

**Predicting China's Response to the
Trans-Pacific Partnership**

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Introduction

On 5 October 2015, the United States, Japan and ten other Pacific Rim countries struck a historic free trade deal, the U.S.-led Trans-Pacific Partnership (TPP). The TPP, which awaits ratification by lawmakers in each country, draws together countries representing about two-fifths of the world economy, and has been described as the centerpiece of the Obama Administration's economic rebalance to Asia.¹ As an agreement that stretches across the Pacific connecting economies in Asia with those in the Western hemisphere, China – the world's second largest economy – is conspicuously absent among the initial participants of the TPP.

This paper seeks to predict what China's response to the TPP is likely to be, and will do so by comparing three possible scenarios. In the first scenario, China, despite its erstwhile absence from the agreement, eventually opts to join the TPP. The second scenario predicts that China would adopt a more retaliatory posture towards the TPP and seek to push through a competing economic agenda. Between these first two scenarios, this paper argues that the second is by far the more likely. The third and final scenario this paper considers is an extension of the second. As both the U.S. and China pursue their respective economic agendas so as to extend their reach in the Asia-Pacific, they might find that their proposed frameworks are complementary rather than competitive. This third scenario thus explores the possibility of their rival economic initiatives eventually morphing into a wider cooperative framework.

¹ Tom Donilon, "Obama is on the Right Course with the Pivot to Asia," *The Washington Post*, April 20, 2014, accessed on April 30, 2016. https://www.washingtonpost.com/opinions/obama-is-on-the-right-course-with-the-pivot-to-asia/2014/04/20/ed719108-c73c-11e3-9f37-7ce307c56815_story.html

China Joining the TPP

In the six years leading up to 2007, China's GDP grew at an average rate of 11 percent annually. Since the global financial crisis, however, China's growth rate has slowed down to a relatively modest seven percent. Although this figure is still very impressive by most of the world's standards, the slowdown is a reflection of serious long-term problems that plague the Chinese economy. These problems include "chronic overcapacity" in many (particularly manufacturing) industries, a rapidly aging population which entails a rapidly shrinking workforce, and high levels of corporate debt.² More fundamentally, China's economic troubles are perhaps an inevitable byproduct of the painful transition from an investment and export-driven economy to a service and domestic consumption-driven one.

To tackle these problems, the Chinese government has implemented policies that appear to work in the short run, but ultimately fail to address the roots of these problems. For instance, to fuel continued economic growth following the drop in demand for Chinese exports caused by the global financial crisis, the government increased the level of state-directed investment, which has reached more than half of GDP in recent years.³ A high level of investment may not, in and of itself, be a problem. However, economists point to evidence suggesting that "China is overinvesting significantly," with large swathes of investments being misallocated to, and wasted on, building bridges to nowhere.⁴

² John Cassidy, "China's Two Big Economic Challenges," *The New Yorker*, January 12, 2016, accessed on May 1, 2016. <http://www.newyorker.com/news/john-cassidy/chinas-two-big-economic-challenges>

³ David Dollar, "China's Rise as a Regional and Global Power: The AIIB and the 'One Belt, One Road'," *The Brookings Institution*, Summer 2015, accessed on April 29, 2016. <http://www.brookings.edu/research/papers/2015/07/china-regional-global-power-dollar>

⁴ Michael Pettis, "People are Finally Waking Up to China's Massive Over-investment Problem," *Business Insider*, December 28, 2012, accessed on April 29, 2016. <http://www.businessinsider.com/the-imf-on-overinvestment-2012-12>

To address the chronic problems the economy faces, the Chinese leadership has recognized the need to introduce market reforms into the Chinese economy; recent efforts at reform include the creation of the Shanghai Free Trade Zone and nascent Chinese investment agreements with the U.S. and the European Union, both of which are deemed as important steps for China to further open its market.⁵ In spite of resistance from vested interests in China, Chinese President Xi Jinping has vowed “to crack hard nuts and ford dangerous rapids” in the process of implementing more market-based reforms.⁶ Overall, the Chinese elite have clearly acknowledged the need to allow a greater liberalization of its economy in order to deal with the chronic problems it currently faces, or will face in time to come.

