	1.7	1.3	2.4	2.8	3.6	7.2	9.5	11.0

Sources: Data for ASEAN countries are from the *ASEAN Statistical Yearbook 2008* published by the ASEAN Secretariat, Jakarta, in July 2009, p. 50, Table IV.12. There are no statistics for Myanmar; hence it is not listed in the table. China's data come from the *International Financial Statistics*, 2010, published by IMF. The GDP is in RMB, and we use the yearly average exchange rate to obtain the figures in US dollar.

Figure 1 Foreign Exchange Reserves of China and ASEAN Countries, 1997-2009 (US$ million)



Source: IMF, *International Financial Statistics*, 2010. The figure for China in 2009 was from the official website of the State Administration of Foreign Exchange, <*www.safe.gov.cn*>. The figures for ASEAN were added for the ten members except some missing data.

average annual growth rate is as high as 35.4 per cent. Till the end of 2009, total reserves of China and the ASEAN countries were more than half of the total of that in developing countries, accounting for over 1/3 of the world's total reserves. According to the traditional theory about the demand for foreign exchange reserves, such a high level of foreign exchange reserves is far greater than the appropriate amount based on the level of imports. Many economists explain this phenomenon by considering the influence from the Asian financial crisis. These countries have seen foreign exchange reserves as an insurance fund against the speculative attacks and a protection from the crisis (Aizenman, 2006). Therefore, after recovering from the crisis, these countries are keen to continuously accumulate foreign exchange reserves, and most of the reserves are held in the form of dollar-denominated assets.

Then, what could be done in the financial cooperation between China and the ASEAN countries in such a scenario?

First, this great amount of foreign exchange reserves is clearly a very important resource for financial cooperation. The 1997 East Asian financial crisis began to promote the financial cooperation in this region. So, how to prevent speculative attacks and the exchange rate fluctuations from the potential outflow of capital is an important task of financial cooperation. Based on such thinking, both the "Chiang Mai Initiative" and the various types of cooperation between China and the ASEAN countries are about the liquidity arrangement and cooperation between central banks. This is helpful for the avoidance of financial collapse. With a great amount of international reserves that are mainly denominated in US dollars, central banks could support each other in liquidity in time of need within the region. By the end of 2009, the US$120 billion reserve pool based on the "Chiang Mai Initiative" has been build up. In the future, the problem in financial cooperation is how to effectively and efficiently use these resources.

Second, on the contrary, effective currency cooperation should be able to decrease the need for foreign exchange reserves for the member countries. It is costly to hold foreign exchange reserves. On the one hand, the accumulation of foreign exchange reserves means the delay of consumption of this region because of the current account surplus. On the other hand, the foreign exchange resources occupied in the form of reserves could be more profitable for the economy, i.e. the opportunity cost of foreign exchange reserves might be higher than the investment return of reserves. Therefore, it might not be an optimum choice to accumulate foreign exchange reserves continuously. Through effective currency cooperation, the member countries could share to some extent the foreign exchange reserves, which makes it possible to decrease the accumulation of foreign exchange reserves in each individual country. Then, the more specific institutions are required in the financial cooperation. Meanwhile, if we look at this phenomenon from the angle of capital flow, there are capital outflows from China and the ASEAN countries through the channel of foreign exchange reserves, and capital inflows at higher cost. It is a kind of capital cycling out of region. To make it within the region is a direction for further financial cooperation.

Third, while we are exploring the financial cooperation based on the foreign exchange reserves, what deserves more attention should be the reform of the international monetary system by the efforts of China and the ASEAN countries. The reason that "global imbalance" was criticized by some economists lies not only in the imbalance of trade, but also in its effect on capital flow. The huge amount of foreign exchange reserves entered the US capital market again, which create a very loose monetary environment and help pop up the bubble of assets prices. When the bubbles burst, the financial crisis comes. Every country then could not avoid the impact in such a globalized world. It is also why the criticism and review on the prevailing monetary system occurred as soon as the crisis took place. After the collapse of the Bretton Wood System, US dollar is still the most important reserve currency. It is the reason that so many countries have been accumulating the US dollar-denominated reserves. Then, how to reform this international monetary system? China, and the cooperation between China and the ASEAN countries, should play active roles in the process of reform. This is also for the benefit of the region.

Another change in the international economic environment that we must notice is the sovereign debt crisis emerging in the Euro zone from early 2010. The Euro area is always a good sample and even model regarding regional currency cooperation. The united or single currency looks like the summit of currency cooperation. Hence, naturally it is also implicitly the aim of currency cooperation for other regions. For example, there was once the dream of an "Asian currency" for currency cooperation in this region. The occurrence of the European debt crisis, however, forced us to rethink. Is there a real "optimum currency area" in reality? How could it be lasting in practice? As for the East Asian region including China, how should we choose and realize an appropriate format of regional currency cooperation? So far, there is still much uncertainty in the change and development in this region, hence it is still not feasible to set up a format for the currency cooperation (Huang, 2010), let alone the unique currency.

Above all, with the changing international economic environment, China and the ASEAN countries should make use of the opportunities supplied by CAFTA and push forward the financial cooperation. In this process, because of its status in economy scale, population, etc., China should take the responsibility of being the leader. It is not only the responsibility of China in this region, but also the basis for her to play the role of a big country in the world.

4. Directions and Challenges of Financial Cooperation in the Future

If the importance and direction of financial cooperation between China and the ASEAN countries could be agreed, then the specific exploration needs to be exercised in reality. Of course, we have observed the efforts and achievements in this respect in the first part of this paper. However, there are still many to be done in the future. In October 2009, just before the beginning of CAFTA, the "Leaders' Forum on the Financial Cooperation and Development between China and ASEAN" took place in the city of Nanning, Guangxi Province, China. The participants ultimately announced a "Joint Declaration", in which three goals were pointed out. They are to protect the financial stability of the region, to enforce the currency cooperation in the region and to accelerate the capital cooperation within the region. We could consider these three goals as the long-term and macro-goals for the financial cooperation between China and ASEAN. By the guidance of these three goals, many specific policies or activities could be carried out in financial cooperation between China and ASEAN regarding the changing international economic environment.

4.1. Capital Flows in Private Sector

According to the past experience, both China and the ASEAN countries depend on the foreign direct investments to quite an extent. The data shows a simple positive relationship between the economic development and the amount of FDIs. Nevertheless, the FDIs between China and the ASEAN countries are very limited in the past according to the previous data. These countries even compete with each other in attracting FDIs from other countries outside this region because of the similar economic development level and the policies favourable to the export industries (Yu, 2008). Therefore, with economic development and increase in intra-trade among these countries, there is potential to increase the direct investments between each other. Especially, with the rapid growth these years, China has seen the growth of many big corporations. These corporations equip themselves with advanced technology, scientific management and grand capital. They have good conditions to invest abroad. On the other hand, there are also abundant resources in the ASEAN countries. Hence, China's enterprises should seek opportunity in investing in these neighbouring countries and make use of the advantages in these countries. Of course, the direct investment decision-making depends not only on the private sector, but also the policy environment. Therefore, both China and the ASEAN member countries should create a friendly policy environment to accelerate the further development of direct investment. It is good for capital to find better investment opportunities and also helpful for the increase of trade within the free trade area.

