

China's Relations with Southeast Asia

Testimony for the U.S.-China Economic and Security Review Commission

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Introduction

Chairman Reinsch, Vice Chairman Shea, and Honorable Members of the Commission, thank you for inviting me to share my perspective with you on China's growing economic ties with Southeast Asia. It is an honor to participate in this timely hearing. Southeast Asia is a central focus of the Obama administration's "rebalance to Asia" and a region of growing economic and strategic importance. This year is critical for Southeast Asia's trade diplomacy and future economic relationship with China given that four major trade initiatives are underway that will have a significant impact on the region's trade flows. The establishment of the ASEAN Economic Community (AEC), the upgrading of the ASEAN-China Free Trade Area (ACFTA), and completion of the Regional Comprehensive Partnership (RCEP) and Trans-Pacific Partnership (TPP) negotiations are all targeted for this year. China's increasing economic weight is a major consideration for ASEAN members in pursuit of all these initiatives as they seek to carefully manage economic relations with China.

Background

For Southeast Asian countries, China is both an important trading partner and a formidable competitor for market share, manufacturing, and foreign direct investment (FDI). China surpassed the United States, Japan, and other economies to become ASEAN's largest and most important external trade partner in 2009, while ASEAN has been China's third-largest trading partner since 2011.¹ According to the grouping's external trade statistics for 2013, China ranked first out of the regional bloc's top ten trade partners, making up 14.0% of total trade. ASEAN's next largest trading partner, the European Union (EU), made up 9.8% of the bloc's total trade in 2013. While the degree and nature of China's economic importance varies among individual ASEAN members, China is a critically important economic partner for all ten. It is the most important export market for Malaysia, Singapore, Laos, and Cambodia and the largest foreign investor in Cambodia, Laos, and Myanmar.²

¹ "ASEAN Eyes Greater Investment from China," Xinhua, January 14, 2014, http://news.xinhuanet.com/english/china/2014-01/14/c_133044481.htm.

² Vinayak HV, Fraser Thompson, and Oliver Tonby, "Understanding ASEAN: Seven Things You Need to Know," McKinsey & Company, May 2014, http://www.mckinsey.com/insights/public_sector/understanding_asean_seven_things_you_need_to_know.

Recognition of the importance of healthy economic relations with China is deeply understood in ASEAN capitals. The importance of China to the region's economic prospects was clear in the aftermath of the 2008 global financial crisis. Southeast Asia weathered the crisis fairly well, continuing to post favorable growth rates of 5.4% on average despite recessions in key export destinations such as the EU, Japan, and the United States.³ Growing domestic demand, supported by favorable demographic profiles in key economies such as Indonesia and the Philippines, was a contributing factor along with rising trade within ASEAN and with broader Asia, particularly China.⁴ Approximately 26% of Southeast Asia's exports go to other ASEAN members.⁵ The total value is expected to continue to climb as regional supply chains mature, providing an increasingly important ballast as China's economy slows.

As a result, Southeast Asian policymakers increasingly see their countries' economic fortunes tied together as well as to China. This has spurred vigorous trade diplomacy from ASEAN members targeting three goals: (1) increased ASEAN integration, (2) closer ties with Asia's economic powerhouses China and India, and (3) closer ties with the United States, the EU, and Japan to gain market access and maintain balance in their economic portfolios. The United States has a strong interest both in fostering an ASEAN that forms a cohesive, independent, and prosperous economic community and in ensuring that ASEAN's trade ties with China are balanced.

ASEAN Centrality and Regional Integration

The ten members of ASEAN have committed to strengthening ASEAN's regional economic integration as well as its role in coordinating approaches to external partners and driving the development of regional architecture through the principle of "ASEAN centrality."