Considering the reforms already underway in China, the TPP, then, “constitutes an external justification for the [Chinese] government to carry out its domestic reform agenda.”⁷ In the words of President Obama, the TPP would serve to “strengthen the hands of reformers inside of China,” thereby driving domestic economic reform in China and furthering China’s engagement of the global economy.⁸ Chinese spokesmen have indicated that even though they are not yet ready to meet the requirements, they might be in a few years and could possibly, at that time, seek to join the TPP.⁹

⁵ Adrian H. Hearn and Margaret Myers, “China and the TPP: Asia-Pacific Integration or Disintegration?” *The Dialogue*, July 2015, accessed on April 30, 2016. <http://www.thedialogue.org/wp-content/uploads/2015/07/CLA-TPP-Report-final-web.pdf>

⁶ Charles Hutzler, “Despite Slump, China’s Xi Jinping Pledges Economic Reforms,” *The Wall Street Journal*, September 22, 2015, accessed on May 1, 2016. <http://www.wsj.com/articles/despite-s slump-chinas-xi-pledges-economic-reforms-1442894460>

⁷ Hearn and Myers, “China and the TPP.”

⁸ Interview by Kai Ryssdal. “The Full Interview: President Obama defends the TPP.” 6 Oct 2015. *Marketplace*. Web, accessed on 29 April 2016. <http://www.marketplace.org/2015/10/06/economy/president-obama-talks-trade/full-interview-president-obama-defends-tpp>

⁹ Barry naughton, Arthur R. Kroeber, Guy de Jonquieres, Graham Webster, “What will the TPP Mean for China?” *Foreign Policy*, October 7, 2015, accessed on 30 April 2016.

<http://foreignpolicy.com/2015/10/07/china-tpp-trans-pacific-partnership-obama-us-trade-xi/>

However, even though the Chinese leadership has expressed a desire to implement more market-based reforms and to allow markets more sway in allocating resources, it has also emphasized that the government will maintain firm regulatory hold of the economy;¹⁰ a “crucial party blueprint for reform passed in late 2013 [made clear] that state ownership must still play a ‘leading role’ in the economy.”¹¹

Further, it is apparent to observers that “preservation of communist party rule is the core interest of China’s leaders.”¹² It is therefore likely that China will find some of the rules of the TPP too politically sensitive to accept, especially those that set standards relating to the protection of intellectual property, labor rights, the environment, and the privatization of state-owned enterprises. An example of a stipulation the Chinese government would find particularly objectionable is one that relates to “Investor-State Dispute Settlement” (ISDS):

“ISDS gives a foreign investor the right to use international arbitration (such as tribunals presided over by the World Bank or the United Nations) to settle its dispute with the host country government. Essentially, ISDS creates a dispute settlement mechanism that is above the host country government to ensure fair and impartial dispute settlement between the host country government and the foreign investor. In a country that already has a fair and impartial dispute settlement mechanism, ISDS may not be even necessary and is merely another channel to resolve disputes. However, if the host government has absolute power and the legal system is there to serve government policy, ISDS would fundamentally undermine the government’s power.”¹³

¹⁰ Hutzler, “Despite Slump, China’s Xi Jinping Pledges Economic Reforms.”

¹¹ Cary Huang, “It’s the Geopolitics, Stupid: US-led TPP Trade Pact Less About Boosting Economies than About Containing China’s Rise,” *South China Morning Post*, November 6, 2015, accessed on May 1, 2016. <http://www.scmp.com/news/china/policies-politics/article/1876024/its-geopolitics-stupid-us-led-tpp-trade-pact-less-about>

¹² Bilahari, Kausikan, “Asia’s Strategic Challenge: Manoeuvring between the US and China.” *The Centre of Gravity Series, Australian National University*, July 2015, accessed on January 5, 2016. <http://ips.cap.anu.edu.au/sites/default/files/COG%20%2322.pdf>