In the other formats of capital flows, there is also low level investment between China and the ASEAN countries. However, East Asia has been a popular destination for the global capital for rather long period. Comparatively, this region was not affected so much in the global financial crisis that just passed. Rather high growth rates are still projected for this region. Then a question is how to enjoy the benefit of economic growth in this region by the countries involved. It means countries in this region could actively make use of the investment opportunities within this region. Therefore, after the commencement of CAFTA, China and the ASEAN countries should increase the capital flow by investing in the capital markets mutually. At the same time, some capital flows such as loans and trade credits could accelerate trade in this region. In addition, besides the traditional fund investments or credit arrangements, each country could also make innovation or more flexible formats to facilitate the specific projects based on the features and characteristics. Another critical factor that may influence the success of cooperation is the policies in reality. It means that the governments should keep making efforts in pushing forward the cooperation and free flow of capital in this region. Meanwhile, the financial infrastructure inside each country is a necessary condition for the cooperation among countries (Cowen *et al*., 2006).

Another important point is that the capital flow is a kind of flow of qualified financial practitioners to some extent. This flow includes two levels of meaning. Firstly, the practitioners in the finance areas need to know of the policies, institutions and environments in the markets in this region. Secondly, there should be the exchange and movement of the qualified human resources among the countries. All these construct the solid foundation for the capital flow. Therefore, from the angle of China, a friendly environment should be built up for the better understanding of the ASEAN countries' finance markets and the exchange of personnel in the financial sectors since the operation of CAFTA. If the government could issue some encouraging policies or tax preferences, there could be more incentive for further cooperation in the financial areas.

While the capital flows in the private sector will benefit the region, there are also more risks. The capital flows are the choice of individuals. However, they are limited by the policy environment to quite an extent. Therefore, the capital flows between China and the ASEAN countries in the future should follow the principles of "market activities accelerating policies" and "policies regulating the markets" for the prevention or control of the risks.

4.2. Financial Cooperation among Authorities

From the observation made, it can be seen that there are already many achievements in the financial cooperation among the authorities in East Asia. Then, what are the future directions? Based on the previous analysis on the world economic environment, the cooperation could be continued in the following aspects.

4.2.1. Further developments on Chiang Mai Initiative

CMI multilateralization and the Reserve Pool began to run after several years' preparation. Obviously, this is the not the end of the financial cooperation, but a new start. Firstly, there will be more problems coming out in practice. To solve these problems will be the main task in the future. Secondly, so far the scale of this Pool is US$120 billion, which needs adjustment along with the development of the economies and the change of the financial environments. Thirdly, the issues related to foreign exchange reserves have been discussed before. How to improve the management and cooperation in foreign exchange reserves is a challenge for China and the ASEAN members. Fourthly, the conditions on the credit arrangement under the Reserve Pool should also be adjusted when necessary in accordance with the specific situation.

4.2.2. Improvement on the system of risk surveillance

Because of the continuously changing environment, the risks in the financial areas have become more complicated. Hence in the future, more efforts are needed in developing the system of risk surveillance in this region. Both qualitative and quantitative methods (indices) could be employed.

4.2.3. Construction of regional bond and capital market

There are already much effort and progress in the construction of the regional bond market. In the future, on the one hand, the regional bond market is going to operate with mature arrangements by more construction; on the other hand, the regional capital market deserves similar attention and efforts.

4.2.4. Cooperation currency and exchange rate regimes

As of the commencement of CAFTA, the expanded use of RMB in the region is significant due to the status of China in this region. More developments about RMB's transaction and settlement in the ASEAN countries are needed, which is also a good condition for the cooperation. As regarding the exchange rate regimes, the Southeast Asian countries were suffering in the financial crisis of 1997-1998 with their currencies in free fall, while China resisted the pressure to devalue its currency, thereby saving the Southeast Asian countries from being further hurt. Since then, China has received more and more recognition from the Southeast Asian countries as a responsible big country playing a constructive role in the regional economic and political affairs (Zhao *et al*., 2007). So in the future, to find a way of cooperation in exchange rate regime is also an important task for this region, particularly for China.

4.2.5. Financial cooperation in the "Greater China" zone

At the beginning of this paper we use "China" in the scope of "Mainland China". In fact, in geopolitics, Hong Kong, Macau and Taiwan are all parts of the "Greater China" zone. Therefore, the financial cooperation in this zone is very meaningful for the financial cooperation in the Southeast Asian region, not only at the level of economic development, but also at the level of regional peace and stability.

4.3. Difficulties and Challenges in Financial Cooperation

Generally, China and the ASEAN countries are very different in development level, economic scale, business cycles and political regimes. Even inside the ASEAN, the regional cooperative organization, the members are diversified in culture, religion, resource-endowment and so on. The legal system, regulations and taxations are all different in each country. Cooperation is difficult under such context.

In particular, there are also many differences in the financial areas, such as the liberalization level, the regulations and the related policies. Hence each country is faced with the difficulties in dealing with the relationship between financial development inwards and financial cooperation outwards. At the same time, how to learn from the experiences of other regions is also important.

So far, there are many arrangements related to the cooperation besides CAFTA or CMI. To balance the efforts from various organizations is critical for the efficient use of the resources.

In addition, the financial cooperation between China and the ASEAN countries are crisis-driven, according to the past experience. Therefore, two questions are calling for our attention. The first one is to make financial cooperation a routine task. The second one is to build up the surveillance and signaling system for the financial system, which is the most direct way to prevent financial crisis. However, with the occurrence of the global financial crisis, how to understand the supervision on financial system becomes a question. Hence, this is also a challenge for China and the ASEAN countries.

To improve the performance of financial cooperation, macroeconomic coordination in is necessary for China and the ASEAN countries. Obviously, at the level of economy development, the macroeconomic policy goals are not exactly same for each country. How to deal with the problem may thus influence the financial cooperation.

5. Concluding Remarks

With the advance of trade in this region by the induction of CAFTA, cooperation at the financial level also becomes more necessary and important. In this paper, we have discussed the related problems on financial cooperation between China and the ASEAN countries.

After the introduction, we presented an observation on the past financial cooperation between China and the ASEAN members, including the status of private sector capital flows and currency cooperation between the state financial and monetary authorities. In fact, since the 1997-1998 Asian finance crisis there has been continuous progress in financial cooperation. Nevertheless, in contrast, the capital flow among private sectors is rather limited and unbalanced. This was followed by an analysis on how to understand the financial cooperation under CAFTA, while we considered the change in global and regional economic environment, such as the latest global financial crisis and the sovereign debt crisis in the Euro zone. Subsequently, some recommendations were made on how to strengthen the financial cooperation between China and the ASEAN countries, mainly from China's perspective. Also discussed were the difficulties and challenges that might be encountered along the way of pushing forward the financial cooperation.

