



## China's Relations with ASEAN Economies

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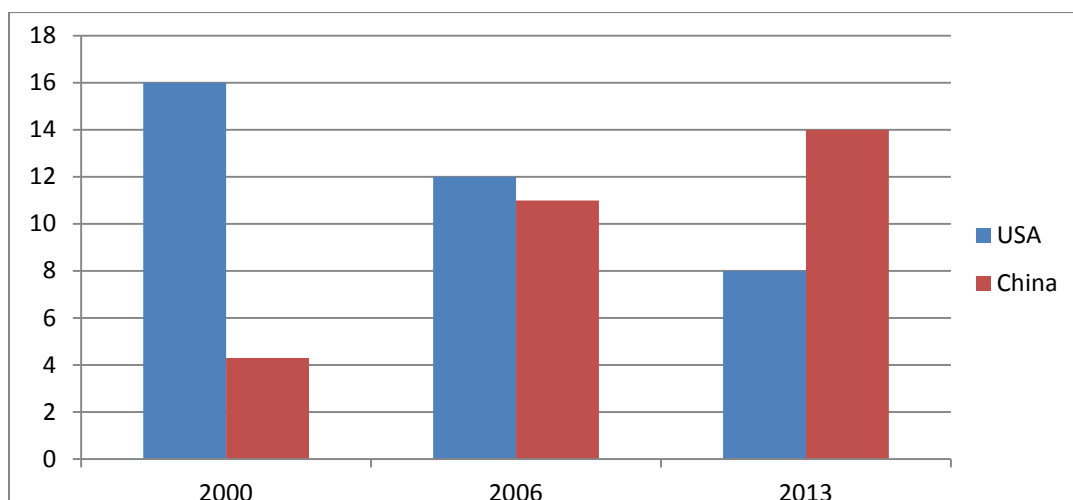
### I. Introduction

China is intensively involved in Southeast Asia (SEA) as a major importer, exporter, aid provider and investor. Many Chinese citizens work, live and visit in SEA and China is a major diplomatic presence. This situation has both positive and negative aspects which most of the nations are trying to manage in different ways. These comments will not focus on the "China Sea" issues, which primarily involve the Philippines and Vietnam as they are more military and diplomatic than economic – though some resource issues are involved. Instead, these remarks will focus on the implications of Chinese economic engagement with the region.

### II. Trade

Over China's trade with SEA has grown rapidly. If we take the period since 2000, Graph 1 shows the share of China and the US for combined imports and exports. Most ASEAN exports are of raw materials, though some nations export components for electronics. Most ASEAN imports are of manufactured goods, either for consumer goods or machinery. For all of ASEAN in 2013, China bought 12% of their exports (compared to 3.5% in 2000) and supplied 16% of their imports by value (it was 5.2% in 2000), or 14% of total 2013 trade. This increasing share may slow or stabilize in the future as China's growth slows down.

**Graph 1: China and US – Share of ASEAN Trade**



Source: "China's "Soft Power" in Southeast Asia", 1/4/2008, CRS RL 34310; and ASEAN data base for 2013

The trend since 2000 is of a rising share of trade with China and a falling share from the US – indeed, the US share has fallen in half since 2000. The current US share is slightly more than half of China's share and likely to fall further. However, the US tends to import more manufactured products from ASEAN in comparison to China. These products are labor-intensive and often have low domestic value added in the exporting (assembly operation) country. China's exports tend to have more domestic value added. The migration of labor intensive exports from China to ASEAN might slow the decline in the US share.

It is likely that China's GDP growth will slow in this decade, perhaps to 5-6%<sup>1</sup>. More significantly, the composition of their growth will skew away from exports and investment to domestic consumption and services. These will be less material intensive and so products such as coal, copper and iron ore will drop in price, a process already underway. However, the major exports of ASEAN by value are food and fuel, not hard minerals. Fuel consumption will move from coal<sup>2</sup> to gas and, to a lesser extent, oil. Oil is not a major ASEAN net export but gas is. US export policy towards its own natural gas will certainly influence the price of LNG in Asia, perhaps as much as China's growth slowdown.

Food imports are harder to predict, since they depend not only on China's policies towards self-sufficiency but also Chinese attitudes towards food quality. Water shortages, soil pollution and an aging farm work force will tend to depress China's food production. Overall population growth in China is slowing with a rising share of elderly. Incomes are rising, leading to less direct grain consumption and more meat, poultry, fish and dairy. Fresh vegetables and fruits are likely to take more of the food budget. ASEAN is well placed to supply a portion of this rising demand, though less so in dairy and meat than others.