¹³ Seung Ho Park and Shaomin Li, “Does China Need the Trans-Pacific Partnership?,” *Forbes Asia*, November 17, 2015, accessed on May 1, 2016. <http://www.forbes.com/sites/ceibs/2015/11/17/does-china-need-the-trans-pacific-partnership-tpp/#7db3859b6b0f>

Even though the Chinese leadership recognizes the importance of introducing market-based reforms for the sake of the economy's long-term health, it is only willing to allow the reforms to take place insofar as they do not threaten the Communist Party's rule. Therefore, it is unlikely that China will seek to join the TPP given that doing so could well undermine the stability of the regime.

Another factor for China to consider in deciding whether to join the TPP takes the form of the costs that would accrue from its absence from the TPP. According to some estimates, income losses to China from not participating in the TPP will amount to over U.S. \$46 billion by 2025.¹⁴ Conversely, should China participate in the TPP, it could, according to these same estimates, gain over U.S. \$800 billion over a similar time period.¹⁵

Some scholars, however, question the extent to which China would be hurt by the TPP, and argue on the contrary that the economic impact of the TPP to China could in fact be rather marginal.¹⁶ First, some of the TPP member countries – such as Australia, New Zealand, and Singapore – are at a very different stage of economic development compared to China. While China relies heavily on exporting “low-end manufactured goods, the [afore-mentioned] member countries ... specialize in producing high-tech products and intermediary goods.”¹⁷ As such, the extent to which these countries would divert trade away from China as a result of the TPP is likely to be minimal. Malaysia and Vietnam are the only two member countries of

¹⁴ Joshua P. Meltzer, “Why China should Join the Trans-Pacific Partnership,” *The Brookings Institution*, September 21, 2015, accessed on May 1, 2016. <http://www.brookings.edu/blogs/order-from-chaos/posts/2015/09/21-us-china-economic-integration-tpp-meltzer>

¹⁵ *Ibid.*

¹⁶ Wen Jin Yuan, “The Trans-Pacific Partnership and China's Corresponding Strategies,” *Center for Strategic and International Studies*, June 2012, accessed on April 30, 2016.

http://csis.org/files/publication/120620_Freeman_Brief.pdf

¹⁷ *Ibid.*

the TPP that would have a “competitive trade relationship” with China.¹⁸ However, the relatively small sizes of their economies as well as their modest overall trade volumes mean that the negative effect on China of increased competition with Malaysia or Vietnam is not likely to be too significant.

China Retaliating Against the TPP

Due to the differing assumptions on which different researchers base their predictions, there is no clear agreement about the economic effect exclusion from the TPP would have on China’s economy. Even if one were to concede in the worst case that being excluded from the TPP would indeed have a sizable negative impact on China’s economy, China evidently does not see joining the TPP as its only recourse. Rather than join the TPP to make up for these losses, it seems likely that China would seek to retaliate against the TPP by pursuing its own regional economic initiatives.