Appendix

The multilateralized arrangement will be governed by a single contractual agreement. The total size of the CMIM is US$120 billion with the contribution proportion between ASEAN and the Plus Three countries at 20:80. The maximum amount that each country can borrow is based on its contribution multiplied by its respective borrowing multiplier.

Country	Contribution (US$ billion)			Borrowing Multiplier
Brunei	0.03			5.0
Cambodia	0.12			5.0
China	38.4	China (excluding Hong Kong, China)	34.2	0.5
		Hong Kong, China	4.2	2.5*
Indonesia	4.77			2.5
Japan	38.4			0.5
Korea	19.2			1.0
Lao PDR	0.03			5.0
Malaysia	4.77			2.5
Myanmar	0.06			5.0
Philippines	3.68			2.5
Singapore	4.77			2.5
Thailand	4.77			2.5
Vietnam	1.00			5.0

Note: * Hong Kong, China's borrowing is limited to IMF de-linked portion because Hong Kong, China is not a member of the IMF.

Source: <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/200905/t20090508_141000.html*>.

Notes

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1. Unless defined otherwise, "China" here means the mainland area of China.
2. According to the latest data of 2010, China has overtaken Japan in GDP.
3. Capital Account includes the capital transfer and the purchase or relinquishment of non-financial assets. According to the International Monetary Fund database (IFS, 2010), prior to 1996 the balance of capital account was nil; the values are relatively small since 1997.
4. The calculation of the rate of growth has also referred to the data from the official website of the Association of Southeast Asian Nations <*www.aseansec.org*>.
5. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/*>.
6. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/*>.
7. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/*>.
8. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/200905/t20090508_141000.html*>.
9. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/*>.
10. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/caijinghezuochangshi/200904/t20090429_138273.html*>.
11. The "Executives' Meeting of East Asia and Pacific Central Banks" (EMEAP) was established in 1991, initiated by Japan. The members include central banks or monetary authorities of Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippine, Singapore and Thailand.
12. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/caijinghezuochangshi/200904/t20090429_138273.html*>.
13. <*http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/*>.

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Research Note

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Perception of Reform: "China Model" as Affirmation?

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Abstract

In May 2004, Joshua Cooper Ramo's paper "Beijing Consensus" aroused hot discussion in China and abroad regarding China's development path. This paper analyzes the development of Western countries' image of China. During the late Middle Age, people in Western nations spoke highly of China, but China's image declined significantly in modern times. From the Cold War era's ideological hostility to the remarkably rapid economic development of today's China, the West's impression of China has undergone further notable changes, while the way Chinese scholars react reflects a mix of cautiousness and confidence regarding their country.

Keywords: *Beijing Consensus, China Model, emerging China*

JEL classification: *N45, P26, Y30*

1. Introduction

In May 2004, Joshua Cooper Ramo, the senior editor of US's *Time* magazine and senior adviser of the Goldman Investment Bank, published a paper, "Beijing Consensus", at the British Foreign Policy Centre in London, which analyzed the experience of China's reform and opening up since 1978. Following the publication of the paper, intense discussion on China's development took place, and a considerable number of scholars have reacted to the paper. While initially only a few scholars in China reacted to the paper, "Beijing consensus" (北京共识) and "China model" (中国模式) once again became hot topics after China successfully hosted the Olympic Games and the subprime crisis in the US led to the global financial crisis. Faced with ongoing intense discussions, the scholars in China began to be involved in the discussion, each trying to have a say in the process. The participants not only try to summarize the basic contents and characteristics of the "China model", but also intend to redefine “China model” itself. In Section 2 of this paper, the author presents the evolvement of the Western impression of China, including both positive and negative images. Section 3, in turn, discusses Ramo’s “Beijing Consensus” and the rising China. Section 4 focuses on Chinese scholars’ attitudes and reaction to the issue. Section 5 concludes.

2. Origin of the West’s Impression of China

The West’s impression of China can be traced back to the Second Century BC, when the Silk Road (丝绸之路) was initiated after the ambassador Zhang Qian 张骞 of the Han Dynasty was sent on his diplomatic mission.[1] However, at that time no merchants from the Roman Empire had ever arrived in China. According to *Hou Hanshu – Xiyu Zhuan* 后汉书. 西域传 [“Documentary on western regions” in Book of the Later Han], Da Qin 大秦 “conducted trade with Anxi 安息 and Tianzhu 天竺 with great benefits” (Zhang, 2001). Apparently they conducted silk trade through intermediaries from Persia and India. *Periplus of the Erythraean Sea* about Roman merchants’ impression of China appeared in the First Century AD. The book describes a city “Thinae” which is located in “Thin” (秦) country, which specially provided raw silk, raw silk thread and other silk products to Da Xia (大夏国). At the first half of the Second Century AD, the geographer Ptolemy found records about a country called “Seres”. According to textual research by historians, “Thinae” and “Seres” both referred to China (*ibid*.).

These should be the earliest records about China. Those merchants described China as a distant, mysterious, rich and powerful country. Since at that time, these Western countries were underdeveloped, the people there regarded China as an ideal world. Later, more and more Roman businessmen conducted business with China, and the people in the West began to have a better understanding of China. For example, at the beginning of the Second Century AD, the Greek/Roman writer Bardesane described people’s social manners in Seres.[2] However, compared with the total population in the Roman Empire, the number of people who arrived in China was rather small. The most important reasons are the large geographical distance between the two empires and the lack of a sophisticated means of transportation. Therefore, China had always seemed to be a mysterious place in minds of the people in the West.[3] In the 13th Century, the conquest of Eurasia by the Mongol Empire promoted exchange between the two continents, and the number of books about China increased dramatically.

Zhou (2005) specifically regarded “The Travels of Marco Polo” and “The Travels of Mandeville” as the representative pieces of work. He even believed that to some extent, “The Travels of Marco Polo” has significant impact on the impression of China among the people in the West. In the book, China is described as a wealthy, stable and advanced nation. At that time, European countries were underdeveloped (*ibid*.).

Such a positive impression reached its peak in the West by the age of geographical discoveries and the Enlightenment. Increasing number of Christian missionaries, who were more educated than the businessmen, arrived in China, and they described China in a more detailed manner and more accurately. Based on their first-hand image of China, they described China as a superior and more ideal world.

Those Christian missionaries also began to describe the Confucian moral thinking, imperial bureaucracy, the beautiful Chinese language and the hardworking labour force. Hence more and more people knew more about China at the time when these European nations began building their capitalist societies (*ibid*.). In the minds of the Western people, China was no longer a mysterious nation. On the contrary, it was a good example to learn from, which in a way justified their mission to build a new society. They perceived that with great efforts from the public and the impact of Confucianism, the Chinese indeed led a happy life.

