

# CHAPTER 7

## Australia and China in regional economic diplomacy

**KEY MESSAGES**

Australia and China face new challenges in Asia and the Pacific as a result of the changing structure of regional and global economic power. The economic and political rise of China is changing the regional as well as the global order. Regional economic interdependence now includes a wider group of economies, including India, and a wider range of issue areas. The established regional institutions and arrangements in East Asia and across the Pacific do not encompass all economies and were not set up to deal with the interaction between economic and political-security affairs, and there are gaps in coverage within the architecture for economic and political-security cooperation. These challenges require Australia and China to play an active role in forging a new consensus around the principles that will guide future regional cooperation. Over the past three decades, Australia's and China's economic integration into the regional and global economy has occurred within a framework that has been inclusive, has avoided arrangements that weaken the global system and has led political cooperation. The two countries can now direct their bilateral relationship toward these common regional and global objectives.

Australia and China should work with other partners in Asia and the Pacific to:

- Connect and extend existing regional arrangements, such as APEC and the EAS, so they can provide a platform to address the new priorities in regional cooperation.
- Initiate high-level political dialogue on cross-cutting issues that require close cooperation, including the environment, energy transformation and regional infrastructure investment.
- Mobilise a coalition to define the path forward in forging the TPP and RCEP into a Free Trade Area of the Asia Pacific (FTAAP) that strengthens the WTO and the global economic system. Consolidation of the TPP and RCEP may not be a practical objective in the medium term but finding ways to make both the TPP and RCEP inclusive and complementary is.
- Seek to establish a common framework for infrastructure investment and funding in the region. Currently many players are acting independently and at cross-purposes. Ministers and senior officials can meet to discuss priorities, strategies and mutual interests in infrastructure delivery to further regional connectivity. Such a regional forum might involve the AIIB, ADB, World Bank, country-specific institutions and recipient regional groupings such as ASEAN.
- Use ambitious bilateral initiatives to progress regional and global arrangements. China could use the investment chapter in ChAFTA to push for a higher quality investment chapter in RCEP and set the benchmark for other bilateral investment treaties. Australia and China can pioneer services sector opening, capitalising on Australia's potential role as a testing ground for wider domestic and regional liberalisation.
- Initiate a dialogue on the articulation of a common, plurilateral set of principles to govern foreign investment — both for facilitating investment before it is made and the treatment of investment once it has been implemented.

- Leverage the bilateral relationship to build cooperation in third countries in areas such as aid and development and infrastructure and connectivity.
- Further enhance bilateral security ties as an important step in creating effective working relationships on security issues among all countries in the region, thereby strengthening the foundation for political confidence and regional economic prosperity.

China and Australia are both integrated into the regional and global economy, and their bilateral relationship is nested in a highly integrated East Asian region. China is the centre of regional supply chains and its trade and investment expansion have been the driving forces of its rapid development and industrialisation. Going forward, regional trade and investment liberalisation and integration will continue to be key drivers of China's future economic development and reform. The share of East Asia in Australia's trade is one of the highest of any country in the world, with 66 per cent of Australia's trade taking place within East Asia (Figure 7.1). Moreover, Australia is a stable and secure supplier of energy and raw materials to China and the rest of Northeast Asia.

East Asia is one of the most economically integrated regions in the world — on par with Europe by a number of important measures. Economic cooperation has led political cooperation, and regional economic integration has been market-led rather than institution-led. As Asian economies have liberalised and opened up to regional and global trade, institutions have been created to help manage and secure these thickening and deepening economic relationships. Asian countries opened their economies to international competition within the global institutional frameworks and did so because they had growing confidence in the global trading system and the global economic order created after World War II around the Bretton Woods institutions.

Australia and China have also actively engaged in regional cooperation and institution-building as a way to promote economic development and reform at home, and to foster closer political cooperation in the wider Asian region. The relationship between Australia and China has developed in the context of deepening regional economic integration, and strengthening the bilateral relationship serves to foster broader regional cooperation. For both countries, economic cooperation has underpinned regional economic diplomacy and institution-building processes in Asia. Regional political and security cooperation, on the other hand, has been piecemeal and less comprehensive, but includes notable achievements, such as cooperative efforts on the Cambodian peace settlement and the United Nations Transitional Administration in East Timor.

The diversity within the Asia Pacific region — with countries having different economic and political systems, and being at different stages of development — demands a collaborative approach to regionalism. Regional cooperation has occurred on a voluntary basis where agreements were based on forging consensus and ordered around positive-sum economic interests. Importantly, the political and security relationships have been underpinned by the US alliance framework created after World War II, and US rapprochement with China since 1972.

The institutions that have furthered regional cooperation in Asia and the Pacific, including APEC, ASEAN and its Plus Three and Plus Six processes (including the subsidiary Chiang Mai Initiative), have done so largely on the basis of non-binding commitments and without the cession of sovereignty to any supranational regional authority. The establishment of

these institutions was characterised by evolution, flexibility, consensus and voluntary participation, because of the differences in political and institutional systems in the economies around which they have been built. They have served to build political trust and cooperation among countries across a region in which previously there had been a substantial deficit in mechanisms through which that could be done. This model of cooperation constitutes an important institutional innovation that has proved valuable in other theatres, such as in the global G20 forum, which has a similar *modus operandi*.

Asian regionalism has therefore not proceeded at the expense of, or in a manner that undermines, global institutions. On the contrary, it has sought to complement and reinforce global institutions. That remains an overarching objective for both Australia and China in their approach to regional cooperation. The principle of open regionalism — that is, regional cooperation and integration that is open to the rest of the world and which reduces barriers to all states in a non-discriminatory fashion — on which Asia Pacific economic cooperation was built, has ensured that regional cooperation has strengthened, rather than detracted from, global cooperation.

But things are changing. The rapid pace of economic growth and integration in Asia is bringing about a more complex and multipolar order, and throwing up new economic and political-security challenges. A new regional consensus is needed to ensure that the principles upon which Asia's economic cooperation was built — open regionalism, consensus-driven cooperation and stable relations between the great powers — are not eroded. Australia and China are well placed to work together to forge this new consensus because they have successfully worked together in the past to foster regional economic cooperation on these same principles.

This chapter describes Australia and China's joint interests in regional economic diplomacy and some of the principles that have served their past cooperation well. It reviews the changes to the structure of the regional and global economy that have already occurred as a consequence of the rise of China and the rest of Asia, and outlines some future trends. The chapter then examines whether current institutional arrangements are adequate under circumstances in which the structure of regional and global economic weight has changed significantly, and discusses the areas that are most in need of change. The chapter concludes by identifying common interests and goals for China and Australia in regional economic diplomacy.

### **Australia and China's joint interests in regional economic diplomacy**

Australia and China share a number of common interests in their pursuit of regional economic diplomacy:

- using regional economic frameworks to strengthen and reform their domestic economies;
- promoting an open trading environment in Asia that supports the global economic order; and
- using regional economic institutions to build stronger frameworks for political and security cooperation in Asia.

These interests have underpinned Australia's and China's approach to regional economic diplomacy over the past three decades. Australia and China have a successful record of working together in building the foundations for Asia's regional economic cooperation.

Following World War II, Australia built steadily its engagement with Asia and reduced its economic dependence on Britain. Australia's Menzies government signed a momentous bilateral trade agreement with Japan in 1957, and renegotiated its traditional preferential ties with the United Kingdom as the formation of the European Common Market loomed. This steady diplomatic shift was accelerated with the reforms of the 1980s, which reoriented Australia's economic and foreign diplomacy towards Asia. Australia sought to capitalise on the large-scale economic growth and structural changes taking place in Asia and their potential economic benefits to Australia. There was recognition that unless Australia removed its protectionist trade barriers and undertook major domestic economic reform, it would not enjoy the benefits of Asia's economic ascendancy and risked being left behind by rising Asian powers. Trade liberalisation thus became a key policy strategy and was viewed not only as a way to unleash Australia's domestic economic potential, but also as a way to underpin Australia's engagement with Asia.

In 1989, the Australian government proposed a new mechanism — APEC — to promote regional objectives in the GATT Uruguay Round and to foster long run economic development cooperation. APEC was designed to foster trade liberalisation and economic reform in Asia and to bolster the global trade liberalisation agenda of the Uruguay Round. But, importantly, APEC also served Australia's goal of pulling together the two halves of Asia and the Pacific — East Asia and North America — in a cooperative endeavour. This goal was driven by the alignment of Australian and East Asian interests in improving access for labour-intensive and other manufactures in North American and other international markets, and improving Australia's own direct engagement with the East Asian economies. APEC was therefore explicitly designed to link the countries of the Western Pacific (including Australia and New Zealand) and East Asia with those of North America, via common multilateral economic opening strategies.

