

**The Policy Study Group on
China-Japan-US Cooperation in Asian Pacific Regional
Trade and Investment Liberalization
(Trilateral Forum)**

**FINAL REPORT
with
Summary of the Concluding Session**

An American View

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Introduction

Over the three years of trilateral discussions, world economic events have greatly changed the context of our dialogue. In this short period of time, the Asian miracle became a crisis and, as the failed Seattle talks reminded us, the WTO is not yet a World Trade Organization. At the same time, issues such as e-commerce and the changing nature of trade and financial flows threaten the WTO's structure and stability. None of these issues are easy to tackle. However, they all indicate that dialogue between the three largest Pacific economies is more important than ever. In this last meeting sponsored by the US-Japan Foundation, participants discussed some of the most pressing issues facing the China-Japan-US trilateral economic relationship. Among the most critical items were the progress of Japanese economic reforms and China's possible accession to the WTO. Discussions began with assessments of the changing Asian economic environment and present shortcomings of the WTO.

The Aftermath of the Asian Financial Crisis

At a most basic level, the crisis showed how integrated Asian economies have become and how swift recovery has depended on the "market of last resort," the United States. One American participant described a typical pattern among crisis-hit countries as one of crisis, recovery, and only partial reform. While crisis management is now over, there is still much concern over the unfinished recoveries. Among these concerns are fiscal sustainability (many of the costs of the crisis have not yet been paid), social

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expenditures (the countries are running high deficits), and possible impediments to reform due to financial changes such as a fiscal slowdown. The most important question that emerges from the crisis is how East Asia will become more competitive and capable of dealing with an open market. Recovery is occurring in a context of declining global prices for manufacturing commodities, the mainstay of Asian trade. Another American participant pointed out that perhaps one of the key economic changes with the crisis is the form of investment to the region. Early stage venture capital investment from the US to Asia is likely to increase, especially outside of Japan. However, despite such investment and Asian economies' recent rebound, as a whole the regional economy is quite fragile as a Chinese participant pointed out. As a result, bad debts, lack of economic revival and a continuing export orientation in Japan and China can have serious effects on the rest of Asia.

The World Trade Organization in Crisis?

The failure of recent WTO talks in Seattle points to the many challenges facing the WTO as an organization. Yet the world trading system cannot depend on a single economy: the US. Thus the imperative for liberalization still remains. As the WTO comes to embrace a growing set of countries and issues, the power balance within the organization and its dispute mechanisms are likely to change. According to an American participant in the Forum, the WTO has mainly been designed to guide negotiations between the United States and the European Union. It is unclear how China's entry into the WTO will affect this power balance. Yet discussants from all three trilateral countries stressed the desirability of China's entry into the WTO in order to anchor reforms in China. If intra-Asian trade increases and is qualitatively different from trans-Atlantic trade, this may require major revisions to the WTO dispute process. At times trade negotiations seem to lose sight of the bigger picture: encouraging greater liberalization. As another participant pointed out, WTO trade disputes tend to be win-lose clashes. If this continues, consensus-based processes and organizations outside the WTO may become more preferred by Asian leaders. Organizations such as the World Semiconductor Council were suggested by American industry discussants to the forum as a model because they involve key government and industry players from early stages in trade discussions. Early stage discussions on e-commerce are particularly pressing. E-commerce is restructuring many industries and bringing an unprecedented speed and scope to this process. As Japanese and American participants noted, technology has been moving faster than world trade negotiations. WTO pacts may have to be renegotiated if e-commerce is not taken into consideration now. In short, what is certain is that diligent diplomacy will be required of all parties involved in order to pursue continued trade and investment reform.

Pressing Issues for the WTO in the Trilateral Relationship

The Asian crisis and the challenges facing the WTO make dialogue and mutual understanding among China, Japan and the US ever more important. In this trilateral

relationship, each side brings important issues that need to be addressed. Different conditions and interests motivate each country's approach to, and potential impact on, the WTO. For China, its size and incomplete reforms present the greatest challenges to WTO accession. The fragility of the Japanese financial system and the country's slow recovery prevent it from supporting world demand and Asian recovery. Large continuing US trade deficits bring into question the sustainability of current trading arrangements. As a leader of the WTO, the inability of the US to find and promote a middle ground on issues such as the environment, labor and human rights also raises concerns.