For ASEAN's goal of closer economic integration, efforts have focused on the formation of the AEC. The AEC aims to transform ASEAN into a union with free movement of goods, services, investment, skilled labor, and capital in order to realize efficiencies, build economies of scale, and compete with neighboring China and India as a destination for FDI. ASEAN is in the final months of fulfilling the requirements for the AEC Blueprint to meet the deadline of December 2015. According to ASEAN officials, approximately 90% of these requirements have been met.⁶ The final commitments—in areas such as investment, financial services, and labor flows—are the most challenging, however, and many observers have expressed skepticism that these will all be fulfilled this year. Under Malaysia's 2015 ASEAN chairmanship, the grouping is already working on developing a new ten-year strategic plan and targets for deeper integration post 2015.⁷

³ Asia Development Bank, *Asia Development Outlook 2014: Fiscal Policy for Inclusive Growth* (Mandaluyong City, Philippines: Asian Development Bank, 2014).

⁴ Asia Development Bank, *Asia Development Outlook 2014*.

⁵ "External Trade Statistics," ASEAN, July 24, 2014, <http://www.asean.org/news/item/external-trade-statistics-3>.

⁶ Ming Tian, "Regional Integration, Cooperation Top Priorities of ASEAN Summit," CCTV, April 24, 2014, <http://english.cntv.cn/2015/04/24/VIDE1429864084814390.shtml>.

⁷ "ASEAN on Track to Deliver Measures under AEC, Says ASEAN Deputy Sec-Gen," *Malay Mail*, April 25, 2015, <http://www.themalaymailonline.com/money/article/asean-on-track-to-deliver-measures-under-aec-says-asean-deputy-sec-gen>.

As part of its push for greater integration, ASEAN has also actively pursued free trade agreements (FTA) with external partners to achieve the policy goal of “a coherent approach towards external economic relations” among members and to reinforce the principle of ASEAN centrality in broader regional integration efforts with North and South Asia.⁸

The first and perhaps the most significant FTA that ASEAN has negotiated to date is with China. Entering into full effect in 2010, ACFTA is the world’s largest free trade area covering 1.9 billion people and third-largest in terms of nominal GDP after the EU and North American Free Trade Agreement (NAFTA). The first tranche of commitments reduced tariffs on nearly 8,000 product categories, or 90% of imported goods, to zero for China and the six founding members of ASEAN. More recent and less developed members (Cambodia, Laos, Myanmar, and Vietnam) were given a five-year phase-in period and are committed to implement these terms this year.⁹

Under ACFTA the average tariff rate on Chinese goods exported to ASEAN dropped to just 0.6%, down from 12.8%. The tariff rate on ASEAN goods exported to China also fell from 9.8% to 0.1%.¹⁰ Since the implementation of ACFTA, two-way trade has grown and resulted in trade deficits for most ASEAN members.¹¹ The agreement also has the potential to further influence how manufacturing develops in the region. As labor costs in China rise, ACFTA becomes a potentially attractive option for Chinese and multinational companies to move manufacturing to lower-cost areas of Southeast Asia while continuing to service the Chinese market.¹² For example, with Vietnamese wages currently at about a third of those in South China, manufacturing capacity for products ultimately destined for the Chinese market is increasingly finding its way to Vietnam. Vietnam’s full implementation of ACFTA commitments this year could lead to an uptick in employment and help ameliorate the country’s trade deficit with China.

In 2013, Chinese premier Li Keqiang called for an “upgraded version” of ACFTA, pledging economic and trade cooperation of “a greater scope and higher quality.”¹³ China proposed including better measures on trade facilitation, lowering tariffs, cutting non-tariff measures, holding talks on a new round of service trade commitments, and promoting openness in the area of investment. This proposal was well received by ASEAN and the two sides have set a goal for

⁸ Yoshifumi Fukunaga & Ikumo Isono, “Taking ASEAN+1 FTAs towards the RCEP: A Mapping Study, ERIA Discussion Paper Series, January 2013.

⁹ Chris Devonshire-Ellis, “Understanding China’s Free Trade Agreements,” China Briefing, February 10, 2014, <http://www.china-briefing.com/news/2014/02/10/understanding-chinas-free-trade-agreements.html>.

¹⁰ “Upgraded Version of ASEAN-China FTA,” *China Daily*, November 13, 2014, http://www.chinadaily.com.cn/world/2014liattendealm/2014-11/13/content_18910660.htm.