Crucially, this period of reform coincided with China's own efforts to reform and open its economy and to deepen its economic and diplomatic engagement with Asia. After three decades of limited trade and other economic interdependence, the introduction of Deng Xiaoping's 'reform and opening' policies in 1978 paved the way for greater Chinese engagement with regional economies. Australia sought to harness these changes taking place in China by involving the Chinese leadership in the development of ideas about Asia Pacific economic cooperation. Economist and former secretary of the Australian Department of Trade, Sir John Crawford, led a mission to China in 1980 to talk about China's participation in informal processes of regional cooperation. In 1986, China, Chinese Taipei and Hong Kong were, at Australia's initiative, invited to join the tripartite Pacific Economic Cooperation Council (at its Vancouver meeting of that year). Australia also attempted to engage China in the first foreign and economic ministers' meeting in Canberra in 1989, although the Tiananmen Incident earlier that year made this politically impossible. In 1991, China joined the APEC meeting in Seoul, and in 1993, China's then president Jiang Zemin attended the first APEC Leaders' Summit in Seattle.

APEC provides China with an important channel for participating in the process of international economic governance and regional economic integration, as well as promoting its own domestic policy agenda (China APEC Development Council 2009). Like Australia before it, the Chinese government used participation in APEC and the regional trade liberalisation agenda to push politically sensitive tariff reduction and economic reforms at home. At APEC's Osaka summit in 1995, China announced reductions in tariffs on 4900 items, and within a year the simple average tariff rate was reduced from 36 per cent to 23 per cent. By October 1997, China had reduced its simple average tariff rate even further, to 17 per cent. APEC's agenda closely coincided with the global agenda, and it was in this context that China undertook the liberalisation and economic reforms necessary for its accession to the GATT/WTO. But China's unilateral trade liberalisation efforts and active participation also helped to bring momentum to APEC, and brought economic gains to China and its trading partners, such as Australia.

After laying the foundations for regional economic cooperation in the 1980s, the 1997–1998 Asian financial crisis revealed the benefits but also the limitations of existing regional economic frameworks. Australia's economic system and institutions allowed it to benefit from economic integration with Asia while protecting against much of the potential financial volatility. The floating exchange rate, for example, was key to Australia avoiding recession or any severe downturn during the Asian financial crisis. The exchange rate acted as a shock absorber as exchange rate movements protected against volatility in the domestic economy. In China's case, the Asian financial crisis deepened its understanding of the benefits of regional economic cooperation. The contagion-like spread of the financial crisis around the region demonstrated that regional economies were now deeply interconnected, and that in this era of globalisation, states could not act alone in trying to protect against economic vulnerability. China received international accolades for resisting pressure to devalue its currency — thus avoiding beggar-thy-neighbour exchange rate competition — and for providing aid packages and low-interest loans to its crisis-affected neighbours. The Asian financial crisis increased China's confidence in its ability to play a constructive leadership role in the region, but also demonstrated the limitations of existing regional and global economic mechanisms such as APEC, the World Bank and the IMF.

The Asian financial crisis therefore spurred greater regional efforts to develop new East Asian economic arrangements, such as ASEAN Plus Three (including China, Japan and South Korea) and the Chiang Mai Initiative (CMI). At a time when global financial arrangements were perceived to have failed the region, these new East Asian arrangements sought to strengthen and deepen East Asian regional economic and financial cooperation as well as regional regulatory capacity. Bolstered by its leadership role during the Asian financial crisis, China played an important role in this regional cooperation process, joining the ASEAN Plus Three group and subsequent East Asian economic arrangements with enthusiasm. China unilaterally liberalised many of its key sectors, including agriculture, thereby opening its markets to Southeast Asian exports. In 2002, China initiated a framework agreement for the China–ASEAN Free Trade Agreement. China's commitment to further opening up, and its willingness to sign up to the rules and norms of the global trading system through accession to the WTO in 2001, gave trading partners confidence in the direction of Chinese reforms. Unilateral trade liberalisation also created significant goodwill between China and its smaller Southeast Asian neighbours. Even in Northeast Asia, where political and security relationships waxed and waned, trade and economic exchange grew rapidly.

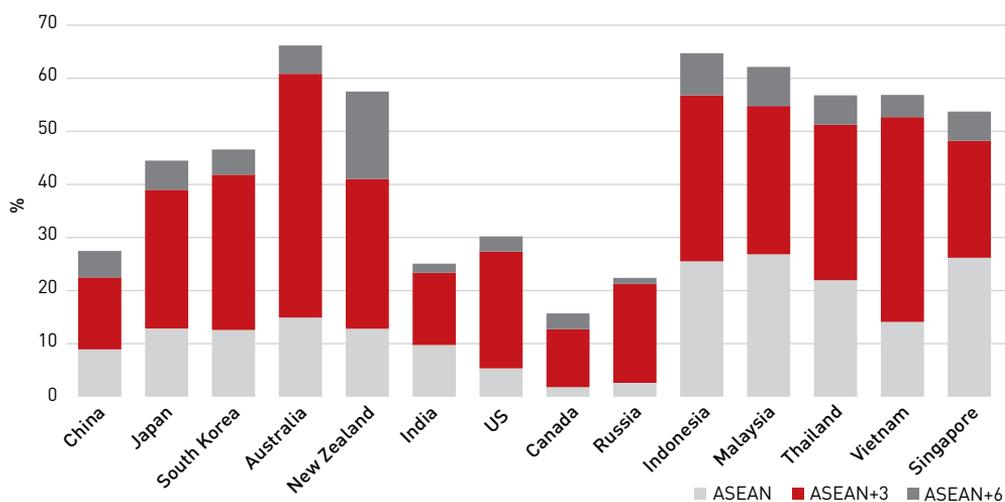
Beyond economic benefits, Australia and China have also viewed regional economic diplomacy as a way of building stronger political and security cooperation in Asia. The legacy of colonialism, Cold War division, and unresolved historical tensions between Japan and its neighbours had stymied institution-building processes in Asia since the end of World War II. Although ASEAN had been established in Southeast Asia in 1967, the wider Asia Pacific region remained institutionally underdeveloped. The region was comprised of states with very different political systems, as well as many newly independent states that were fiercely protective of any perceived threats to their sovereignty. Indeed, these factors had led ASEAN, the region's most significant existing institution, to develop particular practices of consensus, flexibility, non-interference in internal affairs and non-binding resolutions, as a way of reassuring postcolonial states' anxieties about international institution-building.

Given these obstacles, the Australian and Chinese governments have both observed the value of economic cooperation as a non-threatening way for regional states to develop habits of dialogue and cooperation, and the ASEAN approach to institution-building as a way to foster trust and ultimately political cooperation in the region. In addition, participating in APEC provided a valuable way for Beijing to reassure regional neighbours of its peaceful rise, and to help build a stable regional environment that would be conducive to China's future economic growth (Zhang 2014; Zhong et al 2014). China was encouraged by the way in which Australia, Japan and the Southeast Asian states used regional economic institutions as a way to enmesh China into a regional web of relationships, and to demonstrate the benefits of regional cooperation. China publicly acknowledged these benefits in 1997 when its 15th Party Congress officially declared that 'multilateralism' was a guiding Chinese policy principle (Harris 2000).

### **Asia's economic integration**

China, Australia and the wider Asia Pacific region have benefited greatly from the stunning levels of regional economic integration that have been achieved since the late 1980s. Despite the comparatively lower density of its multilateral economic institutions, as compared with Europe for example, Asia now enjoys high levels of trade interdependence in resources and intermediate goods, and high levels of exports of final goods. By many measures, East Asia is the most economically integrated region in the world, led by its extensive production networks (Armstrong and Drysdale 2011).

The ongoing success of Asia's economic integration is critically important to Australia and China's prosperity. Trade with East Asia accounts for 66 per cent of Australia's total trade (Figure 7.1). This makes Australia the most East Asian-oriented trading nation in the world. Just under 46 per cent of Australia's trade is with Northeast Asia (ASEAN's 'Plus Three' countries), higher than any other major East Asian country. Australia also has the highest trade dependence with ASEAN, at 15 per cent, of the other non-ASEAN economies in the ASEAN Plus Six arrangement (New Zealand, India, China, Japan and South Korea). Indonesia and Malaysia also have over 60 per cent of their total trade within the ASEAN Plus Six grouping, with over a quarter of their trade within the ASEAN grouping. In China's case, just under 27 per cent of China's trade is with the rest of East Asia. The China-ASEAN free trade area is now the world's largest free trade area comprised solely of developing countries, with trade of US\$480 billion in 2014 and total mutual investment reaching more than US\$150 billion. By 2020, China-ASEAN trade is expected to reach US\$1 trillion (Zhong 2015).

**Figure 7.1: Asia Pacific economies' share of trade with East Asia, 2014**

Source: UN Comtrade and authors' calculations.

China is at the centre of regional supply chains and has been a hub for East Asian trade with the rest of the world. In the past it played a major role in the assembly of manufactured goods that would be exported to North America and Europe, but the value-added in China during the production process has already started to increase rapidly and China is becoming a much larger consumer of those final goods (see Chapter 2). China is now focused on further liberalising regional trade and investment as well as strengthening regional connectivity and integration as a way to enhance the international competitiveness of the Chinese economy, and to gradually build a global, high-standards free trade area. China is also the largest trading nation globally and its vast trade relationships with North America, Europe and the rest of the world mean that it is a key global trader.