Coping with China's Size and Incomplete Reforms

Key concerns raised regarding China were the potential dislocation WTO accession might bring, renminbi devaluation, and the lack of consistency and transparency in many trade-related decisions. American and Japanese participants asked how China will deal with the predicted unemployment that is to occur with WTO accession. A Beijing-based research institute has predicted the dislocation to be twenty-five times that of NAFTA while China has only five times the population. Similar to its Southeast Asian neighbors, one of China's fundamental challenges is to develop human resources. With the decline in manufacturing commodity prices and the growing importance of adaptive innovation, China like much of Asia is paying a price for not having quality college education systems. This issue has not been adequately recognized or addressed, even by foreign donors. If unemployment does not improve, American and Japanese discussants worried that this may lead to backlash and a curtailment of reform efforts.

Chinese participants responded to these concerns by acknowledging that unemployment has been a historic problem in China and will continue with WTO accession. In the view of one Chinese discussant, unemployment is really a state-owned enterprise (SOE) problem. Thus, the gravest unemployment is in northern China where SOEs are more prevalent. Another Chinese participant pointed out that calculations on WTO-related displacement in China have not adequately taken liberalization-related growth into consideration. Research conducted in Shanghai shows that while unemployment is likely to increase with further market reforms and WTO entry, it is unlikely to be as serious as some US media reports claim.

China's restraint from devaluing the renminbi during the height of the Asian crisis was lauded by many participants. As Chinese participants pointed out, this was to show that China is a responsible member of the global economic community. It also hopes to gain WTO concessions for this action. However, despite Chinese restraint most commentators believed that devaluation is likely to occur at some point. The high exchange rate has forced economic reforms and industrial upgrading, but a US participant did not think this was sustainable. Chinese participants concurred. Concerns were also raised that China may attempt an export-oriented growth strategy to overcome industrial restructuring problems. As American participant pointed out, given the size of China, domestic economy reform will always have a greater impact on welfare improvements

than exports. Moreover, with China's size, an export growth strategy is likely to threaten the stability of the WTO.

Lastly, an American discussant raised concerns over the mismatch between economic arrangements in China and the WTO. This industry participant argued that the rest of the world only knows how to work in a firm-based commercially-driven environment. However, given the yet significant public sector in China, worries were raised regarding discrimination in areas from procurement to intellectual property rights. Other problems cited included the uneven implementation of laws at different levels of government and the different sets of rules for different provinces. In short, it would help if all commercial arrangements were more predictable and transparent. A Japanese participant echoed these concerns and pointed out that the lack of transparency may be one reason that Japanese investment in China has declined. The different rules for economic activity in the large Chinese economy also threaten to overwhelm WTO dispute mechanisms upon China's entry.

A Fragile Financial System and Uncertain Recovery in Japan

Discussions regarding Japan centered on the prospect of economic recovery. As the largest Asian economy, growth in Japan can contribute to further Asian recovery. However, participants differed as to how far this recovery has progressed. While acknowledging that there has been some recovery in the last year, an American participant pointed out that the upturn has not been strong. There have been no growth predictions in the range of 4 to 5 percent. Problems still facing the economy include the nature of fiscal stimulus (mainly through public works) and the potential collapse to expansion once this stimulus dries up. Although banks are reforming, most of the reforms have been about downsizing. However, the real problem is how Japanese banks have conducted business, not labor costs. Concerns were raised as to whether reform efforts may be slowing, especially with the coming elections. According to another American participant, policy mistakes in Japan have exacerbated the country's economic problems. A Japanese participant concurred by pointing out that the timing of policies has often been poor, especially for fiscal policies. However, this Japanese participant was more optimistic than some American commentators because he felt that now the Japanese public generally supports reform. Another Japanese participant mentioned the coincidence of Japanese recovery with greater openness to foreign direct investment. He pointed out that while the Japanese economy took ten years to recover, most Asian economies have recovered in only one year because of their openness to foreign investment. In addition to liberalization, some American and Japanese participants also argued that a strong yen is good for the Japanese economy. The stronger the yen, the greater the recovery in Asia; this will also benefit Japan. In short, unless Japanese policymakers greatly improve the country's liberalization and reform programs, Japan is likely to be the slowest growing member of this triad over the next decade. If Japanese recovery continues to be slow, questions remain regarding the sustainability world economic growth given large US trade deficits.