Later more and more Western philosophers were interested in China, at the time when they began to criticize European theology and politics. Gottfried Wilhelm Leibniz, Voltaire, and Christian Wolf were good examples among them. Although Leibniz himself had never been to China, with information from various sources, he concluded that the Confucian philosophy was similar to Christian theology to some extent.[4] So he believed that on the one hand, China needed more modern scientific knowledge from Europe; on the other hand, the "Natural Theology" (i.e. Confucianism 儒学) from China was needed in Europe. At the same time, some other philosophers criticized the European feudal autocracy system vis-à-vis China's political system.

After the Renaissance, Western capitalism gradually developed, but European capitalist economy only began growing rapidly around the mid-Seventeenth Century. With the advanced technological level, the comprehensive national strength of European nations increased dramatically. With the new international order, Western nations were accumulating wealth on a large scale. As the rapid development of the domestic economy called for more raw materials, the Far East became the ideal choice. China which had once been described as an ideal world became a good choice of invasion. With advanced scientific and technological level, the Westerners had no problem in reaching China. At the beginning of the Eighteenth Century, the Westerners' impression of China became more and more rational, and they soon found that China was not as good as they once imagined.

From the mid-Eighteenth Century onwards, the Westerners' impression of China changed significantly. Seeing China from the perspective of Western capitalism, they began to question the brutality of the Chinese monarchy. They also thought that the peasant economy in China was backward, in contrast to the rapid expansion of the Western capitalist economy. Confucian rituals began to be regarded as social indoctrination, because individualism was advocated in the West and people were encouraged to leave the countryside for the urban areas.

From the mid-Eighteenth Century to the early Twentieth Century, the ideal impression of China in the Western countries had completely disappeared. Many historians who study Chinese and Western modern history argue that the Westerners described China as an ideal world for certain purposes. In 1793, British ambassador George Macartney visited China and described China as an uncivilized, cruel and chaotic country. In his mind, the Chinese people were apathetic, greedy, backward, ignorant and rude. This affected the fact that the Westerners began to believe that China was actually not as good as they had imagined and was far behind Europe.

Subsequently, several wars with China further confirmed such Western perception. Although they were still interested in China, they no longer regarded China as an ideal world and they even looked down upon it. Based on data from various sources, the great German philosopher Georg Wilhelm Friedrich Hegel, who had never been to China, concluded that the Chinese culture was stagnant (Hegel, 2005 (tr.): 5). The French philosopher Montesquieu (Charles-Louis de Secondat, baron de La Brède et de Montesquieu, generally referred to simply as Montesquieu) also described China as an autocratic nation. They even thought that the Western invasion of China was beneficial to China in its modernization.[5]

From the beginning of the Twentieth Century, the Western impression of China varied over time. According to Zhou (2003), the Western impression of China had experienced changes for at least 4 times, oscillating between the positive and the negative. After the Communist Party took power in China and a new government was established, their impression of China changed over time. For example, in the sixties when the left-wing socialist ideology was dominant, there were positive comments in the Western societies on the Cultural Revolution in China. While the famine in China at that time had attracted some attention, it was largely ignored by the mainstream media (*ibid*.). It was only after China's reform and opening up that the scholars began to reflect on the negative aspects and the real causes of the Culture Revolution. At the same time, with increasing trade between China and the Western nations, many Western companies began to invest in China, and the number of positive reports related to China's economic reform had also increased. Many Western scholars also believed that China would "choose the capitalist road", leaving its communist allies aside and joining the Western capitalist nations in the future. Adding to the general fogged perception of China in the West was the fact that China was virtually isolated from the other nations for certain period of time in the Twentieth Century. Little was known about China, and hence the Western image of China would tend to go to the extremes. Since China's reform and opening up, the West's negative perception of the Chinese regime's political ideology has tended to be mixed with their positive comments on its economic development.

3. "Beijing Consensus"

Based on this historical background, Ramo's "Beijing Consensus" is apparently related to the West's image of China, although at the beginning of "Beijing Consensus", he clearly declared to have studied China without being coloured by the existing Western image of China.[6] He also indicated that he intended to look at contemporary Chinese development from the perspective of a Chinese. In fact, he proposed that China had emerged as a large nation, and it should not be ignored by other nations. Hence he believed that the discussion on whether to isolate or approach China is irrelevant, and the Western countries needed to have a more comprehensive understanding of China in order to deal with it better.

"Beijing Consensus" is divided into four parts. At the beginning, Ramo proposed that a new and better international consensus had begun to replace the "Washington Consensus" after its failure in all areas of development. In the paper, he negatively commented on the "Washington Consensus", while positively described the "Beijing Consensus". To Ramo, China's new ideas have had a major impact on foreign countries. For these countries which are not only trying to figure out how to develop, but also want to know how to integrate with the international order, while enabling them to be truly independent, China presents a good example in terms of the way of life and the political choices (Ramo, 2005 (tr.): 6). However, Ramo thought that the "Beijing Consensus" seemed to be similar to the "Washington Consensus" which was proposed by certain group of scholars and was imposed on the developing countries. However, the fact is that the so-called "Beijing Consensus" was proposed by Ramo, not by the Chinese government to be imposed on its allies. Therefore, in a way, Ramo seemed to lean on warning the West regarding the possible threat of the emerging China on the existing world order established by the West.[7]

In the second part of the article, "The Useful Axioms of Chinese Development", Ramo described the definition of "Beijing Consensus". Here, he concentrated on innovation and explained the core value of China's development strategy. As a nation which started modern development much later, China has not followed the experience of the advanced countries. On the contrary, it has aggressively introduced innovative and latest technology to promote its economic development. The author suggested that China managed to solve various reform problems in this way. While cutting-edge innovation is essential to conduct reform, reform inevitably leads to more issues, and China reduces "friction" in reform through innovation (*ibid.*: 12). The so-called "friction" mainly refers to social inequality, corruption and environmental pollution in the process of reform. Ramo believed that these innovations had led to economic growth, but they had also brought about controversies. The government had relied on resources obtained from economic growth to solve the above issues. This is an innovative way of resolving social issues.

In its national development model, the Chinese government is seen as not only paying attention to per capita GDP, but also taking into consideration the people's quality of life. Following Deng Xiaoping 邓小平's "black cat/white cat" dictum, Ramo proposed the concepts of the "green cat" and the "transparent cat". The former refers to environmental protection and the scientific outlook on development to achieve sustainable development, while the latter refers to information transparency regarding data on China's economic development. According to Ramo, the Chinese government is working hard to build an economic environment for sustainable and equitable development (*ibid.*). Such development concept reflects the Chinese government's pragmatic approach. Therefore, Ramo specifically pointed out that the continued reform and change since 1979 is driven by knowledge rather than ideology. Those changes seem strange in the eyes of the Westerners who regard China as an ideology-driven society. The author also believed that reform had led to the rapid growth of total factor productivity. In other words, its growth outweighs the sum of the original human and capital investment. The additional growth is a result of emancipation. It is obvious that the modernization of China is different from the "Washington consensus", as China is developing according to its own development path.