¹¹ Nargiza Salidjanova and Iacob Koch-Weser, U.S.-China Economic and Security Review Commission Staff Research Report, “*China’s Economic Ties with ASEAN: A Country by Country Analysis*”. March 17, 2015

¹² Devonshire-Ellis, “Understanding China’s Free Trade Agreements.”

¹³ “Upgraded Version of ASEAN-China FTA.”

two-way trade of \$500 billion by 2015 and \$1 trillion by 2020 as well as achieving two-way investment of \$150 billion by 2020.¹⁴

ASEAN has also continued efforts to solidify ASEAN centrality, which positions the grouping as the driver of broader multilateral cooperation in the region through its leadership of the East Asia Summit (EAS) and ASEAN Defense Ministers' Meeting and trade diplomacy with external partners. The flagship economic initiative for ASEAN centrality is the RCEP between ASEAN members and six dialogue partners (Australia, China, India, South Korea, Japan, and New Zealand). This comprehensive partnership would knit together ASEAN's existing FTAs with these countries. When completed, RCEP would create an integrated market with a combined population of over 3 billion people, representing 49% of the world's population, and with a combined GDP of about \$20 trillion, or 28% of the world's GDP based on 2011 figures. As currently envisioned, RCEP does not have the depth or scope of the TPP, though it could provide a model and alternative vision for a Free Trade Area of the Asia-Pacific (FTAAP). For ASEAN, RCEP is important not only for its trade and economic benefits but for the role it plays in strengthening the strategic imperative for ASEAN's continued engagement in regional integration.¹⁵

Diversification Strategies

ASEAN members have also employed strategies as a group and individually to buffer against overdependence on China's economic growth. Central to these strategies is diversification of economic partners and export markets. This is part of the impetus behind the many bilateral FTAs that ASEAN has negotiated as well as the participation of Brunei, Malaysia, Singapore, and Vietnam in TPP negotiations. Both ASEAN and the United States are also committed to deepening economic ties across the Pacific.

The TPP is the most significant trade negotiation underway in Asia for the United States. The TPP is an FTA that would knit together twelve Asia-Pacific Economic Cooperation (APEC) economies, including four from ASEAN (Brunei, Malaysia, Singapore, and Vietnam), into an arrangement that liberalizes approximately one-third of world trade and covers new "21st century" issues such as e-commerce, cross-border investment, and intellectual property rights. The TPP also includes an open accession clause and is intended to be a building block toward an eventual FTAAP. Formation of the FTAAP is a goal endorsed by the 21 member economies of the APEC forum, which include 7 ASEAN members, the United States, and China. This year is also a critical juncture for the TPP as negotiators are striving to conclude the agreement as soon as possible. Critical to the eventual outcome of TPP negotiations will be congressional approval of trade promotion authority (TPA), allowing for a congressional up-or-down vote on trade pacts without amendment.

The timing of the conclusion of the TPP and granting of TPA is important not only in terms of the economic benefits that will be accrued by the United States and other TPP partners but also in the context of the wider push toward economic integration in Asia through the AEC, RCEP, and vision of an FTAAP. How the TPP, RCEP, and other existing FTAs in the region relate to the

¹⁴ ASEAN-China Statement, 2014.

¹⁵ "Factsheet: What you need to know about Regional Comprehensive Economic Partnership (RCEP)," Ministry of Trade and Industry (Singapore), June 18, 2014, <http://www.mti.gov.sg/MTIInsights/Pages/FACTSHEET-WHAT-YOU-NEED-TO-KNOW-ABOUT.aspx>.

FTAAP is an open question for many regional economies. It is in the long-term interests of the United States and Asia for the TPP to be the accepted model for future economic integration.

Successful conclusion of the agreement this year would strengthen the credibility of the TPP as the vehicle for the FTAAP and would provide a high-standard template for future regional economic integration. In the meantime, it is critical for the United States to continue to work closely with ASEAN to ensure that more developed ASEAN members such as Indonesia, Thailand, and the Philippines are prepared to enter the TPP in the near term and to flesh out a roadmap for eventually including all the ASEAN members.