If raw material prices (including rubber, coffee, and so on) do soften further, this will push ASEAN to accelerate the growth of its non-farm sectors. These had been growing faster before the Asian crisis but slowed during the Crisis and this slower rate continued as China's demand for commodities led to a greater focus on raw materials. The migration of labor-intensive exports from China gives ASEAN, especially the lower-income portion, a clear path forward. In any case, agriculture normally declines as growth progresses and productivity and incomes in the rural sector are much below those of cities. It would be natural and desirable to move labor from lower productivity rural areas to higher productivity sectors. However,

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<sup>1</sup> Japan is not covered in this paper. It is a major investor and trading partner but with high debt and a shrinking population, it will be a receding factor going forward.

<sup>2</sup> Indonesia is the world's largest thermal coal exporter, with exports of about \$25 billion, or 12-15% of total exports by value. While Chinese coal imports can be expected to fall, India and other nations may pick up much of the slack. Domestic policy is also restricting some illegal exports and there has been little growth in recent years.

this process is already underway among younger workers and most farmers are aging. They may be less able to shift advantageously to urban jobs.

### **III. Investment**

ASEAN had \$334 billion of FDI in 2011-2013. The “big three” sources were the EU, Japan, and intra-ASEAN investment, which together accounted for 56% of total FDI coming into ASEAN. China's three year total for FDI was \$21.9 billion or 6.5% of the total – if Taiwan (1.8%) and Hong Kong (4.1%) are added, the total was 12.4%. The US directly invested \$24 billion in the three year period or 7.2% of the total, though some US multinational investment is counted as coming from Singapore or other places. Thus, China is an important but not dominant investor.

It may be that Chinese are buying land and real estate in significant amounts and some of their purchases may not be captured in the normal FDI statistical net. It is hard to evaluate this channel in terms of value or trend. If overall Chinese credit grows more slowly, it is likely to slow as well. China now has a credit to GDP ratio of 200% to 250% and credit cannot safely grow rapidly as the economy slows. While the Chinese authorities realize this, they have very recently cut reserve requirements and interest rates as expansionary measures. It remains to be seen if this creates bubbles not only in China's but also ASEAN's stock and real estate/land markets. Such bubbles eventually collapse and slow future growth.

### **IV. Chinese Aid**

It is sometimes difficult to distinguish aid from investment coming from China due to the intertwined nature of Chinese state enterprises and the government. For example, in Afghanistan, China won a contract to exploit a large copper deposit with the help of major infrastructure which was financed with Chinese government loans. Funds to Chinese companies to invest in “drug substitution” programs in Myanmar have resulted in large land grants for rubber and other tree crops. Because of Myanmar practices, these land grants often come at the expense of ethnic farmers and complicate peaceful resolution of ethnic conflicts. The “New Silk Road” initiative will lend many billions of dollars for infrastructure in ASEAN. (The recent trip of Xi Jinping to Pakistan produced promises of \$45 billion of infrastructure investments.) The loans for these projects will be at or close to commercial rates, say 5-6%.

China has nearly \$4000 billion in foreign exchange reserves, much of it earning essentially nothing if held in Treasury bills. It also has excess capacity in steel, cement, and companies making high-speed trains or in construction. It certainly makes internal sense for them to finance roads, trains, ports, dams and other projects desired by the borrowing countries. They get a higher return on their funds, employ Chinese people and physical capital that would otherwise be idle and extend their influence as well.

Cambodia has been a special focus of aid, receiving billions of dollars over the years.<sup>3</sup> Laos and Myanmar are also recipients, while Vietnam and Thailand have gotten some loans in the past five years. The interest of China in having Cambodia stall ASEAN resolutions on the South China Sea or other issues is obvious and there is likely a linkage. The other nations do not show any clear correlation between Chinese influence and aid levels. Thailand, for example, is more open to China than Vietnam in many ways but gets relatively little in aid from them.<sup>4</sup> I am not a political scientist or diplomatic observer<sup>5</sup>, but it would be mistaken to take aid, investment or trade flows as a determinant of attitudes towards China though they obviously are a factor for the relevant country to weigh. In Thailand's case, the authoritarian military government is not a concern for China but is to the US, so it is easier for China's influence to grow because they do not try to or want to change the type of government.

