

# WHAT DOES THE ECONOMIC ASCENDANCY OF CHINA IMPLY FOR ASEAN?

by

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## 1. Introduction

With China's phenomenal industrial growth over the last two decades, it has emerged as a major economic power in Asia. By 2002, China was the biggest economy in Asia after Japan in constant dollars and largest in purchasing power parity (PPP) terms (second largest in the world behind the US), the sixth biggest merchandise trading nation in the world, the world's twelfth largest exporter of commercial services, and the largest recipient of foreign direct investment (FDI) among developing countries. China's accession to the World Trade Organisation (WTO) in December 2001 is widely expected to give further impetus to the country's export, FDI and overall growth prospects.

While some troubling questions about the accuracy and reliability of official Chinese statistics on growth and investment persist, there can be no doubt that the economic ascendancy of China is a very real phenomenon. While terms used to describe China's industrial strength such as "global factory", "the world's manufacturing center" or "export processing zone of the world" are surely colourful exaggerations, they do underscore how far the country has come in the last two decades.

Nowhere has the rapid economic ascendancy of China been more closely watched than in Southeast Asia. ASEAN policymakers are anxious to know the answer to the six million dollar question -- *"Is the emergence of China as an economic power a boon or bane to ASEAN?"*

## 2. China's Impact on ASEAN's Exports

Bilateral trade between ASEAN and China totalled US \$39.5 billion in 2002, growing at an annual average of slightly over 20 percent since 1991 when overall trade amounted to only US\$ 7.9 billion. While both ASEAN's exports to and imports from China have increased in tandem, the latter has consistently exceeded the former ensuring that China has enjoyed a persistent trade surplus with ASEAN.

There are signs that this deficit has been on the rise in the last few years as the rate of growth of ASEAN's imports from China have outpaced that of its exports. In 2000, China was ASEAN's sixth largest export market accounting for 3.1 percent of ASEAN's total global exports. While this share is still rather small, assuming current growth trajectories persist, China may eventually act as an independent engine of growth for Southeast Asia in the long run on its own, or at least could provide a much needed cushion to smaller ASEAN countries against gyrations in the industrial country economic environment.

Apart from a growing domestic consumer market for Southeast exporters and businesses, China offers strong potential as a source of tourists. China is the world's fastest growing tourist market in both inbound and outbound travel. Two-way flows between ASEAN and China have been on an increase. While ASEAN tourists visiting China totaled almost 1.1 million in 1995, the number reached an estimated 1.8 million in 2000. While ASEAN received about 0.8 million tourists from China in 1995, this number almost tripled to 2.3 million persons in 2000. The growth in tourists from China was particularly significant in Malaysia and Singapore, where Chinese visitors increased from 10<sup>th</sup> largest visitor group in 1995 to 4<sup>th</sup> and 5<sup>th</sup> positions, respectively in 2001.

More generally, with China's WTO accession there will be greater scope and demand for services by China, particularly with regard to distribution, professional and infrastructural services (telecommunications and financial). As China continues to rapidly urbanize and industrialize, there will invariably be vast opportunities for ASEAN businesses to be involved in major infrastructural development projects. Thus, richer and more developed ASEAN countries like Singapore and Malaysia, which have growing strengths in these areas, should benefit significantly from China's continued economic transformation.

While there is little doubt that in the long run ASEAN will benefit from a prosperous and economically strong and stable large neighbour, the issues tend to be more complex in the short and medium terms. Inevitably, like all other neighbours, China can be expected to be both a formidable economic competitor as well as a reliable partner. China will certainly continue to alter the division of labour in East Asia. This in turn will involve some degree of economic dislocation as other countries adjust to these changing dynamics. This said, there is little basis for the high degree of export pessimism that has been voiced by a number of regional observers and some policy makers. Such pessimism – “fallacy of composition” - has often been expressed in the past by some Development Economists (e.g. Arthur Lewis) but has always proven to be largely unfounded. *International trade is not a zero sum game*

*and neither is it one that is static.* By definition, one country -- no matter how big -- cannot have a comparative advantage in the production of all goods and services.

In fact, with the extent of production sharing that is increasingly taking place in many goods, especially electronics, there are ample for opportunities for all countries/regions to specialize in niche areas. To be sure, with the major improvements in transportation, coordination and communication technologies, globalization provides vastly increased opportunities for the fragmentation of previously integrated goods and activities into their constituent PCAs which in turn may be spread across countries on the basis of comparative advantage. The importance of such “production sharing” is that it suggests that openness, by expanding opportunities for international specialization and trade, will be beneficial to all parties involved. Thus, free trade ought to be an unambiguously positive-sum game (i.e. all round wealth-creating outcome). This is of particular relevance to East Asia where machinery and electrical equipments constitute a high and growing proportion of intraregional trade. Seen through the lens of production sharing, the cost effectiveness of the PRC ought to benefit all countries that are part of the production network (this leads on to issue of ASEAN-PRC FTA later on). In particular, countries that are at the more advanced production stage than the PRC, i.e. those that import intermediate inputs from the PRC will specifically benefit given the availability of lower cost intermediate products from the PRC. This should help maintain profit margins of businesses that are being faced with an increasingly harsh economic environment.