## Shared principles

The success of Asia's regional economic diplomacy and the achievement of deep economic integration has been underpinned by three core principles: open regionalism in support of global frameworks; consensus-driven cooperation; and stable relations between Asia's great powers.

### Open regionalism in support of global frameworks

Regional economic integration has been open and has developed in support of global frameworks. Asia's economic successes outlined above have been achieved because Asia's economic arrangements have generally been outward-looking rather than inward-looking. That is, they have worked to strengthen rather than substitute global economic arrangements such as the GATT and WTO. As trading nations, Asia Pacific regional economies have learned that their own economic prosperity relies on open engagement with North America, Europe and other parts of the globe.

Open regionalism — regional economic integration that is not at the expense of economies outside of the region and is supportive of the global trading system — can be seen most prominently in APEC and ASEAN. At the APEC summit in Bogor, Indonesia in 1994 member

economies agreed to the 'Bogor goals'. These were a set of ambitious targets that aimed to achieve free and open trade and investment in the Asia Pacific, by 2010 for industrialised economies and by 2020 for developing economies. The Bogor goals encouraged member economies to undertake unilateral liberalisation — that is, not preferential or between members only — and therefore promoted free and open trade with the rest of the world, rather than just among APEC members.

Much of Asia's regional cooperation — economically and geopolitically — is ordered around the ASEAN grouping, which has also pursued open regionalism. This is because most of ASEAN's major economic partners have always been outside of Southeast Asia — including China, Japan, Australia, the United States and the European Union. For ASEAN to have pursued inward-looking arrangements — that is, liberalisation at the expense of these major economic partners — would not have been politically or economically sensible. This approach is recognised in the design of the ASEAN Free Trade Area (AFTA), which was launched in 1992. AFTA initially pursued preferential liberalisation by only removing border barriers to goods traded within the ASEAN zone. However, from the outset there was an agreement that these preferences would be extended to all external trading partners as well, and thus multilateralised, when it became politically feasible to do so in each domestic polity.

More recently the ASEAN region has been pursuing an ambitious ASEAN Economic Community (AEC), which was established in November 2015. The aim of the AEC is to 'transform ASEAN into a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy' by 2020 (ASEAN 2008). The AEC would allow the free flow of goods, services, investment and skilled labour, and the freer movement of capital across the region. Because integration into the global economy is one of the four pillars of the AEC, integration in the ASEAN region will not divert trade or commerce away from non-members towards the ASEAN grouping. The goal is ambitious but would help move ASEAN towards a single market and production base that furthers the opportunities and economic engagement of China, Australia and other neighbours in the Asia Pacific.

### **Consensus-driven cooperation**

Consensual processes have driven Asia's economic integration. Consensus has been critical for achieving cooperation among a group of states with diverse political systems and levels of economic development. Consensus has also encouraged the cooperation of Asia's many postcolonial states, which had little or no prior experience of multilateralism before World War II, and which have therefore always been strongly attached to the protection of state sovereignty. But this approach to regional and international diplomacy has enduring value. Consensus-forming strategies reassure small powers that large powers will take their views into consideration in adopting policy positions and that they will not dominate institutions; they also reassure large powers that smaller countries will not band together against them. This consensus-building approach has encouraged Asia's diverse mix of states to participate in regional institutions, even at times when they have been uncomfortable with the membership, structure, approaches or the issue-focus of a particular institution.

Though often criticised for being process-driven (rather than outcome-driven) 'talk shops', the Track 1.5 and Track 2 dialogues, meetings and other processes that have accompanied the creation of institutions such as APEC and the ASEAN Plus processes have been crucial in shaping shared regional understandings about the importance of trade and investment

liberalisation, economic reform and multilateral economic cooperation. In particular, Asia's regional institutions have acted as forums for building critical consensus on three issues: first, that opening up to trade and investment benefits one's own economy; second, that these benefits are compounded if opening up occurs in concert with other countries; and third, that opening up without discriminating between trading partners is the best mode of strengthening economic relationships. Achieving consensus on these issues underpinned Asia's rapid expansion in trade and investment in the 1990s, lifted the incomes of Asia Pacific economies, and ensured that economic relationships deepened even in the absence of strong political relationships. That Asia has been able to achieve these levels of regional cooperation and economic integration is because institutional arrangements have evolved through consensual processes, have protected state sovereignty, have been voluntary and have allowed a diverse group of states to make non-binding commitments that are appropriate to their levels of economic development.

#### **BOX 7.1: ASIA PACIFIC REGIONAL INITIATIVES AND THE GLOBAL SYSTEM**

When APEC was created in 1989, disadvantage to non-member economies would have been inconsistent with the importance of economic links between member economies and those outside the grouping. APEC cooperation was founded on the principle of aligning Asia Pacific trade standards with global standards, and resulted in extending and strengthening the global GATT process. APEC has taken initiatives to the global level.

In 1996, APEC initiated negotiations on an Information Technology Agreement (ITA) in the WTO, and the agreement was concluded in December that year. The ITA prevented countries from introducing trade barriers for what were then relatively new forms of trade in information and communications technology (ICT) goods and services. By requiring countries to apply zero tariffs and other barriers to newly emerging ICT goods and services, the ITA encouraged rapid expansion in the trade of these new technologies. This in turn made possible the proliferation of supply chains in the electronics industry, which have fundamentally changed the way in which countries' international business is integrated, and which have deepened economic interdependence across Asia. Supply chains rely on logistics driven by rapid communications and technology, and the proliferation of supply chains has been critical in transforming China into the 'factory of the world'. Without the ITA's agreement on zero tariffs for newly emerging ICT trade, supply chains would not have developed so readily as they did.

More recently, the ITA 'model' has been emulated for trade in environmental goods. In 2012, APEC negotiated the Environmental Goods Agreement (EGA), which removes tariffs on trade on goods such as equipment for air pollution control and wastewater management. The global market for these new environmental goods and technologies is expected to expand to around US\$3 trillion by 2020 (DFAT 2015a). Building on APEC's regional agreement, negotiations on an EGA were subsequently launched on a plurilateral basis (that is, with many but not all members participating) in the WTO in 2014.

The CMI, which was created in 2000 in the wake of the Asian financial crisis, represents another case in which regional cooperation has sought to strengthen — not divert from — global financial arrangements such as the IMF. The CMI endorses global, market-based principles of financial cooperation, and only permits a small percentage of its funds to be released to ailing economies without IMF approval.

Not all regional arrangements, processes or institutional innovations have been the product of consensus, but those that have had success, buy-in and ownership by countries in the region have done so through a process of building consensus. For example, the formation of APEC was an initiative taken by Australia and Japan, but the idea of APEC required much socialisation among other Asia Pacific economies before it could be introduced and accepted. APEC has subsequently evolved and has been shaped over time by its members. The ADB (Box 7.2) is another example of the way in which consensus has underpinned Asia's approach to regional economic cooperation and institution-building. Ultimately, examples like APEC and the ADB demonstrate that economic institutions and other regional arrangements have had to evolve and develop through consensual processes. It is often assumed that a static 'rules-based order' was created in 1945 and has remained unchanged since that time. That is not the case. As new economic issues and demands have arisen in the region, new institutions, norms, rules and regional arrangements have evolved through processes of consensus, communication and socialisation.

### **BOX 7.2: CONSENSUS AND THE CREATION OF THE ASIAN DEVELOPMENT BANK**

The principle of consensus has been a critical element underpinning the evolution of rules and norms in Asia. One key example is the ADB, which was created in 1966. The ADB was created on the back of Japan's rising economic power. Japan was dissatisfied with its lack of representation in global institutions such as the World Bank and International Bank for Reconstruction and Development (IBRD), which were dominated by the interests of countries in Europe and North America. Japan also viewed the ADB as a way of achieving greater international political power, and of maintaining its export-led economic growth strategy. Though fellow Asian states supported Japan's developmental agenda, they were also fearful that the ADB would become a platform for Japanese regional dominance. At the same time, the United States was wary of Japan's development-state approach to economic development.

Thus, although Japan has always contributed the largest share of capital to the ADB, and holds the largest number of official positions — including that of Bank president — Japan has not dominated the ADB. Instead, since the 1980s in particular, the almost equal voting shares held by the United States and Europe have balanced Japan's voting share. This has required member states to engage in a consensus-building process to determine the Bank's principles on procurement, lending practices and issue focus. For example, the United States' preference for private capital and market-based economic development has always been balanced by Japanese and East Asian preferences for more state-activist approaches to economic development. Since its creation, the ADB has continued to evolve as a multilateral development financing institution.

