

# Trade and Economic Integration in the Asia-Pacific Region

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## Abstract

In 2021 New Zealand will chair APEC within a very different Asia-Pacific economy than was the case when New Zealand last chaired APEC in 1999. The Asia-Pacific production network is now much more intensive, covers more economies and is a much larger and more influential part of the international economy than was the Japan-led ‘flying geese’ model of the years before 1999. The single most important change is China’s increasingly pivotal role in both the Asia-Pacific and the global economy, despite continuing challenges. United States dominance of the international framework is more constrained. Adaptation, which has always characterised global and regional governance, will continue as China and the US contest technological leadership and the formulation of international rules and norms, especially in response to the digital revolution.

**Keywords** Asia-Pacific, rise of China, China-US, international governance

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**N**ew Zealand will chair APEC virtually in 2021, 22 years after its last and to date only hosting. This article reviews the Asia-Pacific regional economy in which New Zealand participates, with an emphasis especially on the impact Covid-19 has had on its prospects.

The Asia-Pacific economy is now a much larger part of world economic activity, as production networks link firms in these economies and their outputs. This development was led initially by Japan’s activities in the region, joined later by the ‘tigers’ – South Korea, Hong Kong, Taiwan and Singapore – and then extending throughout South East Asia, creating a ‘flying geese’ pattern of economic development. The rapid rise of China and its overwhelming size, however, meant that it could not be seen simply as another member of a flock.

Building on GATT – the General Agreement on Tariffs and Trade – as the first major regional trade architecture post World War Two, APEC met for the first

time in November 1989 in Canberra. Today, it maintains some of the nature of ‘track 2’ diplomacy, providing a venue for agreeing on common objectives and reporting on progress towards their achievement. It does not negotiate enforceable agreements. The prominence of ‘track 2’ remains a distinguishing feature of the Asia-Pacific.

APEC has witnessed a significant rise of the Asia-Pacific economies. But there have also been major setbacks, such as the Asian financial crisis in 1997–98, the global financial crisis in 2008–09, and now the Covid-19 pandemic. The economies in APEC now contribute 50% of world

Resources, especially a large supply of affordable labour which had been isolated from the international economy, became available, and the world benefited as many Chinese were lifted out of poverty.

The devaluation of the Chinese yuan in January 1994 by 33%, from 5.9 yuan to 8.7 yuan to the US dollar, has created significant cost advantages for China since. By the time of its accession into the World Trade Organization (WTO) in 2001, China had become the sixth-largest economy in the world. By 2010 it was the second largest. In 2013 it overtook the US to become the world’s largest trading nation and it has

as China, grows faster than the aggregate of which it is a part, it becomes a larger fraction of the whole. But, given that its economy has grown tenfold since its accession to the WTO, with an average annual GDP growth rate of 9.2%, its growth will inevitably slow down. Of course it must. But there is still a great deal of underutilised resources in central and western China which has yet to be fully absorbed into the global economy.

### *More expectations from China*

The Covid-19 pandemic has led to some concerns around China, one of which is over-dependence on it of other economies. Some instances of relocating factories from China to Vietnam and Thailand have been observed, but there have been no discussions around how this could be undertaken on a larger scale that also involves trade. It takes significant commitment, effort and time to displace a large trading partner. Commitment and effort can be driven by a government, but businesses are unlikely to act for nationalistic reasons. Arguments for reducing risks only make sense if the current profits and opportunities are not forsaken for a future potential reduction of risk. Governments that want to exploit this hollowing-out will need to have the proper infrastructure and human skill sets in place to do it, and building these takes time. No country possesses the combination of capabilities and capacity needed to displace China’s role in the global supply or value chains.

Trade can be impeded by infrastructure limitations. Logistical challenges include limited and expensive air freight options and limited throughput in shipping services. This is one of the major motivations of China’s Belt and Road Initiative, to service further trade growth (among other benefits). Scepticism of China has ensured that the Belt and Road Initiative continues to receive a lukewarm reception in some countries, most notably in the West. For the time being, cross-border closures will slow the project down. However, China’s commitment to the Belt and Road Initiative will remain, as it is now part of the constitution of the Communist Party of China.

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product trade and 40% of world service trade.

Thirteen of New Zealand’s 15 largest trading partners are APEC members, with the UK and Germany the only exceptions. Clearly, developments in the Asia-Pacific are critical from New Zealand’s perspective, given that Asia-Pacific economies are likely to be leading global economic growth during this pandemic period, and are also the likeliest sources of growth in the next two decades.

The Covid-19 pandemic is a major disruptive force for the economic progress in the region. But the pandemic also puts a serious dent in many economies outside the region, so we are unlikely to witness a drop in the economic contribution of this region beyond 2020. We believe several trends will dominate the next decade.