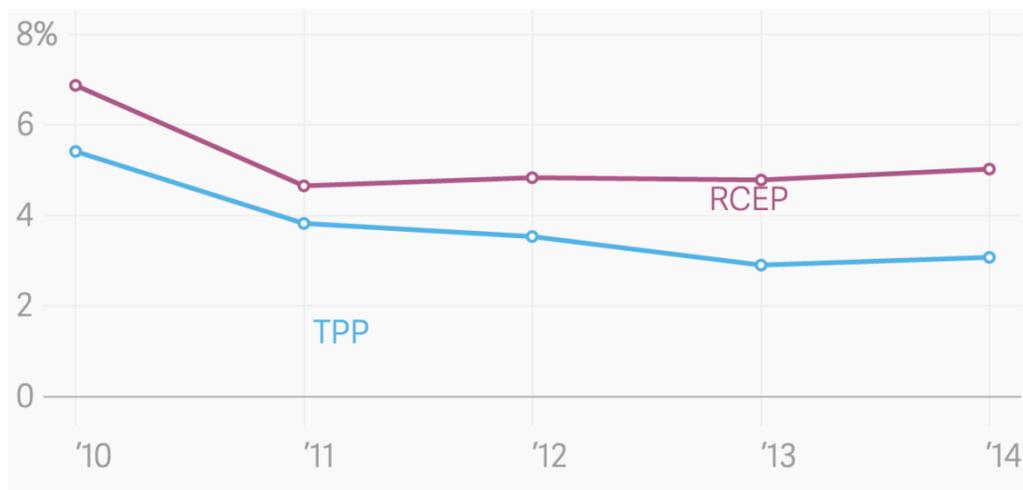
One of the means through which China appears to be retaliating against the TPP is the Regional Comprehensive Economic Partnership (RCEP). The RCEP, conceived in 2013, is a regional free trade agreement currently being negotiated by the 10 member states of the Association of Southeast Asian Nations (ASEAN) as well as such countries in the region as Australia, India, Japan, New Zealand, and South Korea. If this initiative goes through, it will “create an economic bloc with a combined population of 3.4 billion and trade volume of \$10.6 billion, accounting for nearly 30 percent of the world’s trade.”¹⁹ Just as China is missing from

¹⁸ *Ibid.*

¹⁹ See Kit Tang, “RCEP: The Next Trade Deal You Need to Know About,” *CNBC*, October 14, 2015, accessed on April 30, 2016. <http://www.cnbc.com/2015/10/14/tpp-deal-pressures-rcep-trade-talks-in-busan-china-keen-for-progress.html>

the TPP, the U.S. is excluded from the RCEP, which reinforces the notion that the RCEP is China's answer to the U.S.-led TPP.

Prima facie, the RCEP does not appear to be an adequate rival to the TPP: For starters, as a proportion of world GDP, the countries involved in the TPP cover 36% of the world's economy, whereas the countries of the RCEP represent only 29%.²⁰ However, in terms of average GDP growth, the member countries of the RCEP have outpaced the member countries of the TPP, which suggest that in the foreseeable future, the combined GDP of the RCEP nations could well exceed that of the TPP nations.²¹ Thus, from a strictly economic perspective, there is good reason for China to promote its own economic initiative rather than join the TPP.



(Average GDP Growth Rate of TPP nations vs. RCEP nations)²²

²⁰ Richard Macauley, "Thought the TPP was a Big Deal? China's Rival Free Trade Pact Covers Half the World's Population," *Quartz*, October 8, 2015, accessed on May 1, 2016. <http://qz.com/519790/thought-the-tpp-was-a-big-deal-chinas-rival-free-trade-pact-covers-half-the-worlds-population/>

²¹ Not to mention the number of people represented by both trade blocs. With India thrown in the mix, the RCEP represents almost half of the world population, while the TPP represents only slightly more than 10 percent.

²² Macauley, "Thought the TPP was a Big Deal?"

This rings all the more true when we consider the uncertainty about whether the TPP will actually come into force. The TPP only comes into force either if all the signatories complete their own domestic ratification procedures or if “at least six countries, which between them represent at least 85 percent of the total GDP of the original 12 ... [ratify] it within two years.”²³ In other words, the TPP cannot and will not come into force until the U.S. Congress votes to pass it. Immediately after the deal was signed in Auckland late last year, there were signs that it was going to be an uphill battle, as lawmakers from both the Republican and the Democratic parties criticized the deal for different reasons; this situation is likely to be further complicated by the fact that it is an election year.²⁴

Moreover, a retaliatory response from China is also more likely given the predominant perception among the Chinese leadership that the TPP is part of the U.S.’s strategy to contain China’s rise and growing influence. An article published in the People’s Daily – an official newspaper of China’s Communist party – noted that “[the] TPP is superficially an economic agreement but contains an obvious political purpose to constrain China’s rise.”²⁵ This perception is reinforced in no small part by comments made by some American leaders. U.S. President Barack Obama said that the TPP is important in prevent China from writing the rules of the global economy, one that has hitherto been dominated by the U.S.,²⁶ while U.S. Secretary of Defense Ashton Carter has stated that the TPP is “as important to [him] as