### **Stable relations between Asia's great powers**

The achievement of deep economic integration in Asia has been underpinned by stable, peaceful relations among Asia's great powers. The most important of these relationships is that between the United States and China. US–China rapprochement in 1972 transformed the relationship between these two countries in ways that were of great benefit not only to the United States and China but also to the wider region. Since 1972, China and the United

States have developed deep diplomatic ties and high levels of economic engagement, and have recognised that stable bilateral relations are the only way to ensure a peaceful Asian region. Moreover, the leadership role played by the United States has been of great value to both Australia and China. The United States has played a leading role in creating and underwriting the global economic and financial system, and has strongly encouraged China's integration within that system. The United States' diplomatic and military presence in Asia has also served as an important 'backstop', which has encouraged regional states — many of whom have adversarial political and security relationships — to feel secure enough to pursue economic cooperation and institution-building. These arrangements have been helpful in a number of ways to Asian nations in the past, including those that are not United States alliance partners, such as China.

Alongside bilateral cooperation between the region's great powers, Asia's economic and other institutions have also served as important venues for trust-building, dialogue and socialisation around regional norms of behaviour. This is due, in part, to the 'ASEAN-way' principles of consensus, non-intervention, sovereignty and non-binding resolutions on which they are built. These principles have been critically important in enmeshing great powers such as the United States and China into regional multilateral processes. These institutions have never replaced the need for direct negotiations between the great powers themselves. But these institutions have provided important occasions for bringing the great powers together in frameworks respectful of wider interests. They have also provided opportunities for great powers to hold off-the-record, informal meetings on the sidelines of public summits, and have impelled the great powers to listen to the concerns of smaller states in the region.

## **Changing structure of regional and global economic power**

For the past three decades, Asia has been a remarkably peaceful and prosperous region. Asia's peace and economic vibrancy has been underpinned by: the United States-led economic, political and security order created at the end of World War II, China's acceptance of that order since 1972, and by the efforts of China, Australia and others to foster regional economic cooperation since the 1980s. But this existing order is now under strain — partly because of its success and the dramatic economic rise of China and other regional states.

The latter half of the 20th century saw the rapid industrialisation and rise of the Japanese economy in the 1960s through to the 1980s, with the newly industrialised economies (NIEs) of Singapore, South Korea, Taiwan and Hong Kong following in the 1980s and 1990s. The major force of growth in the global economy since the turn of the century has been China, with an average growth rate of 10 per cent per year over the 30 years since reform and opening in 1978 (Figure 7.2). The growth rates of the economies of Japan, China and the NIEs have slowed as they have become larger and more mature economies with higher per capita incomes. India's economic development and the rise of other Southeast Asian economies such as Vietnam, Myanmar and Indonesia are already showing promise as the next driving force of growth in Asia and the global economy.

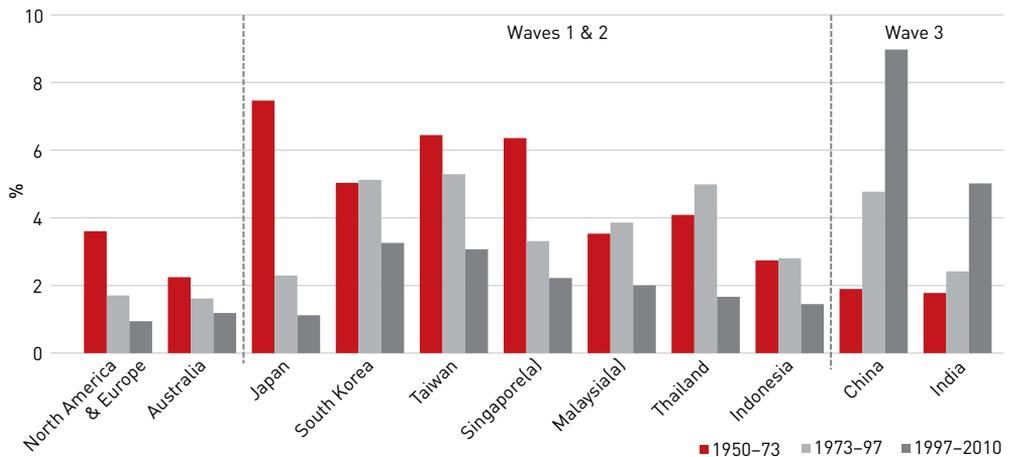
China's economy has already grown to be as large as that of the United States in purchasing power parity (PPP) terms (see Chapter 1, Figure 1.6). Forward projections on current trends with conservative assumptions will see China overtake the United States as the largest economy in the world in nominal market exchange rate terms by the end of the 2020s, with many projecting this to happen earlier in that decade.

The growth of China’s importance in the world economy has occurred very rapidly. This swift change is creating some uncertainty about how to manage the new responsibilities and challenges posed by the rise of China and other regional economies (Zhang 2015). There is a risk that some of the responses to these quick changes could unravel the shared principles that have underpinned Asia’s economic achievements to date.

**Threats to open regionalism**

First, there are growing challenges to maintaining the primacy of open regionalism in Asia. In the past, Asia’s deep economic integration was built on the basis of the Most Favoured Nation (MFN) principle, which extends trade and other economic benefits to all states, regardless of whether they are members of the agreement or not. Now, we are witnessing the proliferation of exclusive, preferential trade agreements (PTAs) in Asia, which serve only to deepen economic ties between PTA member countries. Some of the proposed multinational preferential agreements — such as the Trans-Pacific Partnership (TPP) agreement and Regional Comprehensive Economic Partnership (RCEP) — are particularly large and comprehensive. While these large and comprehensive preferential agreements offer more benefits to their members than narrower bilateral agreements, they also have the potential to impose more adverse effects on non-member economies. This can be avoided. Agreements and arrangements that are preferential and exclusive can be made more inclusive over time, just as the AFTA was, and creative ways can be found to extend benefits to non-members. How to negate some of the adverse consequences of new regional agreements such as the TPP and RCEP is discussed later in the chapter.

**Figure 7.2: Waves of regional and global economic growth**



Source: Australia in the Asian Century White Paper 2012 and authors’ calculations.

**Threats to consensus-driven cooperation**

Second, there are growing threats to Asia’s consensus-based approach to regional cooperation. As cross-border economic issues have become increasingly complex, and have begun to affect a wider range of interests and countries, it has become more and more difficult to achieve consensus-based regional cooperation among larger groups of

countries. At times, the principle of consensus has also been used and abused as a way for countries to avoid making progress on reform. In these circumstances, smaller 'coalitions of the willing' have been formed to achieve faster progress on issues including trade and investment liberalisation. For example, with the Doha Round of trade liberalisation stalled, some countries have resorted to bilateral or plurilateral agreements in order to open up market access. Similarly, in areas such as investment liberalisation, where there is no existing global or regional regime, small groups of countries have begun working together to progress bilateral deals or regional agreements. There is nothing inherently wrong with smaller groups of countries working together to introduce new arrangements. Indeed, the presence of coalitions of the willing is a well-established practice in Asia. APEC, for example, has historically used the approach of 'pathfinder initiatives' to achieve progress; these allow some member economies to work together in establishing new cooperative arrangements, which are then communicated to other APEC members who are encouraged to participate when they are ready. In order for these initiatives to succeed in gaining acceptance by non-participants, however, it is important that they be communicated transparently to other countries so as to avoid surprises, and to be developed in a manner that does not disadvantage other countries.

### **Threats to stable relations between the great powers**

Finally, the existing economic, political and security order in Asia is under strain because of the economic rise of China and others in the region. The transition to a more multipolar order is inevitable, but the challenge facing the region is how to manage that order transition peacefully. China's vast trade, financial, demographic, environmental and military footprint gives it a growing and legitimate interest in playing a larger regional and global role. At the same time, while major shifts in the regional distribution of wealth and power make comparable shifts in the regional strategic order inevitable, Australia and other regional states very much prefer that the United States retains a strong and stabilising role in whatever new order emerges. The goal must be to reconfigure a new regional order that enables a leading role for both the United States and China. This new regional order must also allow space for other established powers such as Japan, and for rising powers such as India and Indonesia. Any new regional order must ensure that smaller and middle powers, such as Australia, South Korea and Southeast Asian countries, continue to feel secure and able to participate with independent voices.

Managing this order transition will not be easy. And it will largely be a job for the great powers themselves. Nevertheless, Asia's middle powers still have a vital role to play. They should continue to use Asia Pacific institutions to help manage the orderly transition, playing a positive role in promoting cooperative regional initiatives and moderating great power rivalry. There is a need to ensure that current regional institutions and arrangements are suitable for managing economic integration, structural change and political cooperation as Asia's order changes. Frequent dialogue between the United States and China is critically important, and it is imperative that this dialogue takes place routinely and within frameworks that involve interests and issues beyond the US–China bilateral relationship. There are two regular meetings a year between the president of China and the president of the United States within a framework that includes other countries: the APEC summit and the G20 summit. While there are other occasions for bilateral meetings, including state visits and meetings of the UN General Assembly, for example, the APEC and G20 summits allow for US–China cooperation in the context of broader regional and global cooperation. Those occasions should be made as productive as possible for building consensus towards effecting gradual and peaceful order transition.