From the author's point of view, "Beijing Consensus" does not only play a role in China, but under the incoming tide of globalization, China is trying to impose the "Beijing Consensus" on other nations, which will surely lead to international security concerns, since it may cause changes in the existing international order. Of course, it will also threaten the interests of the Western nations. In this regard, Beijing also emerges in a way different from the Western powers. In the paper, Ramo used Germany which emerged during the World War II as a example. He indicated that as a developing nation with great developmental potential, it adopted an asymmetrical defense strategy. China does not directly confront the United States. On the contrary, the country strongly emphasizes on economic development, solves diplomatic conflicts through peaceful approaches, accumulates foreign exchange reserves of up to four hundred billion US dollars, cultivates high-quality armed forces and develops its non-conventional and asymmetrical military forces.

Expanding the sphere of influence of the "Beijing Consensus", Ramo indicated that China intended to revitalize its national development through reform and opening up, develop good diplomatic relationship with other nations through international trade, and develop its strong armed forces, so as to become a major power in the world. He also argued that such a development model was very attractive for small nations which could learn from China in terms of economic development, and in fact develop their economies by taking advantage of China's large purchasing power. As for China, international trade has the potential to make other nations rely on it economically, which places itself in a favourable condition, while it may be on the way of becoming a major power like the United States or even replacing the latter.

At the end of paper, Ramo concluded that China was building a new development path of innovation and asymmetrical power to achieve people-centered development and a balance of individual rights and responsibilities, and the Western nations should pursue effective measures to deal with China. Those measures must be made in accordance with the nature of Chinese society and politics, and indirect actions are preferable. He also suggested that the Western nations should consider the following aspects: China's weaknesses; indirect manipulation as being more effective that persuasion; the utmost importance of overall environment (*ibid*.: 47). Specifically, it is better not to criticize China's national policies. Instead, the author proposed cooperation with China, through which Western governments could provide subsidies to China, while China could make use of its strengths. For example, on the issues of AIDS in China, traditionally Western countries hold meetings related to HIV in China and send their doctors to China to discuss about its prevention and treatment strategies. However, China is usually against such programmes because of political concerns and the lack of resources. In Ramo's opinion, Western countries should help China to develop an overall healthcare plan, including an HIV programme. In this way, the original purpose of assistance can also be realized (*ibid*.: 49).

Of course, a better choice is to re-establish a more comprehensive framework of bilateral cooperation to work together to solve the relevant issues. In the process, the US should not make efforts to isolate China. Instead, the two nations should work together in the fields of nuclear proliferation, energy security and others to jointly maintain world security. Besides, Ramo advised China to bear more responsibility as a major world power. According to Ramo, although China would want to continue to pretend that it is still a poor country, it needs to realize that the reason why so many nations are paying so much attention to itself is that the Chinese people are hardworking. Hence, Ramo advised that China should continue its practice and maintain harmonious coexistence with other nations, as well as to prove that a developing country can also become a strong nation (*ibid*.: 50).

Ramo stressed that the subsequent five years would present a great opportunity for China's future development, and if China could seize the opportunity in the international arena, it would be well accepted by all countries. Interestingly, at the end of the article, Ramo justified his conclusion with words from Deng Xiaoping. He said that Deng Xiaoping once said that China would help the other nations after it had reached per capita income of a thousand dollars, and help build a more secure, equitable world.[8]

China's per capita income did exceed one thousand dollars in 2003. Hence, Ramo believed that China should be involved more in assistance projects around the world, since it would become a good example from which other nations could learn, and it should contribute to world development.

There were favourable comments on Ramo's paper among the Western nations. As mentioned above, after the Communist Party took over power in China, the Western nations had twice given favourable comments on China. However, it turned out that the favourable comments were due to the lack of sufficient information on China, which was also the cause of negative comments in the past. At the beginning of 2000, some Western scholars proposed the "China threat" theory and the "China collapse" theory, which were also proven to be far from the reality. Ramo's "Beijing Consensus" seems to be comparatively more rational, since he has a better understanding of the Chinese government's political thinking. Instead of negatively commenting on the Chinese government's political behaviour, he in fact gave favourable comments on the government's role in China's economic development, social stability and public issues.

After "Beijing Consensus" was published, domestic and overseas media responded to it actively. As Ramo said, the focus of discussion gradually turned to China's economic development. Therefore, people later paid more attention to the "China Model" than "Beijing Consensus". However, favourable comments remained, and Western scholars still have certain interest in the discussion. Take Ramo as an example. Although he gave much favourable comments on China, he aimed to propose measures for Western nations to deal with China so as to get China involved in the existing international system. Therefore, in discussing the "China model", those scholars were always commenting with their own respective nations' interest in mind. In addition, diverse views usually emerged after discussions. Some thought that the "China model" bore similarities with some past examples. For example, Professor Huang Jing from Singapore argued that the "China model" is simply another "East Asian model", referring to Japan and the Asian "tigers" which achieved rapid economic development through opening up, attracting foreign investment and expanding exports. He concluded that China's remarkable economic development was mainly a result of steady foreign investment and prospering overseas market (Ye, 2009). He also pointed out that Ramo's comment was not a fresh one after all. Huang Yasheng used Brazil's economic development in the 1960s as an example. He indicated that although the state-dominated economic model in Brazil contributed to rapid economic growth to some degree, uneven distribution of social wealth also occurred, which in turn led to many negative economic, political and social issues in the long run (Huang, 2010). These observations led further to more diverse and divergent discussions. It is worth noting that many scholars who are overseas Chinese usually seem to have a better understanding of China.[9]

4. China's Response

Since the "Beijing Consensus" was proposed in 2004, it had attracted intense discussions outside China. However, the Chinese government and the Chinese scholars had kept silent on it for a long time. Chinese officials have never expressed their views on the issue in public. Chinese scholars had also initially been silent about it. In August 2005, an "International Conference on China's Development Road" (中国发展道路国际学术研讨会) was held in Tianjin, in which over one hundred Chinese and foreign political scientists were present. This was the first response on this subject from Chinese scholars.[10] Yu Keping 俞可平, the deputy director of the Compilation and Translation Bureau of the CPC Central Committee (中共中央编译局) and a well-known political scientist, described the "China model" (中国模式) as a strategic choice of China to achieve modernization against the background of globalization. In the future progress of reform and opening up, Yu said, the principle of reform, development and stability should be maintained, and the government should pay attention to both GDP and other human development indicators, such as environmental protection, ecological balance, population growth, national quality, social stability and cultural education (Yu, 2005). While his argument is almost the same as Ramo's as expressed in the "Beijing Consensus", he did not agree with Ramo's appeal for increasing China's international responsibility. Talking about globalization, Yu indicated that China should maintain its own characteristics and continue to be active in the international arena (*ibid*.). Such Chinese official stance apparently was not in total agreement with Ramo's proposals, but it did not publicly oppose them either.