### **Trends in the Asia-Pacific economy**

#### *China’s ascendance in the Asia-Pacific and global economy*

China’s rise in the global economy is not an accident. Since its opening up in 1979, China has been a source of low-cost manufacturing for the rest of the world.

held this position since. China’s trade has been a key instrument of its growth for the past two decades. And as trade rose, so did its economy. To contextualise, in 2018 China’s economy grew an equivalent of seven times the size of New Zealand’s economy.

The core of this achievement was the reorientation of resources in China towards satisfying the demands of consumers in China and in the global economy. That required decisions of the Chinese government to permit utilisation of the resources, and it required decisions of other governments not to exclude Chinese products – a win-win situation. China was incorporated into the global economy because it suited the Chinese desire for development and modernisation, because it made products available to non-Chinese consumers, and because it created opportunities for non-Chinese interests to participate in the mobilisation process through investment in China and related supply chains.

It is a mathematical truism that China’s growth and world growth must eventually converge. When a large component, such

Nor should one focus only on the immediate flow of goods and services across borders. Production in China has to remain aligned with consumer demand. This may require knowledge and equipment sourced from abroad, meaning that a smooth process of international investment is required. The environment has to be attractive to foreign investors, in terms both of the financial return it offers, and of being an attractive location for conducting business. China has boosted its ease of doing business ranking in recent years, rising from 99th in 2012 to 31st in 2019.

Nonetheless, China has its challenges domestically. While the middle-income group is growing, the consumption economy has not taken off. In 2019 China's household consumption constituted only 39% of its GDP, way lower than the global average of 63%. The older generation continues to rack up significant savings. As at August 2020, deposits in banks stood at US\$30.2 trillion (the figure for the US was \$15.6 trillion), slightly more than twice the size of its economy. The domestic economy would be boosted by a small percentage of these savings being spent locally. And the Chinese government is encouraging this. While the younger population has been doing quite a bit of conspicuous consumption in recent years, the uncertainty surrounding the pandemic is likely to slow the consumption economy a little.

China has become an economic centrepiece and an integral part of both Asia-Pacific and global supply and value chains. It has not issued a forecast of its GDP growth since the Covid-19 pandemic began, choosing to manage its growth in more flexible and pragmatic ways. But, given the financial muscle that it has, we should expect it to continue to have a lot of say in Asia-Pacific economic matters.

#### *US versus China: who blinks first?*

The year 2013 saw the US surpassed by China as the world's largest trading nation. When the Trump administration took office in 2016 it adopted a bilateral view of trade, meaning a US trade deficit with individual countries. The US balance of savings and investment ensured an aggregate trade deficit, and it is no

surprise that China was among the largest contributors to it.

We have experienced a 'trade war' between the two in the last few years, with the US imposing more tariffs on selected Chinese imports and China retaliating with its own list. The US has also demanded better trade terms by requesting that the WTO treats China as a developed country. Developing countries are generally able to get away with higher tariffs being imposed; although, in this case, China has not really used its developing country status to its full advantage (Gao and Zhou, 2019).

In fact, the WTO has recently ruled in

technology transfer of foreign companies, refraining from manipulating its currency, strengthening intellectual property protection, increasing imports in some sectors and eliminating some non-tariff barriers to US exports is a major step. This might take a few years to materialise, but when we eventually get there, the wait will have been worthwhile. In exchange, the US promises suspensions on some of the tariffs imposed on Chinese goods.

As Lee (2020) rightly points out, the two countries contribute to the global and Asia-Pacific economy in different ways, and it is unimaginable to have one and not the

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favour of China over its complaints about the US violating international trade rules by imposing tariffs that do not apply equally to other countries (Wall Street Journal, 2020). This ruling is just going to add fuel to the complaints the US has against the WTO of not being relevant and useful for protecting it from unfair trading practices.

Interestingly, even as the US pushed for more tariffs on Chinese imports, US exports to China were affected more than Chinese exports to the US (Shan, 2019). Nonetheless, officials in the US are arguing that trade liberalisation is to be balanced with keeping Americans employed (Lighthizer, 2020). Meanwhile, US consumers are picking up the costs of paying for higher-priced substitute imports from third countries. It is hard to tell how effective this tariff strategy will be for the US in the medium to long term.

The phase one agreement between the US and China in January 2020 may be a good starting point for the world's two largest economies and trading nations to reconcile some of their differences. For China, a commitment to avoiding forced

other for a while. China would rather see a multipolar world, allowing other challengers to force the US to work with Beijing (Yan, 2019).

Unfortunately, what is also brewing is a 'tech war' between the two countries, as the US starts to impose rules of engagement on Chinese technology firms in the US. This also extends to US firms' engagement with these Chinese firms abroad: for example, the use of components or software. This will potentially spiral into a massive decoupling of global supply and value chains, leading China and other countries to create their own sets of rules of engagement. Geopolitics and protectionism will then set in as a result, leading to slower recovery of economies and businesses from the Covid-19 pandemic.