Australia and China should seek to enhance their bilateral security ties as an important element that contributes to building effective working relationships on security issues among all countries in the region. Closer bilateral security ties will help to strengthen the foundations of political confidence on which regional economic prosperity can continue to grow. Australia is committed to its longstanding alliance with the United States, but this does not preclude security cooperation with China. The development of closer bilateral security cooperation on a range of traditional and non-traditional security issues will be an important element in elevating the Australia–China relationship to a Comprehensive Strategic Partnership for Change and in deepening strategic trust between the two countries. The changing regional order makes it increasingly important for China and Australia to clearly understand each other’s approach to regional political and security affairs. A particular area in which there is scope for expanding dialogue that will contribute to this understanding is related to China’s evolving thinking about its maritime economy, in which both countries have direct mutual interests.

### **Moving forward with common interests**

The economic and political rise of China and other regional economies is changing the Asian order and bringing about new economic and political-security challenges. Based on their successful history in jointly building regional economic cooperation, Australia and China are well placed to work together to forge a new consensus around the principles that will guide future regional cooperation.

Australia and China can direct their bilateral relationship toward common regional interests in a number of practical ways. Joint cooperation with third countries can benefit from complementary comparative advantages and can advance broader regional cooperation. There is scope for working together — given Australia’s expertise, regional interests and connections to the United States — on Chinese global governance initiatives such as the AIIB. There are already areas, such as in development cooperation in the Pacific, where Australia and China actively work together. These cooperative endeavours should be extended so that progress in development cooperation, infrastructure investment and other initiatives can help to deepen progress at the regional level.

As China’s economy undertakes its huge structural transformation, many opportunities will be opened up in labour-intensive manufacturing and the sectors that China transitions out of. India, the rest of South Asia and much of Southeast Asia can emulate China and Northeast Asia’s economic success, realise their comparative advantage and transition into low-cost manufacturing. Realising these opportunities in South and Southeast Asia will assist in China’s own transition. And China’s regional infrastructure and connectivity initiatives can play a major role alongside exporting China’s over-capacity, surplus savings and expertise.

The largest opportunity lies in India. India can realise its ‘Make in India’ economic reform agenda through liberalising labour laws, improving infrastructure investment and financing, opening to foreign investment, and pursuing regional economic integration. Regional cooperation that facilitates a more open and dynamic external environment will help India and other economies undertake such difficult reforms. Successful reforms in India will leverage its abundant and growing low-cost labour resources to exploit a comparative advantage in labour-intensive manufactures and services. Australia and China have a strong interest, and can play an active role, in supporting India’s economic growth ambitions.

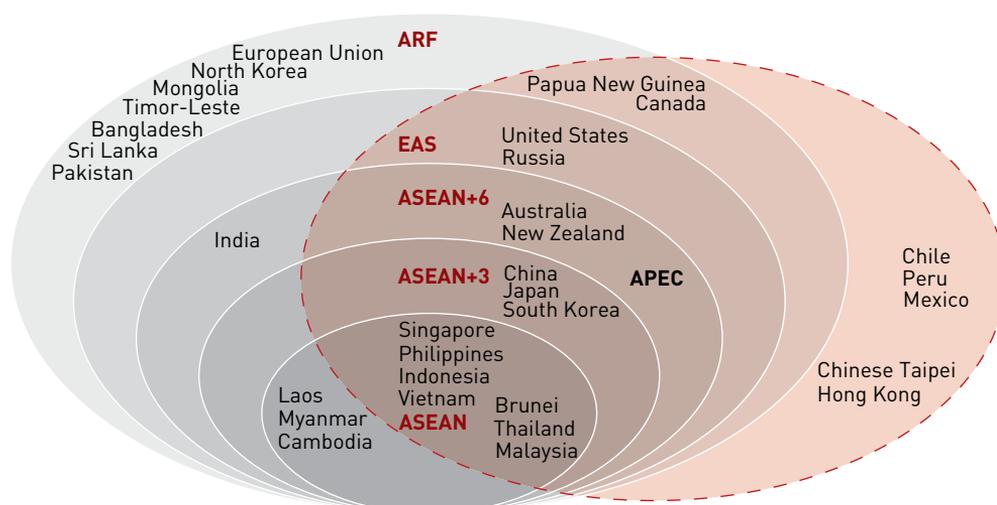
### Strengthening and connecting existing institutions

Asia is now home to a complex web, or ‘variable geometry’, of regional economic, political and security institutions with diverse memberships and functions. Economic interdependence in Asia and across the Pacific includes a wider group of economies, such as India. In reality there is no single regional institution that currently addresses all of the region’s economic, political and security issues.

The established regional institutions, arrangements and groupings in East Asia and across the Pacific do not encompass all economies and were not set up to deal with the interaction between economic and political affairs, and there are gaps in coverage within the architecture for economic and political cooperation (Figure 7.3).

APEC remains the region’s primary venue for discussion of economic issues, and has a particular focus on trade and investment liberalisation. It is the primary institution for US engagement on regional economic affairs, and the APEC Summit has proved to be an important venue for leaders to discuss win-win economic issues and promote economic cooperation initiatives. The routine work done among countries at the official level of APEC has also served to bridge understanding between members, to deepen cooperation and to lead to outcomes that have benefited members and non-members alike (Box 7.1). The network of officials, the work program, and the leaders’ meeting has meant that member economies feel ownership of the process and the institution. Yet there are major gaps in APEC’s membership. As Figure 7.3 shows, while APEC’s membership is broad, there are a number of regional economies — including India, Cambodia, Laos and Myanmar — who are not APEC members. APEC’s diverse membership of economies, rather than states, makes it an inappropriate platform for discussing East Asia’s political and security challenges. While informal meetings on political and security issues take place between leaders on the sidelines of APEC, these issues are not on the main agenda.

**Figure 7.3: ASEAN, APEC, EAS and ARF membership compared**



Source: Authors’ schema.

The ASEAN Regional Forum (ARF), created in 1994, has focused more on regional security issues. It is a large and diverse organisation, involving 27 participants, including the EU. Though it has been a useful platform for regional states to get to know one another, and to participate in confidence-building measures, the ARF's size and the diverse character of its participants has made it very difficult to achieve substantial progress on regional security disputes.

The East Asia Summit (EAS) was created in 2005 and is another ASEAN-led institution. The EAS emerged out of proposals, in the early 1990s, to create an East Asian Economic Caucus. The Asian financial crisis then prompted ASEAN countries to work with their 'Plus Three' Northeast Asian neighbours — China, Japan and South Korea — to build an East Asian economic community. With Japan eager to broaden its membership, India, Australia and New Zealand subsequently became founding members of the EAS in 2005. In 2011, membership of the EAS was further expanded to include Russia and the United States. This expansion in membership has also changed the character of the EAS from being an organisation predominantly focused on economic issues, to one where political and security issues have come to dominate the agenda. In comparison with APEC, the EAS has never enjoyed the same dense network of institutionalised official activity among its members. Given its shift away from economic issues in recent years, there is a risk that much of the EAS agenda will become dominated by countries' political declarations rather than institutionalised cooperation. EAS' main asset is that its agenda does encompass security issues, and that its membership includes all of the major powers in Asia and the Pacific, including India.

These institutions and arrangements have served the region well to this point, but in quite different ways. As relative economic and political power shifts in the Asia Pacific and globally, there is a pressing need to connect and extend existing regional arrangements so that there is a ready platform to address new priorities in regional cooperation. Regional cooperation has to build on and move beyond the core economic agenda. The web of economic, political and security institutions in Asia must now be better linked to address the gaps in membership and function. The flexibility of Asian regional arrangements allows opportunities to connect existing arrangements in ways that allow them to address these new challenges and opportunities.

At the regional level, one option would be to strengthen the connection between the annual APEC Economic Leaders' Meeting and the East Asia Summit. These two meetings are now held back-to-back in November in order to allow the US president to travel to Asia once a year. Currently, leaders move from one host country to the other and discuss different agendas with different memberships. This means that there is a distinct contrast in the nature of the discussions at APEC and the EAS. The Chinese head of state does not currently attend EAS meetings. The APEC host and ASEAN Chair (which hosts the EAS) could work together to ensure that APEC's economic cooperation agenda feeds into the EAS' political and security agenda, without diluting the issue focus of each. This could be facilitated via joint meetings between the APEC and EAS 'troikas' (that is, the previous, current and future APEC hosts and ASEAN Chairs) in advance of the annual Leaders' Meeting and Summit.