Continuing US Trade Deficits with Asia and a WTO Leadership Deficit

As one Chinese participant noted, the US trade deficit may exceed \$400 billion this year. He asked, if this continues, will the recovery in Asia be sustainable? Although the US government has now begun to reduce its debts, the US still retains a high current account deficit. One Japanese participant argued that this deficit is qualitatively different from a Japanese deficit or government debt because foreigners hold much of it. Thus it is a greater threat to the stability of the international financial system. In his view, this threat is likely to increase as Europe and Japan recover and more investment shifts to these areas. One Chinese participant pointed out that the US trade deficit figures may be incorrect. He explained how US trade statistics grossly exaggerate the United States' trade deficit with China. If value-added instead of country-of-origin rules are used for calculations, the annual US trade deficit may be less than \$20 billion instead of over \$50 billion. However, as an American participant pointed out, these Chinese statistics do not include Hong Kong, which is now a part of China.

Some Japanese and American participants agreed that the United States failed miserably as a host to the WTO talks in Seattle. In the view of a Japanese discussant, the US administration was grossly unprepared for the talks. An American participant concurred and pointed out that the nonsensical position of the US – focusing only on issues where the US would win – prevented it from considering an agenda broad enough to promote negotiation. This debacle in Seattle risks losing the momentum of negotiations for trade liberalization. If the drive is not maintained many bilateral issues will likely surface and overwhelm the US trade administration.

Concerns were raised about the manageability of trade relations with China. In the view of one American participant, trade benefits with China have often been overstated by the White House in negotiating China's accession to the WTO. The US will compete with other countries in trading with China. Sino-US trade relations are likely to reach a height of tension in 2004-6. Tariff phase-outs are happening very fast. In addition, new rules will be implemented around the same time. Competition policy and intellectual property will continue to be contested. Issues such as the environment, labor and human rights are unlikely to go away in US politics as we have seen in Seattle. If there is a recession or if Taiwan becomes a hot issue, the manageability of these issues will be difficult. In the WTO, the US will need to exercise astute leadership to promote a middle ground on many of these issues in order to achieve further liberalization and world economic growth.

The Benefits of Trilateral Dialogue

The issues raised in the final Trilateral Forum underscores the importance of dialogue. Each of the three major Pacific economies brings important concerns to discussions on trade and investment liberalization. As one Chinese participant pointed out, liberalization is *the* agenda for APEC. However, given the 'consensus' approach in APEC it is imperative that other fora are held to achieve a common understanding of the perspectives and liberalization processes of key national participants in Asian trade. The Trilateral Forum has been helpful in coordinating policy in a post-cold war era. A Japanese participant emphasized that it is important to have such discussions occur not only among governments but also outside of government. In his view, a new millennium round for the WTO should be implemented. The WTO is important to promote globalization. Likewise, the complementarity and value of other arenas for discussion must be recognized. In the view of an American discussant, American policy has perhaps not been more unchallenged than now. But there are also more disagreements today. All three domestic economies will be facing upheaval in the next few years. As China continues to reform and decrease the state sector, as Japan promotes restructuring, and as the US adjusts to e-commerce and stock market-driven changes, continued dialogue will be imperative to ensure these processes continue. A Japanese participant pointed out that trade arguments on purely technical basis often have not succeeded. While the involvement of politics in working-level trade discussions is important, a vision is needed to promote liberalization. Trilateral Forum discussions have pointed out the often ambivalent attitude of one country to the other pair of this trilateral relationship. Sustained exchanges will be vital to keep all three countries in dialogue and keep the relationships equal. Only then can we hope to achieve greater progress toward trade and investment liberalization.