²³ Catherine Putz, “TPP: The Ratification Race is On,” *The Diplomat*, February 5, 2016, accessed on May 1, 2016. <http://thediplomat.com/2016/02/tpp-the-ratification-race-is-on/>

²⁴ Daniel W. Drezner, “Will Congress Approve the Trans-Pacific Partnership,” *The Washington Post*, October 6, 2015, accessed on May 1, 2016. <https://www.washingtonpost.com/posteverything/wp/2015/10/06/will-congress-approve-the-trans-pacific-partnership/>

²⁵ Ding Gang and Ji Peijuan, “The US Attaches Great Importance to the Pan-Pacific Partnership,” *Renmin Ribao (People’s Daily)*, July 27, 2011. Translated by Wen Jin Yuan in “The Trans-Pacific Partnership and China’s Corresponding Strategies.”

²⁶ Jackie Calmes, “Trans-Pacific Partnership is Reached, but Faces Scrutiny in Congress,” *The New York Times*, October 5, 2015, accessed on April 30, 2016. <http://www.nytimes.com/2015/10/06/business/trans-pacific-partnership-trade-deal-is-reached.html>

another aircraft carrier,” because it would help the U.S. promote a global order that reflects American interests and values.²⁷

In addition to the RCEP, China has also recently launched new initiatives such as the Asian Infrastructure Investment Bank (AIIB) and the “One Belt, One Road.” While these initiatives are undoubtedly motivated by China’s domestic economic challenges and the need to provide new stimulus for its slowing economy, it is evident that they were also designed to extend Beijing’s geopolitical leverage in the region and to respond to what it sees as the U.S.’s attempt at containment.²⁸ The U.S. has again contributed to the geopolitical narrative by discouraging its allies from joining the AIIB, although its advice mostly fell on deaf ears.²⁹

In considering both economic and geopolitical factors, there is good reason to believe that China will respond to the TPP by pushing for economic initiatives of its own; doing so would allow China to maximize its economic benefit while resisting the U.S.’s attempt – both real and perceived – to constrain its rise. However, even though the U.S. and China appear at first glance to be promoting diverging initiatives, some suggest that they would soon come to realize that their goals are not so much competitive as they are complementary. In other words, their distinct and supposedly rival economic initiatives could pave the way for an overarching cooperative framework.

²⁷ Ash Carter, “Remarks on the Next Phase of the U.S. Rebalance to the Asia-Pacific,” Speech delivered at McCain Institute, Arizona State University, *U.S. Department of Defense*, April 6, 2015, accessed on April 30, 2016. <http://www.defense.gov/News/Speeches/Speech-View/Article/606660/remarks-on-the-next-phase-of-the-us-rebalance-to-the-asia-pacific-mccain-instit>

²⁸ Scott Kennedy and David A. Parker, “Building China’s ‘One Belt, One Road,’” *Center for Strategic & International Studies*, April 3, 2015, accessed on May 2, 2016. <http://csis.org/publication/building-chinas-one-belt-one-road>

²⁹ Dollar, “China’s Rise as a Regional and Global Power.”

Moving Towards an Overarching Cooperative Framework

Influential economist Paul Krugman has argued that the formation of large trade blocs, and the “consolidation of the world into a smaller number of such blocs may ... reduce welfare, even when each bloc acts to maximize the welfare of its members.”³⁰ This assertion is premised on the assumption that free trade agreements create costly “trade diversion,” a form of economic inefficiency that results when trade is diverted more efficient exporters to less efficient ones. As trading blocs would presumably erect high barriers against countries that are not members of their respective blocs, large trade blocs that would be formed as a result of both the TPP and the RCEP would have a net negative effect on world efficiency.