#### *The big issue of regional governance*

A major challenge in the Asia-Pacific economy is the maintenance of structures and processes for creating international rules and adjusting them to meet changing circumstances. The post-World War Two international economic architecture

of GATT, the World Bank and the International Monetary Fund (IMF) emerged from a more or less conscious effort to draw boundaries around the spheres for autonomous national decisions and for agreed international constraints.

The initial focus of GATT was on reducing tariffs. But as tariffs were reduced, at least on manufactured goods, other elements of interdependence became more salient. The conditions of interdependence were modified by subsidies on exports. Even if these were constrained, exports and imports were modified if subsidies led to changes in the composition of outputs.

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The flow of goods also depended on consumer safety. Agricultural products became subject to agreed sanitary and phytosanitary requirements, and other goods were subject to safety requirements. Furthermore, firms wanted their products to be interoperable (or, sometimes, to prevent competitors from making competitive components) and private standards were established. It became more difficult to distinguish safety requirements or private standards from efforts to exclude foreign competition, and 'technical barriers to trade' became as important in managing interdependence as tariffs. All of these developments took place while GATT was the essential international constraint on domestic policy. They were formalised and taken into a modern world with the creation of the WTO in 1995. In the 25 years of the WTO there have been continual complaints that the 'policy space' for national decisions was being invaded by extensions of international rules, but there was a continuous process of adaptation of international rules to changing circumstances.

A similar process took place in the financial sphere: the IMF and the World

Bank both evolved under changing circumstances. International economic architecture evolved, and there was never a stable 'liberal international order'. The WTO in effect requires unanimity for important decisions. The US no longer accepts that the WTO provides an acceptable international framework and it has used its capacity to paralyse some WTO activities, such as the Appellate Body. This is happening at the same time as technology and consumer demand are generating a need for changes to the agreed boundary between domestic policy and international norms. The growth of trade in services has

exposed gaps in agreed norms about the conditions under which services can be provided across borders, whether to firms or to final consumers. The growth of digital processes within industry and as a consumption item has generated even more need for renewal of the international economic architecture.

While GATT and the WTO both espoused as a basic principle 'most favoured nation' treatment – that all members should be treated equally – an exception was made for free trade agreements in which parties extended preferential treatment for 'substantially all trade' between them. What was intended to be an unusual exception became a common feature. Now, the WTO is best conceived as overseeing a framework within which groups of economies can agree on the rules by which their economic interdependence is to be managed. The 26 original members of GATT could reach agreement on tariffs as a single entity; the challenge for the current 164 WTO members is to organise groupings with agreed rules, all of which are compatible with an overall envelope of international

rules. Managing such a process is complex, but above all it requires a positive approach by all the major players.

The particular problem for the Asia-Pacific economies is that they sit astride a major divide in the international community. If the Asia-Pacific economies can reach agreement, their wishes still must be reconciled with those of the Europeans, yet there would be reasonable prospects of maintaining an international framework. If Asian economies reached an agreement without accommodating the US, this would be conceived as breaching international understandings. And all that is conditional on the idea that there is an agreed understanding of what constitutes the existing international framework.

#### *Business participation*

Both the longer-term development of the global economy and the more immediate needs of the response to Covid-19 require producers to remain close to their customers. In the modern economy, that means for many businesses being close to other businesses for which their products are an input or component. Even if they make products for final consumers in other economies, they are likely to use intermediaries in the marketing and servicing functions.

For business-to-business links, a government's position is important. First, businesses need to be confident that the rules governing their business relationships will not change unexpectedly. They need assurance that their contractual arrangements will not suddenly become illegal or be penalised in some way. In this, we can see economies working progressively to improve their rankings in the ease of doing business index, to attract investors and to create an impression of how stable their economy is. As businesses plan their ongoing concerns, it will be good to remember that political and regulatory instability can cause angst among current and potential business investors.

It should also be apparent to businesses that it is in their interests for the producer–customer relationship to be their principal concern. Governments should avoid tempting businesses to focus on lobbying for preferential positions against competitors, even in difficult economic

conditions. Corruption is thereby avoided, and so is distraction from effective business management. Perception of protectionism will lead to lower trust and investment.

There are particular issues around state-owned enterprises. Most Western economies have evolved mechanisms for insulating businesses from direct political direction, the ‘arm’s-length management’ of European nationalised industries being an example. Asian economies have generally developed with more direct government involvement in industry. Devising international rules to limit political influence on international commerce should not be impossible, but any such effort has been rendered so by the incompatibility of Chinese notions of ‘markets with socialist characteristics’ and American beliefs that competition cannot be ‘fair’ when businesses are tied to a communist government.