An active discussion has grown up around the Chinese Asian Infrastructure Investment Bank, which the US has opposed on the grounds that it will ignore environmental and other safeguards. If this is the real concern, it would make more sense to be inside and learn of its procedures and perhaps modify some of them rather than being on the outside. This is the inclusive position being taken by most of Europe and Asia. The US, with Japan, is isolated and has diminished influence. Many Chinese suspect the opposition is less principled and reflects a reluctance to allow China to play a growing role.

However confused the US may be on that issue, its own internal disputes have not escaped notice and are more significant. The possible cessation of the Export-Import Bank is one example – it makes no sense to disarm unilaterally in finance and trade any more than it does in military contests. Every other major country has a similar bank to provide credit. China has one that is more active than ours and just got a new \$30 billion injection. Whatever waste or favoritism is in the Export-Import Bank, the better response would be to fix its procedures and the US corporate tax code rather than hand huge amounts of trade to other nations. Other examples are the failure of the US to fix up even its existing infrastructure (bridges falling; gas pipelines exploding; water mains erupting, trains derailing, etc.) at a time of low interest rates and high corporate cash balances. It appears there is an ideological divide that prevents obvious solutions – again, the periodic shutdowns of the government or the shifting of cash balances and forced government worker holidays are watched with a mixture of consternation and bemusement.

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<sup>3</sup> See: <http://www.eastasiaforum.org/2013/07/16/chinese-investment-and-aid-in-cambodia-a-controversial-affair/> and <http://www.channelnewsasia.com/news/asiapacific/chinese-influence-in/1763310.html>

<sup>4</sup> A Chinese Harvard fellow was very interested in attitudes towards China in Vietnam and Myanmar. I observed that he had not asked me about Cambodia or Thailand. "No", he said with a smile, "It is not necessary."

<sup>5</sup> I did review a book by Ian Storey, *Southeast Asia and the Rise of China: The Search for Security*, Routledge, 2011 (hard cover) and 2013 (paperback). He is the one to ask about diplomatic issues.

With a falling share of trade; a secondary role in investment; a small amount of bilateral aid and a dysfunctional political system, the US has ceded much of its leadership role. While it remains a major buyer of many ASEAN exports, and its military power is useful and crucial for ASEAN to balance China, few nations are in a position to choose one nation over the other. China is seen as expansionist, aggressive, unreliable, big and close. The US is seen as distant, distracted, and (relatively) diminishing.

## **V. Tourism, Migrants and the Ethnic Chinese**

Tourism is an important industry for many ASEAN economies and tourist arrival numbers grew by 50% from 2008 to 2013. There were 98 million tourist arrivals in ASEAN in 2013, of which 43.2 million were from other ASEAN neighbors. Of the remaining 54.8 million tourists, 12.6 million (23% of non-ASEAN) came from China and 3.2 million (5.8%) were from the US. China's numbers tripled from 2009 while the US grew just 20% in the same period. This does not account for differences in spending (or behavior!) but the gap in numbers and trend in growth is marked. A growing Chinese middle class is likely to travel even more in the future and further widen the gap. This growing market will mean more learning of Mandarin and increasing overall influence.

In addition to "normal" tourism, some Chinese effectively migrate to some ASEAN countries. In Myanmar, it has been estimated that 1-2 million Chinese, mainly from Yunnan, have moved to Myanmar and purchased citizenship cards.<sup>6</sup> It is likely that additional numbers have moved into Laos and there is visa-free travel into Cambodia as well. It is likely that these movements are individually motivated rather than state-sponsored but they do constitute an important factor it would be foolish to ignore. Those that move typically have access to some capital, marketing contacts, and business savvy. They end up controlling much retail and wholesale trade and often buy up urban land and real estate.

There are also people who have lived much longer in ASEAN but who are ethnically Chinese. In many cases, their ancestors came many generations ago. Most of these people consider themselves citizens of the country they were born in and are in no sense a "fifth column" although anti-Chinese pogroms, such as those orchestrated by Prabowo during the Asian crisis, do little to encourage patriotism! What is relevant is Chinese-linked ethnic groups such as the Wa, who are semi-independent within Myanmar and who rely on Chinese arms and support.<sup>7</sup> Ethnic Chinese-ancestry business people are hugely important in Southeast Asia, but most of them reflect the crony capitalist economic structure in which they operate. They are often good at getting favorable treatment, but not always at competing in world markets. This may be one reason why so many ASEAN economies seem to have slowed down to 4-

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<sup>6</sup> This range of recent migration has been mentioned to me but is hard to document. It is illegal to purchase citizenship cards and no registry is kept.