However, another paper written also by Krugman around the same time suggests an opposite effect, when one takes geography into account. While free trade agreements do have the potential to produce trade diversion, the losses are likely to be limited when a trading bloc comprises “more or less neighboring countries, who would be each other’s main trading partners even without special arrangements.”³¹ The gains from creating free trade agreements/areas outweigh the costs of doing so when so-called “natural blocs” are formed by economies that are already trading extensively with each other prior to the agreement.³²

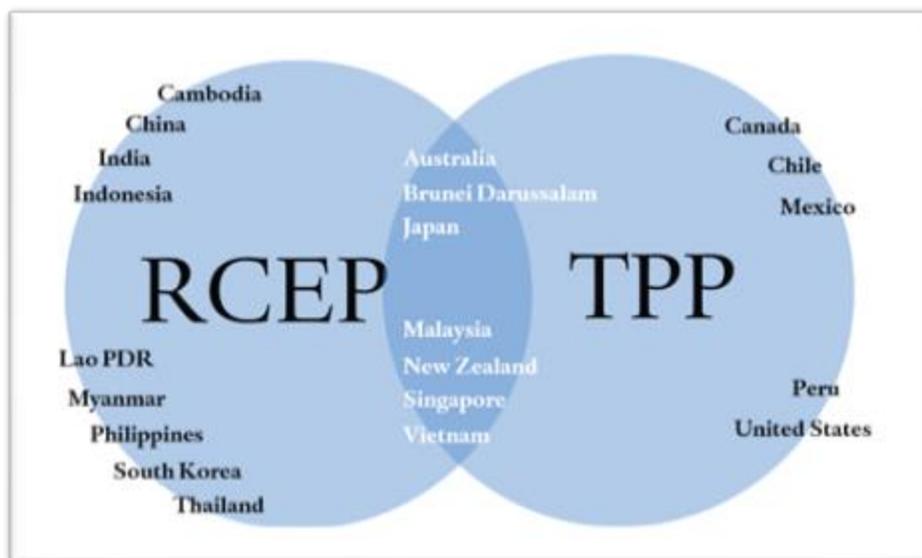
It is important to note, with the RCEP and the TPP, that seven countries in the Asia-Pacific are involved in both initiatives (out of a total of 16 for the RCEP and 12 for the TPP). This suggests that the first scenario outlined by Krugman – in which competition between

³⁰ Paul Krugman, “Is Bilateralism Bad?” *National Bureau of Economic Research*, May 1989, accessed on May 1, 2016. <http://www.nber.org/papers/w2972.pdf>

³¹ Paul Krugman, “The Move Toward Free Trade Zones,” in *Policy Implications of Trade and Currency Zones*, a symposium sponsored by the Federal Reserve Bank of Kansas City, August 1991, accessed on May 2, 2016. <https://www.kansascityfed.org/publicat/sympos/1991/s91krugm.pdf>

³² Peter A. Petri and Ali Abdul-Raheem, “Can RCEP and the TPP be Pathways to FTAAP?” *Pacific Economic Cooperation Council*, accessed on May 2, 2016. <https://www.pecc.org/state-of-the-region-report-2014/265-state-of-the-region/2014-2015/595-chapter-2-can-rcep-and-the-tpp-be-pathways-to-ftaap>

different trade blocs erode overall welfare – is unlikely to materialize, given the significant overlap of countries participating in both.



(Visual Representation of Countries Involved in the RCEP, the TPP, or both)³³

Further, it is very possible that the RCEP and the TPP “will have different depths and areas of coverage.”³⁴ The seven countries participating in both trade agreements notwithstanding, the other countries represented by both trade agreements can generally be divided along the lines of economic development – with the TPP countries as a whole more economically developed than the RCEP countries. As such, while the TPP espouses a “no gold standard, no deal” stance towards its signatories, the RCEP “provides a more generous consideration of each state’s development needs” and allows for the participation of countries that could not and would not otherwise be able to comply with the TPP’s relatively stringent

³³ Alyssa Ayres, “Where’s India on the Trans-Pacific Partnership?” *Forbes Asia*, October 6, 2015, accessed on May 2, 2016. <http://www.forbes.com/sites/alyssaayres/2015/10/06/wheres-india-on-the-trans-pacific-partnership/#5fd0a94f77>

³⁴ Daniel Wu and Marc Mealy, “Explaining ‘Competing’ Visions: ASEAN-RCEP, TPP, FTAAP,” *Pacific Forum CSIS*, June 26, 2012, accessed on May 2, 2016. <http://csis.org/files/publication/Pac1240.pdf>

demands.³⁵ Therefore, given the wide range of developmental stages represented by the countries in the Asia-Pacific, there could indeed be room for both the TPP and the RCEP to coexist, with each serving the varying needs and circumstances of their respective member countries.