In 2008, along with China's hosting of the Olympic Games and the country's rapid economic growth, heated discussions about the "China model" were again common around the world. At that time, public discussion on it also appeared in China. At the 30th anniversary of the Third Plenum of the Chinese Communist Party Congress (中国共产党十一届三中全会召开30周年纪念大会), Chinese President Hu Jintao 胡锦涛 stated in his speech that there was no universal development path and development model in the world, and China should not be bound to theories in books and should not regard those development models which have demonstrated certain advantages as perfect. This speech was regarded as the Chinese government's attitude towards the subject. So basically those institutions and scholars of official background were usually very cautious about the "Beijing Consensus" and the "China model". For instance, in a seminar on China-EU strategic partnership on 19th November, Li Junru 李君如, the former vice-president of the Party School of the CPC Central Committee (中央党校) indicated that referring to the "China model" (中国模式) is not suitable, as it is far from the reality. Professor Li was worried that other nations might think that China was trying to impose its development model on them if China kept referring to the "China model". Therefore, he proposed a more familiar Chinese term "Chinese characteristics" (中国特色) to replace the "China model". Zhao Qizheng 赵启正, the director of the CPPCC Foreign Affairs Committee (全国政协外事委员会) held the similar point of view. In a forum organized by the Western Returned Scholars Association (欧美同学会) on 26th September 2009, Zhao stated that China did not impose the "China model" on any other nations. If any developing country was willing to learn from China's experience in reform and opening up, this was a natural phenomenon in the context of globalization. Imposing the "China model" on other nations went against China's national conditions and its existing policies. Furthermore, the "China model" was not universal all over the world.[11] On the other hand, also on 26th September 2009, the Chinese Academy of Social Sciences (中国社科院) issued the Blue Book on Development and Reform (发展和改革蓝皮书),《中国道路与中国模式》[China's development road and China model], in which the "China model" (中国模式) is used in conjunction with the so-called "China's development road" (中国道路).

Apparently, China tries to separate "Beijing Consensus" (北京共识) or the "China model" from "Washington Consensus" (华盛顿共识). "Washington Consensus" refers to ten advices to Latin American nations from the economist John Williamson, who once served the World Bank, at a conference in Washington in 1989 (Williamson, 2005 (tr.)). Those advices were called the "Neo-liberal Policy Statement", and were supported by the World Bank, and implemented in many countries in Latin America which received assistance from the World Bank. However, due to the fact that most of the international economic organizations were nominated by the United States, the "Washington Consensus" was sometimes seen to be an ideological framework for US dominance (Chomsky, 2000 (tr.)). However, the "Washington Consensus" was ultimately seen as a failure when those Latin American countries did not achieve the expected results. According to Ramo, in contrast, China and India which went against the "Washington

Consensus" had achieved amazing economic development over the years (Ramo, 2005 (tr.)).

In addition, from China's point of view, the Western political scientists were all proposing that China should bear more responsibilities in the international arena. Ramo stated that China had already risen as a major power in the world for the first time. In September 2005, the US Deputy Secretary of State Robert Zoellick gave a speech entitled "The United States and China are Both Important Players in International Arena".[12] Traditionally, China is always regarded as a developing nation in the international community. Therefore, if China agrees with Ramo's appeal, it will not be regarded as a developing country any more. Professor Qiu Gengtian 邱耕田 from the Philosophy Department of the Party School of the CPC Central Committee indicated that China was required to take on international responsibility as that of the US in the Copenhagen climate summit. He believed that those Western scholars had conducted intense discussion on the "China model" so that China would assume responsibility beyond its power. Nevertheless, he also held that China had to bear its own responsibilities. However, as a developing country, China's international role is clearly limited to its commitment to relevant international obligations. Thus, it is impossible for China to act like the US. Apparently, his opinion reflects the Chinese government's attitude towards the issue.

After 2010, Chinese scholars began to actively react to the "China model" subject. The Central Compilation and Translation Press (中央编译出版社) published《中国模式 —— 解读人民共和国的60年》["China model": analysis of the sixty years of the People's Republic], in which "China model" is redefined. This 630-page book consists of articles concerning the "China model" by Chinese scholars in various fields. The involved authors include Professor Pan Wei 潘维 from the China and World Research Center of Peking University (北京大学中国与世界研究中心), Gao Liang 高粱, a researcher at the Institute of Economic System and Management of the National Development and Reform Commission (国家发改委经济体制与管理研究所), Zhang Baijia 章百家, a researcher at the CPC Central Party History Research Center (中共中央党史研究室), Wen Tiejun 温铁军, the dean of the Agriculture and Rural Development College of the Chinese People's University (中国人民大学农业与农村发展学院), Professor Hu Angang 胡鞍钢 from the Public Administration College of Tsinghua University (清华大学公共管理学院), Professor Wang Shaogang 王绍光 from the Politics and Administration Department of the Chinese University of Hong Kong (香港中文大学政治与行政学系), and Professor Zhu Yunhan 朱云汉 from the Politics Department of Taiwan University (台湾大学政治系). According to the book's editor Professor Pan Wei, the "China model" should be called the "Chinese system" (中华体制). In the past 60 years, the "Chinese system" developed gradually based on the experiences of the Soviet Union and the United States (Pan, 2009: 5). He explained that the "Chinese system" consisted of the "national economy", "people-oriented politics" and "social system". "National economy" (国民经济) refers to a unique economic model; "people-oriented politics" (民本政治) represents a unique political mode; and "social system" (社稷体制) is a unique social model. According to a local magazine, the book was selected by the Press and Publication Administration (新闻出版总署) as a classic, and its versions in English and other languages are being prepared (Shu, 2010a). Obviously, Chinese scholars are now confident to conduct discussion on this subject, and plan to play a leading role in the field. Compared with the others, the book《中国模式 —— 解读人民共和国的60年》["China model": analysis of the sixty years of the People's Republic] was completed by Chinese scholars, and it will be difficult to arouse corresponding discussion among Western counterparts. Certain issues may take place if such subjects are not taken seriously. Wang Changjiang 王长江, a director of the Central Party School, once published a paper which pointed out that apathy towards political reform (政治体制改革麻木症) had appeared in China, with some people feeling that political reform was not as urgent as before and believed that the existing political system is perfect (Shu, 2010b). This is due to following factors: misleading propaganda by the media, "Beijing Consensus" and other unrealistic conclusions.