Overall, the efforts of Southeast Asian countries to diversify economic relationships and deepen ASEAN ties have yielded positive results. The impact of China's current economic slowdown has been variable, depending on individual countries' export portfolios, with those that are more heavily dependent on commodity exports, such as Cambodia and Indonesia, feeling the impact more strongly. On balance, according to the most recent outlook from the Asian Development Bank (ADB), Southeast Asia's growth projections are fairly rosy, boosted by continued growth in domestic demand, stronger growth in the United States, and lower oil prices.¹⁶

In addition to not wanting to tie their economic fortunes too closely to China's, many Southeast Asian countries have deeper concerns that Beijing may seek to leverage economic ties in order to coerce political and strategic policy decisions in China's favor. There is good precedent for this concern and several high-profile examples. In 2010, ties between Norway and China plummeted after the Nobel Peace Prize was awarded to Chinese dissident Liu Xiaobo. Five years later, Beijing continues to impose tight restrictions on Norway's imports of salmon.¹⁷ Likewise, headlines about Beijing's unofficial halting of rare earth exports to Tokyo in 2010 at the height of Sino-Japanese tensions in the East China Sea were closely followed throughout the region.

Concerns over China's economic influence yielding political leverage are particularly strong in the Philippines and Vietnam, which are both embroiled in territorial disputes with China. For the Philippines, an April 2012 flare-up with China over the contested Scarborough Shoal in the South China Sea triggered a Chinese quarantine of produce from the country. Chinese officials blocked hundreds of containers of bananas and slowed inspections of papaya, mango, coconuts, and pineapples.¹⁸ Mainland tourist agencies also warned Chinese tour groups to delay or cancel trips to the Philippines due to "safety concerns." In the case of Cambodia, Phnom Penh's chairmanship of ASEAN in 2012 left the grouping unable to agree on a joint communiqué for the first time in ten years due to the strong pressure that Beijing put on Cambodia to omit any mention of the South China Sea from the final statement.

Concerns also stem from public perceptions in many Southeast Asian countries that economic ties are unbalanced and weighted in China's favor. In Myanmar, the desire to balance overwhelming dependence on China is frequently cited as a strong impetus for the political and economic opening in 2011 and Myanmar's efforts to establish positive economic relationships with the EU,

¹⁶ Asian Development Outlook 2015.

¹⁷ "Norway, China Agree on Salmon Trade Deal," Undercurrent News, April 17, 2015, <http://www.undercurrentnews.com/2015/04/17/norway-china-agree-on-salmon-trade-deal>.

¹⁸ Bonnie Glaser, "China's Coercive Economic Diplomacy," *Diplomat*, July 25, 2012, <http://thediplomat.com/2012/07/chinas-coercive-economic-diplomacy/>.

Japan, and the United States. Since 2011, several high-profile Chinese infrastructure projects within Myanmar have been put on hold due to protests over the environmental impacts and concerns that the deals were negotiated to China's rather than Myanmar's benefit.

In Vietnam, popular anger over China's large economic role, coupled with a strongly nationalistic response to maritime disputes with China, has cast a large shadow over the economic relationship. China is Vietnam's largest trading partner, and Hanoi has faced a growing trade deficit, which now equals nearly \$24 billion.¹⁹ Vietnam is closely integrated into regional supply chains, and many of its factories depend on inputs from China. Additionally, China supplies Vietnam with more than 50% of its textile material, a key export for the growing Vietnamese economy.²⁰ Vietnam's leadership is acutely aware of deep public mistrust and antipathy toward China and that safeguarding Vietnam's interests in the South China Sea is critical to the government's legitimacy. The leadership thus must walk a narrow tightrope between public opinion about China and hotly contested territorial disputes and the close intermingling of Vietnam's economic fortunes with China's.