<sup>7</sup> <http://alfredmeier.me/2014/03/18/myanmars-northeast-chinas-version-of-crimea/>

6% growth when still at moderate income levels – a “middle income trap” caused by inadequate structural reform. It would not be fair to blame business people for operating according to the rules of where they live and work, but the semi-separate ethnic status may slow the political coalitions that would otherwise lobby for efficiency-increasing and corruption-reducing measures.

## **VI. Lower Mekong Issues**

The Mekong River is important to tens of millions of farmers and fishermen and is being affected by a large number of dams already built and planned or being built either on its tributaries or the main river itself. China is not a member of the Mekong River Commission and has built several upstream dams. The impact of these dams will in large part depend on how they are managed. It is likely that they will have some impact in lowering flood season flows and increasing dry season flows and will probably influence silt transport to some degree, depending on if or when the dams are flushed of their accumulated sediment. There are already moderate impacts from these dams, including on sediment and water flows and fish. If China were to transport water to its ambitious multi-stage south-to-north water channels and canals, it would have a much larger impact.

While Chinese dam construction is rightly scrutinized, it is likely to be less important than what is being done or planned by Thailand, Laos and Cambodia. These nations account for about four-fifths of the water flow and sediment. Even Vietnam is investing in dams in some of these nations, even though it may adversely influence its own Mekong Delta! The concern for the Mekong, and especially for the Mekong Delta and Tonle Sap Lake, are related to Chinese plans (barring major northward water diversions) in a minor way. A Thai high-level water diversion project could have a major negative downstream impact.<sup>8</sup> It is unclear if it will be implemented, in spite of its poor returns.

The Mekong Delta is itself troubled by its own mining of groundwater, which lowers the ground level itself and makes low lying (most) land vulnerable to rising sea levels. It also leads to water quality problems. Managing underground and surface water resources is of much more immediate importance than controlling Chinese dams. The Tonle Sap has been overfished and is getting silted. Uncontrolled dumping of human and industrial waste into the Mekong from Phnom Penh and parts of the Delta in Vietnam also contribute to pollution problems. When the downstream nations are mismanaging their own resources so badly, it is harder to chastise the Chinese.

The Mekong has historically been a difficult river to navigate due to its rapids. These also provide a habitat for fish. When shallow, rocky areas are blasted to provide

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<sup>8</sup>[http://www.academia.edu/898934/Water\\_Poverty\\_and\\_the\\_Governance\\_of\\_Megaprojects\\_The\\_Thai\\_Water\\_Grid\\_](http://www.academia.edu/898934/Water_Poverty_and_the_Governance_of_Megaprojects_The_Thai_Water_Grid_) is a critical summary of the proposed “Water Grid” which involves large diversions of Mekong water.

navigation channels, this has a deleterious impact on fish and those who rely upon them. Dams, even with fish ladders, also interfere with spawning, much as salmon are harmed in the US. This becomes a distributional issue within and between nations on the Mekong. If fishermen (and women) can find other sources of livelihood and protein, the cost of the reduced fish populations may be tolerable to them. If not, then some suffer to benefit others. Aside from financing studies and projects to help those displaced, the US has only a limited ability to influence the choice and pace of these projects, especially now that the Chinese are likely to support construction of Mekong dams if they are approved by the ASEAN government that controls that section of the river. The Mekong River Commission signatories do have certain obligations to downstream nations, but it is unclear if this will effectively constrain them.

The impact of these Mekong investments will be felt primarily in Cambodia and Vietnam. If Vietnam continues (or regains) its relatively rapid industrial growth, it is likely to be able to absorb many of the displaced. Agriculture is less than 20% of GDP but is still nearly half of the employed workforce in Vietnam, and even higher than that in the Mekong Delta. A growing productivity disparity between a largely unchanged (in number) agricultural labor force and a growing nonfarm labor force will in any case tend to push more workers out of agriculture over time. The main question is how quickly and where else these aging and poorly educated workers can be absorbed. There would certainly be strains and perhaps some reversal of the considerable reductions in poverty, which had measured about 1/3<sup>rd</sup> of households in 1998 in the Delta and now is said (with a somewhat different poverty level) to be less than 10%. It is possible that some of the fish raising would replace rice growing and adjust to less fresh water. This would not be equally true though for shrimp farming which needs fresh water. Overall, it would be a blow but a blow which could be absorbed at some cost.