5. Conclusion

In the past, Western impression of China has changed a lot over time. With development of information technology, such impression of China has become more and more rational. Ramo's article "Beijing Consensus" is a good example in the field. Although he aimed to look at China without being influenced by preconceived opinions, he still maintained his ideological point of view. It is worth noting that he recommended rational exchange with China, since China has become a major power in the world. On the issue of the "China model", silence on the part of China could be counterproductive. When it comes to "Beijing Consensus" and the "China model", Chinese scholars remain cautious, while intending to actively participate in the discussion. While being cautious and confident, it is important for China to take the favourable comments from Western scholars seriously, and pay attention to the possible effects on China's future development.

Notes

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1. *Hou Hanshu – Xiyu Zhuan* 后汉书. 西域传 [“Documentary on western regions” in Book of the Later Han).
2. According to the relevant records, in Seres, killing, prostitution, theft and worship were strictly prohibited. The country had a vast territory, but there were no temples, prostitutes, unpunished thieves, murderers and murder victims. One thing was special: Seres gave birth all the time. Obviously, the author was very curious about the Confucian civilization in the Chinese society, and he was quite impressed with large population in China. Hence he guessed that the Chinese gave birth every day (Coedes, 1987 (tr.): 57).
3. For example, in the Sixth Century AD, in the *Universal Christian Topography* by Byzantine monk Cosmas Indicopleustes, China is called “Tzinitza”. The author respected China as the “country of silk”, and thought that China was far away from the Byzantine Empire. Zhang Xushan 张绪山, professor of history at Tsinghua University, believes that Tzinitza is as important as the Roman Empire in the mind of Cosmas Indicopleustes. (Zhang, 2002) In the Thirteenth Century, in books of travels by Giovanni da Pian del Carpine and William of Rubruck, China was called “Cathay”, a wealthy nation ruled by a highly respected Khan (Zhou, 2005).
4. When he studied *I Ching* 易经 (“Book of Changes”), he found that its mathematical law was similar to his binary numeral system..
5. For related arguments, refer to the famous American historians on China John K. Fairbank, Joseph R. Levenson and Mary Wright.
6. This referred to the Western countries’ basic political attitudes towards China.
7. The meaning of the term “threat” here follows the way the word is used in Ramo’s “Beijing Consensus”. In English the term “threat” is more moderate than in Chinese “威胁” (Ramo, 2005 (tr): 2).
8. In 1979, Japanese prime minister Masayoshi Ohira 大平正芳 met Chinese vice premier Deng Xiaoping 邓小平 in China. The former asked Deng what is the objective in progress of modernization. After a while, Deng replied, “Now, China’s per capita income is US$250. Our goal is to reach US$1000 by the end of this century.” In other words, the figure was expected to quadruple within 20 years. Deng Xiaoping also said, “If we reach the goal, we can do something to contribute to the world’s development. We regard it as a well-off society, at that time, when the problems of food and clothing have been resolved among all Chinese.” (《邓小平文选》第二卷 [Selected works of Deng Xiaoping, vol. 2], p. 237).
9. For more documents on the subject, refer to papers by Zheng Yongnian 郑永年, Huang Jing 黄靖, Zhang Weiwei 张维为, Yao Yang 姚洋, etc.
10. Social Sciences Academic Press (社会科学文献出版社), the Central Compilation and Translation Bureau (中央编译局), CASS International Cooperation Bureau (中国社会科学院国际合作局) and Tianjin Normal University (天津师范大学) jointly held the “International Conference on China’s Development Road” (中国发展道路国际学术研讨会) in which nearly 50 domestic and foreign experts participated in discussions. Their points of view were collected in《中国模式与“北京共识”: 超越 “华盛顿共识”》 [“China model” and “Beijing consensus”: Beyond the “Washington consensus”] published by 社会科学文献出版社 (Social Sciences Academic Press), 2006 (2006年6月第1版).

11. On 7th December 2009, four articles were published in《学习时报》[Study times] which is sponsored by the Central Party School (中共中央党校). The authors of all the articles were against referring to the "China model", which showed that the Chinese government had remained cautious when facing Western scholars' favourable comments. Those four articles are: Li (2009), Zhao (2009), Shi (2009), Qiu (2009).
12. "2005年美国副国务卿佐利克提出中国是美国的'利益攸关方'" [U.S. undersecretary Robert Zoellick stated that China was the United States' 'stakeholder'", 北京晨报 (Beijing Morning Post), 16th September 2009.

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Book Review

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Book Review

Stefan Halper, *The Beijing Consensus: How China's Authoritarian Model Will Dominate the Twenty-First Century*, New York: Basic Books, 2010, 296 pp. + xv.

After thirty years of reform, China has emerged as one of the major powers in the world. Amidst the global economic crisis, China overtook Japan to become the world's second largest economy, successfully organized three major international events (Olympic Games, World Expo, Asian Games), and continued to expand its influence in Africa, South America, and Asia. In contrast, the western powers have been plagued by various threats, crises and problems. Most of these powers seem to have lost the dynamism and optimism that once characterized the "First World". During the good times, the major western powers arrogantly called themselves the Group of 7 (later expanded to G8 to accommodate Russia, which actually was quite insignificant within the organization), as if they were the masters who decided how to run the world. Today, G7 has to relinquish its role to G20, a more diverse group that includes the emerging powers, and among these emerging powers China is undisputedly the most influential.

This change of balance of powers has made some westerners uncomfortable. What makes them even more frustrated is the fact that China is not a democratic state. China's rise has nothing to do with democracy. This statement inevitably challenges the views and beliefs of many westerners who believe liberal democratic values are also universal values. In recent years, within the western policy, academic, and media circles, the China Model (or sometimes called the "Beijing Consensus") has become a hot topic. Some analysts have a very positive view of the China Model (such as John Naisbitt, the main author of *China's Megatrends*), while others hold a more skeptical or negative view. The author of this book, *The Beijing Consensus*, could be said to be one of them.

The Beijing Consensus has seven chapters. The first chapter lays out the fundamental ideas of the book, which I think is also the most important and well-written chapter. The second chapter describes the rise and fall of the Washington Consensus. The third and fourth chapters together discuss the (mostly negative) impact of the rise of China and the China Model. The fourth chapter concentrates on the domestic aspects of China's foreign behaviour. The fifth and sixth chapters discuss what actions and policies should the western powers, especially the United States, take to face the challenges coming from China and the China Model.

What is the China Model? According to Halper, it is composed of two elements, each of which is opposite to the principles of a liberal democratic system. Whereas a liberal democratic system upholds free market capitalism and democratic pluralism, the China Model implements a state-guided market economy and one-party authoritarianism. In short, it can be called "market authoritarianism". Halper is worried that western policymakers have misunderstood the challenges posted by China. The major threat from China, Halper argues, is not in the economic or military spheres. Here, Halper performs an admirable job in the book to dispel the myth that China is capable of launching serious economic or military offensives against the West. The major threat, instead, is that China represents an alternative to the West, a paradigm fundamentally different from the western beliefs that human progress can only be achieved through liberal economics and liberal politics: "Beijing's example illuminates a path around the West. It is making the West less relevant in world affairs. In effect, *China is shrinking the West*." (p. xi) The 21st century, Halper seems to believe, will witness a conflict in which on one side is the West and its liberal democratic allies, and on the other side is China and the countries that follow the China example. This conflict is fundamentally a competition between two contrasting sets of values, systems of governance, and modes of modernity. This is the greatest threat posted by China.