All in all, while both trade agreements are frequently described as rival trading blocs led by the U.S. and China respective, there is evidence to suggest that this simplistic characterization does not sufficiently account for the possibility that these agreements could in fact be complementary. In fact, there are some observers who suggest that there is a chance that these two trade groupings could eventually morph into a Free Trade Area of the Asia Pacific (FTAAP) – a longstanding goal of the Asia-Pacific Economic Cooperation (APEC),³⁶ the benefits of which, according to some estimates, could amount to U.S. \$2.4 trillion of output added to the world economy annually.³⁷ By facilitating “experimentation with and adjustment to deeper integration,” the RCEP and the TPP could serve as foundations upon which an FTAAP could eventually be established.³⁸ This could be achieved by expanding either the TPP or the RCEP to include the member countries of both agreements, or alternatively, by creating a separate “umbrella agreement”; this agreement would be separate from the TPP and the RCEP, but shaped by their provisions.³⁹ China has expressed its strong desire for the formation of an FTAAP; at the 2015 APEC meeting, President Xi voiced the

³⁵ *Ibid.*

³⁶ Petri and Abdul-Raheem, “Can RCEP and the TPP be Pathways to FTAAP?”

³⁷ “China an Active Force in Regional Economic Integration,” *Xinhuanet*, November 19, 2015, accessed on May 2, 2016. http://news.xinhuanet.com/english/2015-11/19/c_134834693.htm

³⁸ *Ibid.*

³⁹ *Ibid.*

“need to accelerate the realization of FTAAP and take regional economic integration forward.”⁴⁰

However, while there are compelling economic reasons for the FTAAP, achieving an agreement on this scale is no easy task. Even though World Trade Organization (WTO) rules serve as the basis of both the RCEP and the TPP, the two agreements nevertheless differ on many difficult issues.⁴¹ As has been discussed, the TPP has higher standards on issues like labor and environmental standards and intellectual property rights. It is unlikely that member states of the TPP – particular the U.S. – would be willing to compromise the standards of the TPP for the sake of greater inclusivity. Ultimately, whether the different economic initiatives can pave the way for a larger cooperative framework is largely dependent on cooperation between the U.S. and China, and on whether they can resolve their core disagreements.⁴²

Conclusion

Of the three scenarios this paper has discussed, the first is the least likely. Given China’s perception of the TPP as an aspect of the U.S.’s attempt to constrain its rise, China is more likely than not to adopt a retaliatory posture towards the TPP. Further, by setting up its own economic initiative in the form of RCEP, China could arguably make a bigger gain economically than by joining the TPP.

This paper makes no firm conclusion regarding the third possibility. Both the U.S. and China – as well as countries in the Asia-Pacific – are well aware of the benefits a wider

⁴⁰ Shannon Tiezzi, “As TPP Leaders Celebrate, China Urges Creation of Asia-Pacific Free Trade Area,” *The Diplomat*, November 19, 2015, accessed on April 30, 2016. <http://thediplomat.com/2015/11/as-tpp-leaders-celebrate-china-urges-creation-of-asia-pacific-free-trade-area/>

⁴¹ Petri and Abdul-Raheem, “Can RCEP and the TPP be Pathways to FTAAP?”

⁴² Hearn and Myers, “China and the TPP.”

cooperative framework would bring, and are understandably keen on making it a reality. However, it is unclear if the key stakeholders are willing and able to lay aside their differences in bringing it to fruition.