The situation in Cambodia is less clear although the economy is more agricultural (51% of workers; a third of GDP) and has less industrial development. It is likely that the possible death (from increased siltation and no flood season flow reversal) of the Tonle Sap would have a relatively large impact on livelihoods which would be harder to offset by gains in industry and services. It is not clear if the reverberations would increase instability. Certainly the governance indicators for Cambodia are not very high<sup>9</sup> and the ability or willingness of the government to respond may not be satisfactory. However, the current trends point in the same direction, even without further Mekong investments.

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<sup>9</sup> The World Bank rates most nations on six dimensions of governance. Cambodia is in the bottom fifth for voice and accountability, government effectiveness, rule of law and control of corruption. While voice is also low in Vietnam, the other variables are close to the 40<sup>th</sup> percentile – that is below the median, but well above Cambodia.

## VII. Conclusions

China's size, proximity, policies and recent growth have been both an opportunity and a problem for ASEAN. China's rising demand for commodities has probably slowed the industrial development of some ASEAN economies and resulted in a focus on producing raw materials. The production of commodities does not usually accelerate overall growth or necessarily help income distribution. On the other hand, ASEAN has been capable of responding to a market opportunity and earned foreign exchange. Economies have grown 4-6% a year since 2000 for the most part and sometimes faster in the poorer nations. Chinese investment and aid tends to promote Chinese interests, but these partly overlap with ASEAN government interests.

A slower growing China will be partly offset by more domestic demand growth within ASEAN and by demand from South Asia and other regions. A tilt towards more industrial development in ASEAN, partly driven by migration of some export industries from China, will offset some of the losses from less agricultural growth. The environment may also feel less pressure to displace forests with palm oil and rubber plantations. China only bought about an eighth of ASEAN exports in 2013, so they are pretty well diversified. Sluggish growth in the EU and Japan is also a challenge, perhaps greater than a 5% Chinese GDP growth focused more on services and consumption.

ASEAN will likely split with "island" Southeast Asia – non-contiguous to China might be a better term – having more room for balancing the influence of China with other partners; and contiguous nations having to bend more or less directly to China's will. Indonesia – an important nation in its own right – is part of the "island" group, as is the Philippines. It should be noted that President "Jokowi" said the nine dash line had no basis in law. Malaysia and Singapore are also able to have foreign policies which consider China but are not dominated by it. Thailand, Laos, Cambodia and – probably – Myanmar fall into the contiguous group. This is true in spite of considerable anti-Chinese feeling in Myanmar.<sup>10</sup> Only Vietnam stands out as a nation that touches China but wants to keep a degree of independence. They will not join an anti-China alliance but will try not to be dominated.

The Mekong basin is being impacted by dams and irrigation schemes in both China and, especially, downstream nations. Poor resource management is widespread in the region and more attention to economic returns on investments and proper water management would do wonders for mitigating the impact of such projects as do go forward. If many of these projects do go forward, the Mekong Delta will have to make large and painful adjustments, but will probably manage with some outflow of workers. In Cambodia, there are fewer alternatives and the impact on poverty is likely to be greater.

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<sup>10</sup> Myanmar is worth a paper in itself. It may become a virtual Chinese protectorate with military bases and a limited degree of maneuver. It is so divided and poorly run that its time to reform is limited.



The ability of the US to control these outcomes is limited. Most governments are authoritarian and not inclined to listen to a country that lectures them, does not often pay attention, and is far away and less important than its giant neighbor. The TPP, if it passes, would help to some extent and keep the US in the game. *Not passing TPP would kill the pivot and all but announce a new period of isolationism.* The US still has soft power – its education is admired and its society is seen as open and more equal and meritocratic than most in the region. Its multinational companies are seen as good places to get a job, though few can even dream of such. US technology remains impressive. On balance, the US position that makes sense is to encourage ASEAN to remain open economically and to information flows and to gently urge it to trend towards more democracy. They do not want to choose between China and America. America being there means they are not forced to choose.

Note on the Author

Professor David Dapice began working in Indonesia as an economic adviser with the Harvard Development Advisory Service in 1971. He became a professor of economics at Tufts University in 1973 where he still teaches and has continued working with Harvard University, engaging in development work on the ground in Indonesia, Vietnam, Myanmar, Thailand and Cambodia. He has been the chief economist of the Vietnam Program in Harvard's Kennedy School since 1990 and worked extensively in Myanmar in the 1990's and since 2009.