A View from China

For China, Southeast Asia is an increasingly important market, a source of critical commodities, and a neighboring region central to its long-term strategic and economic great-power ambitions. China has generally made diplomatic and economic overtures to ASEAN from a platform of shared mutual interests. Its active participation in RCEP and proposal to upgrade ACFTA are examples of this approach. Recognizing the strategic mistrust between China and many Southeast Asian countries, Beijing has also tried to integrate its political and economic approaches, though with limited success.

At a special foreign ministers' meeting in 2013 to mark the occasion of the tenth anniversary of the ASEAN-China strategic partnership, China shared a new vision for the development of its relations with ASEAN. This vision was supported by the "2+7 Cooperation Framework" proposed by President Xi Jinping at the October 2013 APEC Economic Leaders' Meeting in Bali and by Premier Li Keqiang at the 16th ASEAN-China Summit in Brunei a few days later.²¹ The new 2+7 framework for Southeast Asia-China relations consists of a two-point political consensus and seven proposals for cooperation. Li outlined four pillars for this vision, including upgraded trade relationships through RCEP, an upgraded ACFTA, and ultimately the FTAAP. He also pledged that China would continue to adhere to the Treaty of Amity and Cooperation (TAC) and proposed a new treaty of good-neighborliness, continued negotiations on a code of conduct in the South China Sea, and develop a joint security structure in the Asia-Pacific.²² Thus far, most of the advancements of this vision have come in the economic sphere, which continues to provide the foundation for China's relations with ASEAN.

¹⁹ "Vietnam and China: Through a Border Darkly," *Economist*, August 16, 2014, <http://www.economist.com/news/asia/21612234-relations-between-two-communist-neighbours-are-their-lowest-point-decades-through-border>.

²⁰ fiber2fashion, "Vietnam Sources 50% of raw textile material from China", October 30th, 2013

²¹ Bilahari Kausikan, "ASEAN-China Relations: Building a Common Destiny?" *American Interest*, September 23, 2014, <http://www.the-american-interest.com/2014/09/23/asean-china-relations-building-a-common-destiny/>.

²² Zhai Kun, "Chinese Diplomacy Towards Southeast Asia in 2014", *China US Focus*, January 16, 2014

Southeast Asia is also central to China's broader great-power ambitions. In 2013, Xi announced plans for a new Silk Road and 21st century maritime Silk Road, which would construct massive new networks connecting East Asia with Europe, which would position China as the world's economic center of gravity. In rolling out these initiatives, Chinese leaders pledged significant amounts of financing for infrastructure development and the founding of the Asian Investment and Infrastructure Bank (AIIB), which appealed directly to Southeast Asian countries need for infrastructure financing and ASEAN's Master Plan for Connectivity. Greater connectivity is essential for ASEAN to reach its economic integration goals and maintain its role as the hub of Asia, while high logistics costs continue to be an impediment to overall FDI. The ADB estimates the infrastructure needs of developing Asia and the Pacific at \$8 trillion for ten years, or \$800 billion per year.

In announcing the maritime Silk Road initiative in Jakarta, Xi not only indicated Indonesia's important anchoring role in the initiative, but also enmeshed it with new president Joko Widodo's ambition to restore Indonesia as a maritime power.²³ Yet the current levels of mistrust over China's long-term strategic ambitions could limit the realization of Xi's vision for "one belt, two roads" if Southeast Asian countries fear that these new connections and higher levels of infrastructure investment from China could be used to their strategic disadvantage.²⁴

Monetary Policy

China's direct influence over monetary policy in Southeast Asia has lagged behind its overall economic weight in the region. Within the International Monetary Fund (IMF), China has less voting power than the United States and Japan in the absence of reforms to the quota system that are needed to allow China a role commensurate with its global economic stature. This limited role for China and other developing Asian states in the IMF has been a catalyst for the development of regional institutions to serve as a counterweight to U.S. led global institutions.²⁵ While ASEAN has led the development of these mechanisms, China has played a critical supporting role and much needed financing. The Chiang Mai Initiative (CMI), established in the wake of the 1997 currency crisis that created widespread distrust of the IMF, was intended to provide for a regional currency swap system, but it has not been used to date, even during the 2008 currency crisis.