There are well-founded concerns that small variations in costs could lead to large shifts in comparative advantage thus necessitating large and sudden domestic adjustments. Jagdish Bhagwati of Columbia University refers to this phenomenon as “kaleidoscope” or “knife-edge” comparative advantage. Countries need to be ever aware of these potential costs shifts and ensure constant industrial upgrading so as to remain important cogs in the larger regional production network. In other words, the continued opening of China may well contribute to a far more uncertain and competitive environment for ASEAN countries (especially as PRC’s western regional develop and labour intensive industries migrate to the inland regions). In relation to this, opportunities for lower income ASEAN countries to upgrade to higher value added stages of production may be harder to come by compared to the transition made by their higher income neighbours in earlier periods. Offsetting these concerns are the significant potential upside gains noted previously.

In addition to production sharing which involves *vertical* specialization, openness to international trade allows countries to also specialize *horizontally* based

on price/quality. Thus, even if a country's comparative advantage happens to coincide exactly with the PRC (which may be likely given the vastness and differing levels of development of various regions in the PRC), it can still develop its own export market niche by specializing in differentiated products. However, a concern often voiced about the PRC's ascendancy and price competitiveness is that "cheap Chinese imports" will keep the price pressures on imperfect substitutes down, i.e. other countries will import price deflation from the PRC with consequent depressing effects on profit margins and factor returns, including wages. It is in this sense that ASEAN countries may have complementarities with the PRC in production and export structures (i.e. vertical specialization) while other parts are simultaneously competitive (horizontal specialization). These global competitive pressures emanating from PRC and the potential deflationary effects are of particular concern in the areas of textiles and clothing where the PRC's WTO accession is expected to be a significant boon to Chinese exporters who are no longer limited by the quantitative restrictions under the Multifiber Arrangement (MFA). Quantitative analyses suggest that the eventual removal of these quotas (in 2005) will lead to a significant increase in the PRC's exports in these areas at the expense of many ASEAN countries as well as other Asian countries more generally. While the possibility of horizontal specialization suggests that the above costs are over-estimates, there are bound to be non-negligible price pressures and adjustment cost effects on other textile and clothing exporting countries.

### **3. China's Impact on ASEAN's Investment Prospects**

There have been growing fears that ASEAN is "losing out" in the intense competition for FDI inflows to China. To the extent that China's industrialization strategy, like that of ASEAN, is fuelled largely by inflows of FDI, there will invariably be a degree of competition involved in terms of attracting FDI. But has the rise and opening up of China actually altered the flow of FDI to Asia? The commonly noted statistic is that in the early 1990s, three-fifths of FDI to Asia were channeled into the ASEAN countries and less than one-fifth to China. By 1999-2000, over two-fifths went to China (more than two-thirds went to PRC plus Hong Kong) while only about one-fifth found its way to ASEAN. The share of ASEAN to global FDI, which averaged about 6.7% during 1993-96, registered a substantial decline since 1997, hovering at around 1.6% during 1999. As a proportion of all developing countries, ASEAN's share fell from 13.6 per cent in 1997 to 6.8 percent in 1999.

However, even at a superficial level one must doubt the importance of direct competition from China as it too suffered a marginal decline in net FDI inflows in

recent years, albeit less than ASEAN (The FDI decline to China reversed itself in 2001). Indeed, the relatively sharp decline in ASEAN's FDI flows and its share of total FDI to East Asia was primarily due to Indonesia which was the only ASEAN country to experience an outright erosion in the cumulative stock of FDI in the country since 1997, as there has a sharp outflow of FDI between 1998 and 2000. Indonesia in turn has been hurt by domestic socio-political convulsions and investors uncertainty as opposed to competition from China per se.

More detailed analysis of the sources of FDI into ASEAN and the PRC is also suggestive of limited direct "competition" between the two. For instance, the bulk of FDI to the former has been from Japan and the US in particular. Japan has hitherto been a rather reluctant investor to the PRC. The recent declines in FDI flows to ASEAN have in large part been due to lower investment levels from Japan. The extent of decline in Japanese FDI can be seen from the fact that while it has consistently been the single largest investor in ASEAN since the late 1980s, it did not even figure in the top ten investors in 2000. In contrast, the bulk of investments to the PRC have been from overseas Chinese in Hong Kong and Taiwan.

Insofar as the accession of the PRC to the rules-based WTO system as well as removal of uncertainty regarding the PRC's MFN treatment and granting of permanent normal trade relations (PNTR) makes it an even more attractive host for FDI, there may well be (further) diversion of FDI from "unstable ASEAN". Insofar as domestic growth rates have often showed up as a significant factor in attracting FDI, continued outpacing of growth in the PRC relative to ASEAN may well personify diversion of FDI from the PRC to ASEAN. This is particularly so as the PRC remains an under-performer in attracting FDI inflows when one considers looks at FDI as a proportion of GDP.