The South East Asian economies were integrated into the world economy through the internationalisation of Japanese industry. Inter-industry trade – trade among producing companies rather than trade of products to consumers – has intensified in recent years. China’s engagement with ASEAN economies has shown that, despite political tensions, businesses can continue to flourish. This allows continuation of the ‘business-led’ character of Asian economic growth, which should be facilitated by proper alignment of trade regime structures and processes.

#### **Policy implications**

In our discussion above, we have highlighted China’s ascendance in the Asia-Pacific and global economy, the challenges of China’s growth, and its economic relationships with the US around the Asia-Pacific. We have also discussed the major issues around the structures and processes of the regional trade architecture and business participation. We conclude here with some policy implications.

The policy implications which need emphasis are not detailed interventions, but a focused determination to employ analysis to determine where collective effort is required. There needs to be some common understanding around data management, and the extent of governmental interventions in techno-

logical advancement should feature highly on this agenda. This can be facilitated through frequent interactions between governments and businesses, allowing government policies to be as integrated as global supply or value chains.

We have already discussed the need to revive a common understanding that managing economic interdependence requires finding acceptable balances between an agreed international framework and domestic policy choices. An agreed international framework is not one that perfectly serves any one particular country, or even a self-appointed exclusive club of

academic researchers would want restrictions on anonymised records of transactions, although most are aware of the complications which quickly arise around the apparently simple notion of ‘anonymised’. Respecting anonymity is different from seeking to advantage domestic producers by giving them privileged access to databases so that they can better tailor their products to consumer preferences. The notion that access should be available to academic researchers but not those engaged in commercial enterprise easily attracts support, but the number and enthusiasm of academic

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countries, imposing their rules as though they are international.

The international framework has to follow from the construction of the contemporary world. In this world, much public action takes the form of electronic communication. The boundaries for trade set around privacy have to accommodate this development. There is no point in starting from a notion of an inviolable right to privacy. Actions in public can be observed and knowledge can be shared and utilised. Achieving a balance between accessibility of public information and privacy of personal information is a policy problem in every economy, and in an interconnected world national rules have to have a substantial degree of compatibility.

An abstract conclusion to this debate will probably come not in a single step but through the gradual evolution of agreements about specific issues. The most obvious will be dealt with first. Data management is a likely early subject. Few

entrepreneurs destroys any clear distinction between academic research and research for commercial enterprise. National rules should be developed through the standard processes of policy analysis: problem identification, formulation of feasible alternatives, conscious selection of the optimal option, and review. Such a process would necessarily involve international cooperation.

Managing databases has an obvious connection with the development of algorithms and artificial intelligence, and has an immediate connection with the development of vaccines in response to Covid-19, and hence with the role of intellectual property. Deliberate and conscious policy analysis cannot be circumvented in the name of ‘medicines for all’ to bypass intellectual property rights to withhold a vaccine.

The wider agenda includes the interaction between government and business. The focus on state-owned

enterprises as an illegitimate participant in international commerce has always had an element of American crusade about it. European nationalised industries have always managed the delicate relationship of indirect and constrained political direction, and the New Zealand debate of the 1980s rightly focused on making government direction clearly articulated rather than prohibited. (A senior public servant of the time asked incredulously, 'Do you really think ministers do not lean on private sector companies?')

Again, every society has to determine how it manages government–business interactions, but their decisions have to pay attention to international understanding about where the inevitable indirect influence of government decisions becomes illegitimate undermining of appropriate economic decision making. There should also not be an expectation that a government may subsidise without limit research and development or human resource development, but not participate

in resource allocation among competing activities, even if that is a perfectly sensible position for the government. There has to be international agreement about what becomes distortionary.

A similar argument can be made about how economic integration relates to other aspects of international relations. Despite protestations to the contrary, there is no serious argument that economic questions can be entirely separated from other aspects of international relations. The fixation on separation exists because some journalists and commentators wish to write about security or human rights without paying any attention to their economic components. The important connections between economic and non-economic aspects of international relations come when governments seek to use control on economic interactions for non-economic purposes. There cannot be any objection in principle to controlling in some way cross-border economic interactions which involve a breach of an

agreed international norm or requirement, but imposition of a national standard on a trading partner with different standards is much more questionable if it breaches another agreement. And with the elasticity that is inevitable in international agreements, there is plenty of space for contention about which standard is relevant and appropriate. Patient diplomacy and toleration of differences are more attainable than any simple answer.

The Asia-Pacific economy will take centre stage in the next decades, and the rest of the world will be moving closer to it. And as the region becomes more integrated, economically as well as in other ways, international sensitivity and savviness of a government towards the development in the region is expected. The overriding conclusion is that there is no shortage of tasks for appropriately qualified diplomats, and that diplomacy is the only answer to management of the international economy.

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