Another way of strengthening the connection between regional institutional arrangements might be to reach out to invite India and other ASEAN states to join the APEC process — not necessarily as formal members initially but rather as participants. The APEC host has the right to invite government leaders from non-APEC member economies to attend the annual Leaders' Meeting. Building on the initiative taken by China when it hosted APEC in 2014, future APEC hosts could invite India, Cambodia, Laos and Myanmar — that is, those countries who are members of the EAS but not APEC — to attend the APEC Leaders' Meeting. The APEC

Economic Leaders' Meeting will next be held in East Asia in 2017 when Vietnam hosts APEC. In 2017, therefore, there is an important opportunity for Vietnam to invite India, Cambodia, Laos and Myanmar to attend APEC. Leaders could then travel to the Philippines (which will be the ASEAN Chair in 2017) for the East Asia Summit. Finding creative solutions to have all ASEAN members join APEC meetings will make it easier to more effectively connect these regional processes. East Asia and the trans-Pacific relationships have benefited greatly from ASEAN centrality and there is good reason to preserve and strengthen ASEAN as the fulcrum of regional cooperation. Australia, China and the rest of the region have a stake in the success of the ASEAN Economic Community and a unified and integrated ASEAN makes broader Asian cooperation easier.

Important, cross-cutting issues that require close cooperation such as energy and environmental transformation should be the focus of high-level policy dialogue led by a coalition of interested powers in the region and carried across different forums. These issues cut across energy security, climate change, and political and economic cooperation. These are issues that affect all states in the region, and can be advanced by leader-level agreement among all of the major regional players. The energy transition from fossil fuels to renewables will bring new opportunities and challenges that have large transnational spillovers. Focusing on an issue such as energy transformation could lift the level of cooperation between countries, give regional arrangements new impetus and provide a framework for closer political cooperation. This is an issue that affects China and Australia acutely, but also affects Japan, the United States, India, Indonesia and every other country in the region, whether they are energy producers, consumers or both. There is currently no regional forum or theatre in which energy issues are prominently on the agenda, but a small coalition of countries including Australia and China could initiate a dialogue in one or more of the established regional platforms and carry policy development forward across all these forums.

At the global level, Australia and China have a shared interest in feeding regional interests and initiatives into global arrangements. The Asian members of the G20 — Australia, China, Japan, India, Indonesia and South Korea — and the Pacific members of the G20 — Canada, Mexico and the United States — are all leaders in the various Asia Pacific regional forums. A better connection between the regional forums and the G20 at the global level will help to shape the G20 agenda, to implement G20 outcomes through regional institutions and to build confidence among countries that are not members of the G20 in its inclusiveness and credibility. The Asian G20 members are the most important economies in the region, and individually and collectively they represent important voices in global affairs. They already exercise a measure of influence globally, and can represent the interests and views that are expressed in regional forums that operate through a process of consensus.

Regional institutions such as the Chiang Mai Initiative Multilateralization (CMIM) and the ASEAN Plus Three Macroeconomic Research Office (AMRO) surveillance unit can act to strengthen and reinforce the global financial safety net and global surveillance. Although the currency swaps in CMIM have yet to be drawn on — even during the global financial crisis — CMIM and AMRO can build trust and capacity and play an important role as part of the broader global financial safety net in the event of a future financial crisis (see Chapter 8). These new Asian arrangements mark a significant step forward in Asian financial and monetary cooperation. To be truly effective, they need to be coordinated with the IMF. Asia, left to its own devices, would find it difficult to mobilise the resources or impose the conditions on neighbouring countries needed to manage financial crises. A strengthened AMRO that

coordinates with the IMF will help regional financial surveillance. Australia is not party to CMIM or AMRO because they emerged from ASEAN Plus Three, but Australia has an interest in helping to build AMRO's capacity and playing a supporting role within CMIM. More broadly, the Australia–China bilateral relationship should include dialogue and cooperation on issues that can feed into and shape those regional forums and arrangements in which only one country is a member, such as CMIM. There should be creative ways to have Australia become a de facto partner in AMRO. It is in Australia's interest to help strengthen the coordination between the IMF and regional financial arrangements (see Chapter 8).

The institutions and arrangements that have served China, Australia and Asia well in the past must evolve to reflect new regional realities and interests. There is little appetite in the region to create entirely new institutions, but existing institutions could be re-energised and their connections strengthened. And regional efforts should be concentrated on important cross-cutting issues such as energy transformation. Australia and China can work together with regional partners to reform and strengthen these existing institutions and arrangements.

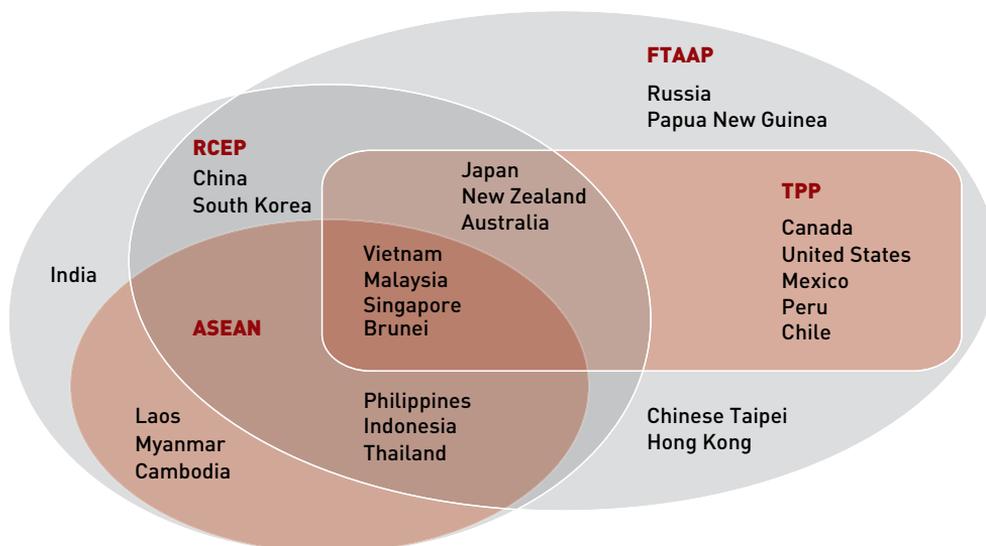
### **Moving towards inclusive regional agreements**

The Asia Pacific region has seen a plethora of bilateral and regional trade agreements signed since the early 2000s. But none of the regional or plurilateral agreements signed to date have been as consequential or large in membership as the TPP, RCEP or the Transatlantic Trade and Investment Partnership (TTIP). These regional economic agreements aim to make major progress on trade and investment liberalisation where the global system has stalled, and to further cross-border commerce and exchange in new areas of importance to business, in some cases by creating new international rules.

Regional agreements can deepen regional and global economic integration and make progress where the WTO has been unable to, and in the process strengthen prospects for progress at the global level. Yet there are risks that these agreements can harm non-members, and that different agreements with different memberships can become avenues for competitive rule-making, thus fragmenting regional and global economic integration. There is strong interest in avoiding or ameliorating these adverse consequences in order to build an inclusive, global economic system.

The 12-member TPP includes Australia, the United States, Japan, Canada, Mexico, Vietnam, Brunei, Singapore, Malaysia, New Zealand, Chile and Peru. Large Asian economies such as China, Indonesia and India are yet to join. Given the standards that the TPP applies and the fact that new members will be required to negotiate bilateral agreements with all other members and be ratified by US Congress, it is unlikely that China will be able to join the TPP in the near future. However, the TPP does provide some country-specific carve-outs and special and differential treatment for developing members regarding their transition periods.

Compared to the TPP, RCEP covers a broader range of countries with more varied levels of economic development. ASEAN's aim is for RCEP to consolidate and harmonise the existing ASEAN Plus One FTAs with China, South Korea, Japan, India and Australia–New Zealand. These FTAs vary considerably in terms of their scope, comprehensiveness and market access commitments. RCEP is expected to be characterised by a set of common rules, but with flexibility for developing countries to commit to certain standards in reasonable timeframes, and market access commitments by individual countries that take account of their level of economic development.

**Figure 7.4: ASEAN, RCEP, TPP and possible FTAAP membership**

Source: Authors' schema.

Australia is party to both the TPP and RCEP and has a role to play with other partners, such as Japan, in dialogue, capacity building and experience sharing to bridge the gap between members and non-members. This bridge-building role is vital because Australia, Japan and others have a number of important trading partners that are not members of both the TPP and RCEP. The TPP and RCEP agreements should be used to deepen market-based economic interdependence and any barriers against non-members should be watered down. The agreements need to be 'living' agreements that change with circumstances and give all members a voice. The criteria for accession to these agreements will also be particularly important if the benefits of these agreements are to be expanded beyond the original signatories.

The TPP and RCEP should not become competing blocs but instead need to be made complementary. RCEP does not include the United States and the TPP does not include China. These arrangements should be directed to enhance economic integration in Asia without fragmenting economic linkages within the region or between the region and the rest of the world.