As trade barriers in PRC continue to decline and infrastructural and communications facilities improve further, FDI may move from some ASEAN countries to the PRC, and the ASEAN markets will be served from PRC in the presence of competitive pressures and squeezing of profit margins. Probably of most concern to the lower and middle-income ASEAN countries (such as Indonesia, Thailand, Philippines and Indonesia) is the fact that Japanese investors, which hitherto have been reluctant investors in the PRC, have begun to make plans to invest in the PRC. Whether Japanese investments into the PRC involve relocation from Japan or from other ASEAN countries remains to be seen. A recent survey of Japanese companies by the Japanese External Trade Organisation (JETRO) in October 2001 suggests that much of that of those planning to relocate operation to the PRC, the distribution will be from Japan (67.5 percent) and only about 7.8

percent from ASEAN. Indeed, insofar as part of the reasons for the recent downturn in investments in ASEAN was because of lower outflows of investment from Japan, there is every possibility that these investment trends may not see any significant recovery in the short and medium terms.

Even here though the competition dimension can and has been rather overblown. There are a number of reasons to remain positive about ASEAN's FDI potential. First, some multinational enterprises (MNE)s, concerned about what might be "excessive" exposure to China, are considering setting up factories in some other ASEAN countries like Vietnam as a form of "risk hedging". Second, China's opening and growth PRC businesses may lead to Chinese investments in ASEAN and third countries. Anecdotal evidence on this count abounds. For instance, CNOOC, which is China's state-owned offshore oil company, has acquired assets in a major Indonesian oil company. There is also significant interest in China in infrastructural projects in Indonesia and other less developed ASEAN countries. Third, the lowering of import barriers (both actual trade barriers as well as "behind the border" ones) in China may reduce the incentive to establish tariff-jumping FDI in China as the Chinese market may, in some instances, be well served via exports. This appears to be the case in some areas such as automobiles and petrochemicals which have hitherto been heavily protected in China.

#### **4. The ASEAN-China Free Trade Agreement (ACFTA)**

It is a fact that in an increasingly globalized world decisions about production, investment and trade are closely interlinked and often cannot be made independently of one another. From ASEAN's perspective, this implies the need for more aggressive and urgent steps to deepen regional economic integration and reduce the extent of fragmentation that currently exists among ASEAN markets.

The ACFTA is a significant development in Asian regionalism, not only because it is the first such agreement that China has entered into after becoming a WTO member, but also because it is going to be one of the largest FTAs ever negotiated, involving about 1.7 billion people, over US\$ 2 trillion in aggregate GDP and US\$1.2 in total trade spanning eleven diverse and heterogeneous economies, both in terms of their size and levels of development. While the ACFTA ought to speed up the growing mutual interdependence between ASEAN and China, the impact of the ACFTA on individual ASEAN member economies is likely to be felt differentially, depending upon the extent to which its economic structure and composition of trade complements or competes with that of China. Differential potential effects of the ACFTA may well act as a roadblock preventing its full

implementation. Nonetheless, an immediate positive side effect of the ACFTA proposal is that it appears to have provided an impetus for ASEAN countries to hasten the process of intra-ASEAN integration. It has had further domino effects, with the other major economic powers in Asia, viz. Japan, India and Korea also seeking out trade pacts with ASEAN. In addition, the US President, George W. Bush, launched the Enterprise for ASEAN Initiative (EAI) during the APEC Summit in October 2002 to strengthen bilateral trade linkages with ASEAN. All of this in turn has offered ASEAN the potential to act as a hub with the consequent benefits of being one. ASEAN needs to encourage and act on such courtships in parallel with the implementation of the ACFTA for their own sake, and also to act as buffers against China's dominance in the Southeast Asian region. At the same time, it is imperative that ASEAN maintain its cohesion and reinvigorate efforts to foster more intensive intra-ASEAN economic integration. Failure to do so could lead to a loss of hub status as the larger economic powers may come to view ASEAN as a body that is disjointed and uncoordinated.

## **5. Conclusion**

China's WTO accession has not been a sudden, one-off event. Rather, it is part of an ongoing process that was initiated over two decades back. ASEAN has hitherto been able to adjust to China's initial opening up between 1990 and 1997 fairly successfully. However, the crisis of confidence following the regional crisis of 1997-98 and loss of forward momentum with regard to regional integration in ASEAN, and feeling of vulnerability to an increasingly volatile global economy, are some of the reasons for heightened concerns about the economic ascendancy of China.

In the final analysis, the greatest challenge faced by ASEAN is not the economic ascendancy of China, India or anything external. As the famous cartoonist Walt Kelly once said -- "*We have met the enemy and it is within us!*" *Adjustment and flexibility are crucial.* Countries that remain alert to the changing dynamics of comparative advantage and are able to position themselves to respond effectively to them will benefit. On the other hand, countries that are bogged down with domestic sociopolitical problems and poor leadership could find the varying landscape in Asia especially painful to adjust to in the short and medium terms.