ASEAN +3 finance ministers agreed in 2009 to set up the CMI Multilateralization (CMIM). The CMIM is a \$240 billion reserve pooling arrangement that enables participating states to borrow at pre-negotiated rates, and 30% of the funds may be drawn without an IMF program in place. The new CMIM provides hard currency support for members facing possible liquidity crises by making available U.S. dollars that borrowers can exchange for local currencies before later reversing the transaction and paying interest²⁶. The volume of reserves that regional banks have pledged give the CMIM the potential to play a meaningful role in emergency finance in Asia. Yet the negative perceptions and stigma associated with the IMF and crisis financing linger, and it is an open question if this mechanism will be utilized.

²³ Zhao Hong, *Trends in Southeast Asia: China's New Maritime Silk Road: Implications and Opportunities for Southeast Asia* (Singapore: ISEAS Publishing, 2015), http://www.iseas.edu.sg/documents/publication/TRS3_15.pdf.

²⁴ Hong, *Trends in Southeast Asia*.

²⁵ John D. Ciorciari, "China's Influence on Monetary Policy in Developing Asia" Paper for the 2013 ISA Annual Meeting, Panel on "China's Influence in Developing Asia" San Francisco, CA, April 5, 2013

²⁶ Ibid

China has moved forward with steps to internationalize the renminbi (RMB) by developing currency swaps with friendly countries such as South Korea, Singapore, Malaysia, and Thailand. The RMB is still not convertible and has not emerged as a significant reserve currency, though Beijing is working slowly toward that status. Fluctuations in the RMB do affect the monetary policy of Southeast Asian countries, particularly those competing most closely with China for export markets around the world. When the RMB depreciates, key competitors are motivated to cut rates, and when it appreciates, they can more comfortably allow their own currencies to increase in value without fearing a loss in market share. Highly export-dependent countries like Singapore, Malaysia, Vietnam, and Thailand track very closely with the RMB, and the relative weight of the RMB in the currency baskets of Malaysia, Singapore, Thailand, and the Philippines has risen while the U.S. dollar's weight has decreased.²⁷

China is also lobbying for inclusion in the IMF's special drawing rights (SDR) basket as part of a strategy to further internationalize its currency. The SDR, an international reserve asset, currently comprises dollars, yen, pounds, and euros. The basket is up for review in May, and Chinese premier Li Keqiang was reported by state news agency Xinhua as saying in April that he had asked the IMF to include the RMB in the SDR.²⁸ This, along with AIIB and bilateral currency swaps, is an important step in China's efforts to internationalize the RMB.

Policy Considerations for the United States

The United States continues to play an essential role as an important economic partner for ASEAN and a leader in setting norms and rules for global commerce. The United States should continue to support ASEAN's efforts to form a cohesive economic area and to diversify trade and economic relationships. First, there is an important role for U.S. industry and government to play in providing input and encouragement for a high level of ambition in ASEAN's post-2015 goals and in strengthening the grouping's cohesion in addressing tough issues with China, such as the South China Sea disputes. Second, the United States should complete the TPP as soon as possible and work on a roadmap for including more ASEAN members in the next round of negotiations. The TPP is viewed by many in the region as an important indication of the U.S. commitment to Asia. Without a path toward full ASEAN participation in the TPP, the grouping will naturally look to RCEP as the model for regional economic integration. Third, the United States should encourage individual Southeast Asian countries to continue to put in place measures to increase domestic demand and productivity in order to safeguard against a potentially protracted slowdown in China.

²⁷ Arvind Subramanian and Martin Kessler, "*The Renminbi Bloc is Here: Asia Down, Rest of the World to Go?*", Working Paper Series, Peterson Institute, Revised August 2013

²⁸ "China Clings to Strong Yuan despite Export Slowdown," *Malay Mail*, April 14, 2015, <http://www.themalaymailonline.com/money/article/china-clings-to-strong-yuan-despite-export-slowdown#sthash.xsMaTHtO.dpuf>.