The TPP and RCEP will serve their purpose only if they are used to foster domestic economic reform agendas. China has been highly successful in its strategy of using membership of external organisations like the WTO to leverage and entrench major domestic reforms. China now has an opportunity to pursue a new round of reforms via external engagement, including financial sector and investment reform, reform of SOEs, locking in improved environmental and labour standards, and further modernising its economy. But the prospect of achieving any of these reforms via the TPP will be long term rather than short term, particularly because China is not a member of the TPP and there will be many hurdles for new members to joining the TPP, and it is not clear when accession might become possible for China. More importantly, those reforms and commitments that China will have to make in order to join the TPP will have to be structured in a way that is consistent with China's domestic reform goals. The major challenge for China, but more broadly for the TPP, will be whether the TPP is able to create an external environment for China and other non-members that is conducive to their

pursuit of domestic reforms. An exclusive set of arrangements in the region that makes the external environment more difficult for further opening up of economies and implementing of domestic economic reforms needs to be avoided.

The RCEP process, on the other hand, shows much more immediate promise through China's participation in negotiating the opening up of borders to trade and investment. China's WTO accession experience demonstrates how interests can align to create win-win commitments via negotiation. It is harder to negotiate domestic reform externally. Reform is more sustainable if it is implemented with external support in the form of agreeing to mutually beneficial goals, capacity building and experience sharing, and by giving countries space to find the best reform path for their own circumstances and institutions. So rather than externally mandating reforms, international agreements can work to provide external impetus for ongoing domestic economic and regulatory reform processes.

The RCEP agreement has the potential to create an environment for both members and non-members that is conducive to opening up of markets and the prosecution of domestic reforms. There is the opportunity to create an agreement that extends the principles and modes of cooperation of ASEAN, especially the AEC, to a broader grouping that includes major-economy neighbours such as China, Japan and India, as well as advanced-economy neighbours such as Australia, South Korea and New Zealand. By RCEP's setting binding goals and allowing some countries to reach those goals in the most suitable way for them over time, with capacity building and experience sharing along the way, the broader East Asian region will move closer to a single market and production base.

Much broader and deeper integration would occur with the East Asian economies through RCEP adopting the four pillars of the AEC — a single market and production base, a competitive economic region, equitable economic development and integration into the global economy — and committing to major liberalisation. This will involve commitments to comprehensive freeing of trade in goods, services and investment and with a framework for economic cooperation. Recognising that a successful agreement will require an ongoing process, members should commit to ambitious binding goals for delivery by 2025, with built-in institutions such as working groups for ongoing implementation.

RCEP has real potential to avoid overly prescriptive outcomes, by providing country-specific market access commitments and setting some agreed rules and directions for future work. As with the experience of ASEAN, multilateralising preferences — so that benefits are extended to non-members — over time will be important to avoid an exclusive membership that truncates economic integration across the Pacific or with the rest of the world. Whether RCEP ultimately results in open regionalism depends on the mode of cooperation, the end goals and how those are pursued.

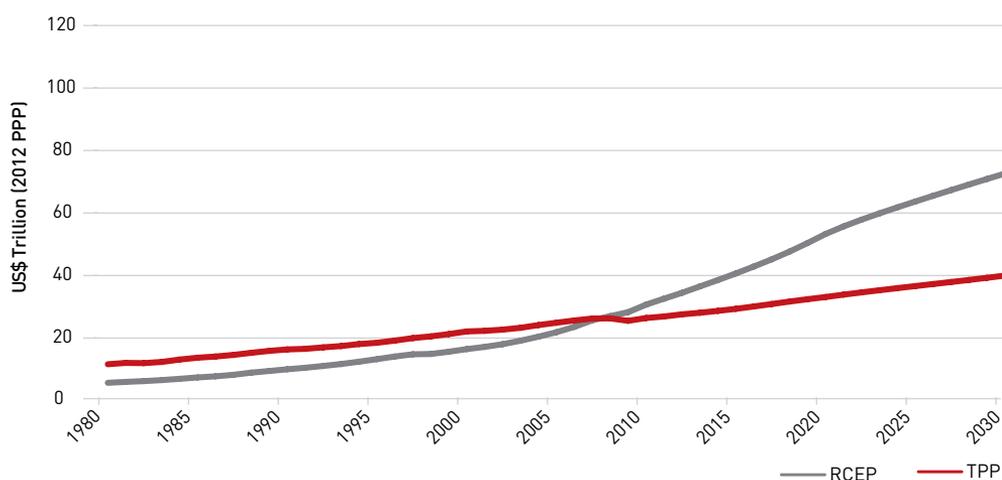
RCEP countries already account for a larger share of the global economy than do the TPP countries and its members also include a faster growing group of countries, led by India and China. RCEP is diverse, with some of the least developed countries in the region such as Cambodia, Laos and Myanmar, which are not APEC or TPP members. The GDP of the RCEP grouping — on conservative projections — could be close to double the TPP's size in 15 years (Figure 7.5).

Pursuing an ambitious RCEP agreement alongside the TPP will be important for furthering economic integration, and Australia and China have a role to play in setting high standards in this process. In doing so, Australia and China can use the best features of ChAFTA —

including the liberalisation of services and investment access — to set the benchmarks for RCEP. Strong initial liberalisation and commitments for phased liberalisation in investment by China and others would help to develop competitive liberalisation between RCEP and the TPP. It would also ensure that a future US–China BIT could incorporate the best features of both the TPP and RCEP, taking account of the interests of the whole region rather than just bilateral interests. This approach would help to achieve convergence between the two regional agreements, thereby addressing the biggest problem they currently face: namely, that the United States and China are not party to both agreements.

Early consolidation of the TPP and RCEP is an unrealistic objective. The track record of consolidating smaller bilateral agreements has not been good and has tended to lead to the creation of additional layers rather than consolidation. The longer-term convergence of the TPP and RCEP, however, can be pursued. A practical way forward would be to mobilise a coalition of the willing to work together in defining the path forward in linking these two regional agreements. Australia, as a member of both agreements, has a crucial role to play, but China and others that are party only to one agreement are also important for finding creative ways to bridge the gaps between the TPP and RCEP.

**Figure 7.5: GDP projections of RCEP and TPP groups, 1980–2050, at purchasing power parity**



*Note: IMF projections to 2020 followed by projections based on an estimate of potential labour productivity for countries currently in transition given institutional quality measured by the World Economic Forum's Global Competitiveness Index. Source: Hubbard and Sharma 2016.*

A related initiative is the effort to develop the Free Trade Area of the Asia Pacific (FTAAP), which was put back on the regional agenda in 2014 when China hosted APEC (APEC 2014a). The FTAAP builds on the ongoing regional undertakings of the ASEAN Plus Three, TPP and RCEP and aims to further APEC's regional economic integration agenda. Consistent with the principles of economic cooperation that have served the region so well until now, APEC leaders have agreed that the FTAAP should support and complement the multilateral trading system, work to help achieve the Bogor goals, and be pursued with a step-by-step, consensus-based approach. It would also need to be a high-quality, 'next generation' agreement and run in parallel to — not as part of — the APEC process so that non-binding voluntary cooperation can be preserved in APEC.

The principles that have served East Asia and its trans-Pacific cooperation so well in the past should guide the formation and architecture of the FTAAP so that it strengthens the WTO and the global economic system. Recognition of the importance of ASEAN centrality and extending the best features of the AEC will be important in achieving a high-quality agreement that moves the region towards a single market in the Asia Pacific. Building on the shared principles that have underpinned Asia's economic integration to date, it is also important to ensure where possible that regional agreements do not undermine the global multilateral system by adversely affecting non-members.

### **BOX 7.3: BUILDING A MULTILATERAL REGIME FOR GOVERNING FOREIGN DIRECT INVESTMENT**

The global trading system has been integral for China's integration into the global economy and regional arrangements such as APEC have helped in this. As investment flows have become more important in the region, the lack of a regional or global investment regime is emerging as a significant gap in the multilateral architecture. Chinese outward direct investment is already large and will only become more important regionally and globally. Australia is a major recipient of Chinese investment, and both countries have a role to play in developing arrangements at the regional and global levels that help with the management of foreign investment and further regional economic integration.

Currently, the lack of a regional or global regime for investment has led to a mix of both unilateral policies (mostly on the part of recipient countries) and bilateral policies, using investment treaties and economic agreements that have varying provisions and protections. Australia and China have an interest in initiating dialogue around the articulation of a common set of principles to govern foreign investment — both for facilitating pre-establishment foreign investment (before it enters a country) and the national treatment of post-establishment foreign investment. This might begin with the implementation of ChAFTA (see Chapter 4). Australia and China can also carry their work on an investment agreement under the aegis of ChAFTA into the RCEP negotiations. Without regional guiding principles, there is a risk that agreements between large countries — such as the United States–China Bilateral Investment Treaty (BIT) — will become the default template for those between all states in the region. It is important that the interests of smaller countries are represented in these discussions so that outcomes are in the interests of all investors and recipients.