The observations made by Halper regarding market authoritarianism are generally representative among the views of western policy elite. One characteristic of market authoritarianism is the close relationship between the ruling elite and large energy corporations and state-owned enterprises, which also dominate the strategic sectors of the economy. These enterprises are not purely commercial entities; they have political functions and purposes: "Commercial decisions … are heavily guided by political actors, and the motivations behind investment decisions are often as political as, or more political than, they are economics." (p. 123) In addition, market authoritarianism also accepts certain liberal economic policies, such as "opening the economy to foreign investment, allowing labor flexibility, keeping tax and regulatory burdens low, and creating a first-class infrastructure through combined private-sector and state spending" (p. 126). This blending of market economics and state control is the essence of the economic aspect of the China Model. Halper also points out that state-controlled capitalism has a distinct advantage over the Western brand of capitalism. For example, "state subsidies of Chinese firms provide the incentive needed to pursue overseas projects that may not be profitable, but which accomplish long-term strategic PRC investment and commodity access goals" (p. 104).

A strong and capable party (or ruling elite) that controls the government, the security apparatus, legislative and judicial organs, and the media usually defines the essence of the politics of market authoritarianism. Authoritarianism provides commercial advantages over its liberal democratic rivals, which have to deal with domestic political actors and competing interest groups in forging a business agreement. In addition, economic development and the welfare it brings are perhaps the only effective means an authoritarian regime is able to keep its people from demanding more democratic rights and participation. Hence the single-mindedness in the pursuance of economic development also becomes the generic goal of such regime. Such goal predisposes a market authoritarian regime to adopt mercantilist economic policies. China's resource grabs in the African and South American continents are manifestations of such policies. Although China's participation in international cooperation and multilateral forums are extensive, she is nevertheless accused of bending (or even breaking) international rules and cooperation when doing so fits China's mercantilist interests. To back up this accusation, Halper frequently cites examples of Beijing's protection of the so-called "rogue states". Just when the major western powers were trying to squeeze these rogue states (Iran, Sudan, Zimbabwe, etc.) in order to change their deplorable behaviour, Beijing provided the much needed protection these rogue states needed as long as they exported the resources Beijing wanted.

Halper's analysis of the China Model should not be read as only a study of China's development experiences and policies. It should also be read as a general analysis of the characteristics and nature of market authoritarianism. In this sense, this book should be added to the list of readings on comparative government.

I also have several disagreements with Halper. First, market authoritarianism is more easily said than done. Despite Halper's arguments, how many states have actually succeeded in following the China Model? Perhaps one could point to Vietnam, and to a lesser extent, Russia. Cuba has been trying to follow China's experience, but after more than fifteen years and countless trips by Cuban officials to China (which Halper also mentions in the book), Cuba has yet to become a good student of China. As for other successful examples of market authoritarianism, such as Malaysia, Singapore, Taiwan and South Korea (before their democratization in the late 1980s), their development takeoffs happened way before China's development can be called the China Model. Interestingly, all of these market authoritarian regimes were (and still are) American allies, not China's.

Second, exactly which group of countries is China leading in this century? In the grand narrative of the West versus the China Model, Halper is actually very vague in terms of the membership of the China Model camp. First, Halper accuses China of leading and protecting the "rogue states" (Myanmar, North Korea, Iran, etc.). Then, he argues that China leads the emerging powers (Brazil, India, Indonesia, etc.). Moreover, the China Model could be prevalent in those middle-range, regional powers (what Halper calls "pivot powers"). Finally, Halper also argues that China is leading the developing countries to confront the West, especially in the forums of the United Nations and other meetings of international organizations. So, which countries are members of this group of countries that upholds market authoritarianism and competes with the West?

Third, Halper also seems to confuse the China Effect with the China Model. In Chapter 3, Halper provides numerous examples of how China's foreign aid and investment projects help maintain various corrupt and authoritarian regimes. The argument is that because of these Chinese aids, these corrupt regimes would not have to undergo political and governance reforms to meet the standards of the aid programs provided by international organizations and western powers. Halper discusses China's "unholy alliance" with deplorable rogue states, accuses China of undermining Africa's reformers and exploiting African resources. While these accusations against the China Effect are undeniable, such alliances between Beijing and other autocracies are based on interest calculation, not upon compatible values or systems of governance. Western powers also forge major partnerships with oil-producing autocratic states. China is merely a good student of the West's realist politics. There is no evidence that China is trying to promote its brand of development to other countries, especially to the rogue states (with the major exception of North Korea). Halper neglects to mention in this book that none of the rogue states are followers of the China Model. In fact, if they were, it would actually be a blessing to the world and the people in these regimes. As Jeffrey Garten (Yale professor) argued in an article in *Newsweek* ("Chinese Lessons", 24th November 2003), "The China model, or something close to it, may have its problems, but it may be the Arabs' best chance."

Suppose North Korea is successfully following the China Model. Its economy is prospering and more integrated with other economies. People's standard of living is rising, which also improves social and political stability. For the sake of continuous economic growth, this regime generally will also act more rationally toward other countries. The West will find a market authoritarian North Korea less belligerent, more cooperative, more predictable and easier to deal with.

The autocratic leaders of rogue states will not be easily persuaded to accept the liberal democratic system and relinquish their monopolization of political power. But they are more likely to accept the market authoritarian model. Barring successful "people revolutions", the China Model could be the next best thing for the people of these regimes and for the West as well. Moreover, the obstacles facing democratization, as well as the likelihood of authoritarian restoration following democratization, will be much lower if democratic transition occurs in a well-governed market authoritarian regime. In short, in spite of all its flaws and repressions, a relatively well-governed dictatorship like China is better than an ill-governed, close dictatorship. For all these reasons, the West should not be discouraged if dictators of the rogue states decide to walk Beijing's route.

Fourth, I also think that China is unfairly singled out by Halper when it comes to "challenging international order". Yes, China is leading other developing countries to rewrite certain international rules that will reduce the influence of western powers, but what's wrong with that? As acknowledged by many western policymakers, the relative decline of the West is inevitable, and international organizations should reflect these changes in order to stay relevant. India, the largest democracy in the world, is also a friend to many rogue states, but why only China is accused of the China Effect?

Despite these criticisms, *The Beijing Consensus* remains an important book. Its discussion of the nature of market authoritarianism is clear, precise, and thought-provoking. Its policy recommendations will surely be carefully studied by the policymakers in Washington and Brussels. Its vision of a major competition between two camps of countries (remember the Cold War?) may still come true. Political scientists, journalists and policymakers will benefit from reading this thoughtful book.

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