### **Promoting infrastructure investment as multilateral regional goods**

Promoting infrastructure funding and investment is a particular priority in Asia and the Pacific. The World Bank has estimated that each additional 10 per cent of global investment in infrastructure increases global GDP growth by one percentage point. Given the modest and uneven growth in the global economy, increasing infrastructure investment is important for many countries. In particular, there is great demand for infrastructure investment within the region. The ADB has estimated that Asia will need US\$8 trillion in national infrastructure and US\$290 billion in infrastructure connecting economies by 2020 (ADB 2009). Meeting that US\$8 trillion deficit in regional infrastructure demand by 2020 is critical to the continuing

growth and development of regional economies. Yet, as is widely recognised, there are currently a number of constraints on infrastructure investment. The scale of funding through the multilateral development banks such as the World Bank and the ADB, which are small relative to the size of demand, has shrunk in recent years. Indeed, since the 1990s, some of the existing multilateral banks, such as the World Bank, have increasingly focused on funding 'social' projects in areas such as education, health, environment and urban development, rather than funding investment in roads, railways, ports and other infrastructure projects. Moreover, the APEC Connectivity Blueprint (2015–2025) released at the 2014 APEC Summit recognises that the quality and distribution of infrastructure in the region remains uneven, and that many countries lack financial support for infrastructure funding. There is clear scope for intermediating Asian savings and facilitating greater private sector financing to cope with the huge shortfall in regional infrastructure investment.

China's launch of the AIIB is an important moment in the emergence of China as a contributor to regional and global public goods (Lin 2015). China already has a number of existing avenues through which it finances infrastructure projects in Asia, including the China Development Bank, its new OBOR initiative, the Silk Road Fund and traditional bilateral financing. Through these avenues, China seeks to strengthen Asian connectivity and economic integration through investment in road, rail, shipping, aviation, telecommunications, power and energy pipeline infrastructure. But the AIIB represents something new. In developing the AIIB, China has voluntarily committed its resources to a multilateral body with formal governance structures and with external oversight. While this multilateral approach necessarily limits China's freedom of action, it offers many advantages to China and the wider region.

First, multilateralising financing decisions can insulate China from bilateral political tensions. With competition among recipients for large infrastructure investment projects, investment deployed through multilateral processes are less likely to become politicised. When commercial decisions take place on a unilateral or bilateral basis, they run the risk of being second-guessed, or being viewed as connected to unrelated disputes or disagreements.

Second, it is in China's direct interest to ensure that the AIIB meets all the standards of a multilateral institution. The AIIB is under intense scrutiny and the international tolerance for missteps will be low. While China originally formed the concept of the AIIB, its governance arrangements have been shaped by its many founding members, and should ensure that the AIIB meets all the accountability and transparency standards of other multilateral development banks and has an appropriately skilled international workforce. The downside of building in those processes and procedures is that it may take longer than China and recipient countries may wish for the AIIB to become a significant player in the region. But China will benefit significantly because there is no question that the AIIB truly is a multilateral institution and not one controlled by China. This does not mean that the AIIB needs to mirror all of the procedures of the existing multilateral development banks. On the contrary, the AIIB should seek to be more effective and efficient than the other multilateral development banks. In doing so, this demonstrates that China can make an effective contribution to providing global public goods and actively lead a multilateral organisation. Moreover, the areas of the AIIB's operations where time and care should be taken — such as rigorous credit assessments, careful project selection, careful attention to environmental and social issues and strong accounting and transparency arrangements — are ones where China can learn from the experience of others. As such, there are a number of indirect benefits that China can gain from the careful establishment of the AIIB.

The OBOR initiative aims to connect Asia, the Middle East, Europe and Africa. It is a bold plan by China that could greatly facilitate infrastructure connectivity and economic integration within and across regions and sub-regions (State Council of the People's Republic of China 2015). China's surplus savings and infrastructure development expertise can be mobilised for the benefit of the development of other countries that lack capital and infrastructure development expertise. It can also ease some of the overcapacity issues in China while expanding trade and commerce for Chinese and other companies. As the success of this Chinese initiative requires active involvement of other countries based on their own interests, the OBOR initiative can also provide a platform for cooperation between developed and developing economies (Zhang 2016b). Australia is actively developing the Northern Australia region and has strong interest in being part of the OBOR initiative. Beyond the bilateral interest in AIIB and OBOR, both Australia and China have an interest in regional infrastructure building and connectivity that would be made more effective through bilateral and regional cooperation.

Ultimately, China's contributions via the AIIB and OBOR form an important plank in Asia's wider connectivity agenda. China's neighbourhood in Southeast Asia has a well-developed ASEAN Master Plan for Connectivity (AMPC). The AMPC is a regional plan for transport and institutional connectivity designed to bring countries closer to one another, and to facilitate better access to trade, investment, tourism and people-to-people exchanges. The AIIB and the AMPC share similar goals. China's capital and expertise in building infrastructure is already highly sought after in Southeast Asia and elsewhere — Chinese-developed ports, high-speed rail and major infrastructure projects such as the Trans-Asian Railway Network and Asian Highway Network have earned China an impressive reputation. Working alongside the AMPC will help China to prioritise investment and embed cooperation among recipient countries. For instance, roads and rail networks will connect countries with shared borders, while a system of short sea shipping will link maritime Southeast Asia with ports for roll-on roll-off vessels.

The AIIB represents an important step in China's provision of regional and global public goods. A successful AIIB will mean Chinese funds, expertise and leadership can be leveraged to support demand for infrastructure investment in Asia and beyond. It is in the interests of Australia and the wider region to see the AIIB succeed.

But the AIIB is not the only important infrastructure investment institution operating in Asia. The ADB, World Bank, and unilateral lenders and donors are all important for infrastructure development in Asia. A positive development is that in its initial operations, the AIIB is focusing on co-financing arrangements with the ADB and the World Bank. However, there is a danger that some of the players may act independently and at times at cross-purposes. It would be productive to ensure a common understanding and coherence to the infrastructure investment network in the region. There would be value in ministers and senior officials from the countries in the region regularly discussing priorities, strategies and mutual interests in infrastructure delivery to further regional connectivity. Regional infrastructure funding and investment is clearly a cross-cutting issue that would be best served by high-level political dialogue. While ASEAN has the AMPC for advancing connectivity among its members, Australia and China could initiate a broader dialogue involving regional countries, regional and multilateral development banks, international financial institutions and recipient regional groupings such as ASEAN. Moving towards establishing a common framework for infrastructure investment and funding in the region would be a major contribution. Existing arrangements should be used creatively and non-exclusively to foster an important dialogue of this kind.

## Australia, China and the next decade of regional cooperation

Australia and China have enjoyed growing prosperity as a direct result of the domestic economic reforms and regional economic integration initiatives they have jointly pursued over the past three decades. But large changes are now underway in Asia due to the changing structure of regional and global economic power. Close cooperation and communication is required in order to avoid misunderstandings and disputes, to narrow differences, and to maintain and build trust among countries in the region. The shift towards a more complex and multipolar order has already created new tensions and has begun to erode some of the region's shared principles. The major challenges now facing Asia's regional economy require innovative solutions.

Australia and China share a common interest in forging a new consensus on the shared principles of cooperation that can bring further economic interdependence, build political cooperation and maintain stable relations between the region's great powers.

The regional and global economic systems are changed as a result of what large economies do by themselves to manage their interactions with other economies and polities. But if we are to achieve a peaceful transition to a more multipolar world, these changes must take place through collective consensus among all the countries that are affected. This chapter has identified a number of areas in which collaboration between China, Australia and their partners in regional economic diplomacy will be of special importance in the coming decades.

Practical progress can be made in strengthening, extending and better connecting the established regional economic cooperation arrangements, such as APEC, the ASEAN Plus frameworks and the EAS, and in securing a framework for political confidence and security within which economic prosperity can be attained. A starting point will be to better connect the cooperation and dialogue on economic issues that takes place in APEC and the ASEAN Plus processes with the cooperation and dialogue on political-security issues discussed within the EAS. Important, cross-cutting issues that require close cooperation, such as energy and environmental transformation as well as regional infrastructure funding and investment, should be the focus of dialogue led by the major powers in the region and carried across different forums.

Australia and China have a strong, shared interest in mobilising a coalition for defining the path forward in forging the TTP and RCEP together towards a FTAAP that strengthens the WTO and the global economic system. The ChAFTA agreement can set benchmarks that will help with ambitious and high-quality outcomes in the RCEP agreement, especially in the investment chapter. Australia and China can pioneer services sector opening, capitalising on Australia's potential role as a good testing ground for liberalisation. China can use ChAFTA as a testing ground for a high quality US-China BIT.

Asia's future economic growth and integration is increasingly dependent on investment in critical infrastructure. Australia and China will both benefit if the region is better connected through sea, road and rail networks and other connectivity projects. The AIIB is an important new channel to funding Asia's infrastructure needs. Starting a high-level dialogue among all the actors in the region — both funders and recipients — aimed towards establishing a common framework for infrastructure funding and investment would reduce costs, bring better understanding and help improve connectivity.

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