

China: Trade Agreements and Relationships with Southeast Asian Nations

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Over the past ten years China has increased its efforts to develop a closer relationship with Southeast Asian countries and to take on the dominant leadership role in the region. Trade between China and the ASEAN member countries has grown dramatically during this period. The treaty negotiated and signed between China and ASEAN for a free trade area (ACFTA) has contributed to the growth in trade. The contributions and roles played by the participants to the trade treaty will be examined.

INTRODUCTION

The aim of this paper is to examine the nature and dynamics of the relationship between China and the Association of Southeast Asian Nations (ASEAN). Over the past ten years China has increased its efforts to develop a closer relationship with the countries of Southeast Asia. Due to these efforts, trade with ASEAN has risen rapidly. An important development is the treaty between China and ASEAN for a free trade area (FTA). The process that led to the treaty and the dynamics of negotiations and implementation will be studied more closely.

China's strides in opening its economy and the following tremendous economic growth have established a model for the smaller countries in the Pacific. China's economic growth can be seen as a driving force for the China-ASEAN integration. China's interests lie in securing supplies of raw materials, opening of additional markets for its exports, but also to stabilize the region and take on the dominant leadership role in Southeast Asia.

For the members of ASEAN, the benefits of ACFTA will be a closer integration and common rules, both stimulating growth. The role played by ASEAN in the negotiations for the treaty will be explored. It is mostly the larger and more developed countries of ASEAN taking the lead in the developments.

METHODOLOGY

A significant portion of this research is based on structured interviews with more than 250 key influencers in Shanghai, Beijing, Hong Kong, Singapore, and Washington, D.C. over a period of 22 years beginning in 1988. Relevant interviews in the summer of 2010 were conducted with experts from the Royal Institute of International Affairs and the School of Oriental and African Studies both in London, The Council on Foreign Relations in New York, and Imprimatur, a private investment firm in London. A significant effort has also been made to examine traditional data and documents from a variety of sources

when and where they were available. The most recent research in China was conducted on-site in Hong Kong, Shanghai, and Beijing for one month in the spring of 2011. Regarding Southeast Asia one author conducted structured interviews and document research in Singapore, Indonesia, Vietnam, and Hong Kong in the winter and spring of 2011. Research on China was also carried out at the Wilson Center and the Johns Hopkins School of Advanced Study of International Relations in Washington, D.C.

It is important to note that many of the professionals and experts on China and Vietnam wish to have their comments kept confidential. Therefore, we choose to respect their request of confidentiality in all cases. We have clearly referenced and documented data where they are public.

The methodology for this study where it involves interviews can be described as an emphasis on key stakeholders and influencers. In general, the interviews were conducted with senior analysts, corporate officers, and professionals. In addition to experts from the above listed institutions, other institution included analysts from such organizations as the Economist Group in Hong Kong, Shanghai, and London, the old Bear Stearns Investment firm, Goldman Sachs, Chase Investment Bank, U.S. Chamber of Commerce, and Boston Consulting Group in at least two locations, Microsoft, and a host of other public and private professionals.

The interview format did not include a formal survey. A partial list of interview sites, together with a list of sample interview questions, can be found in the Appendix.

SHAPING EVENTS

Since the mid 1990's, China has been actively seeking to develop its relationship with Southeast Asia through cooperative approaches such as developing trade agreements with the countries in the region, especially the members of the Association of Southeast Asian Nations (ASEAN). In the period of 1993 to 2001, China's trade with ASEAN had increased rapidly, as much as 75 percent per year. The events of the financial crisis of 1997-98 prompted China to strive for a stable environment in the region to allow for continued economic growth. China's assistance to the region during the financial crisis helped to improve regional perceptions of China's motives (Vaughn & Morrison, 2006; Zhang, 2006).

In 2002, China adopted the ASEAN code of conduct on disputes in the South China Sea. This event turned China's emphasis to ASEAN, rather than to the Asia Pacific Cooperation (APEC) framework which includes the United States. Now China shifted attention to building a ASEAN-China Free Trade Area which marked a fundamental shift in relations between China and ASEAN (Vaughn & Morrison, 2006).

In November 2002, ASEAN and China signed the Framework Agreement on Comprehensive Economic Cooperation to create an ASEAN-China Free Trade Area (ACFTA) within a period of 10 years. Implementation would be staggered over that period. Two years later, in November 2004, the two sides signed the Agreement on Trade in Goods of the Framework Agreement on Comprehensive Economic Cooperation between ASEAN and the People's Republic of China. This agreement included a schedule of tariff reductions and the eventual elimination of tariffs on goods beginning in 2005, reaching zero by 2010. Certain "sensitive" products would have a longer phase-out period (Vaughn & Morrison, 2006).

The Framework Agreement came into force on July 1, 2003. It is an umbrella agreement which provides the general provisions for the establishment of an ASEAN-China Free Trade Area (ACFTA). It contains such provisions as, for instance:

- Progressive elimination of tariff and non-tariff barriers
- Progressive liberalization of trade in services and investment
- Strengthen trade and facilitation measures and
- Economic cooperation in areas of common interest (URL)

Of great importance among the provisions in the Framework is the intent to establish a legal mechanism for trade, investment and services following WTO rules and international standards. Both,

rule of standards and rule of law, will help improve the systems of regional members and assist in economic integration (Zhang, 2006).

The Framework Agreement was followed by the Trade in Goods Agreement which came into force in July 2005, followed by the Trade in Services Agreement in July 2007. In 2010, the full implementation of zero tariffs for most goods in the FTA became applicable for China and the ASEAN 6 (Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand). For the remaining four, Cambodia, Laos, Myanmar, and Vietnam (CLMV), zero tariffs will not come into force until 2015 (Thangavelu, 2010; Zhang, 2006).

The special treatment and development assistance to CLMV countries will further provide opportunities for emerging economies in ASEAN to take advantage of the special provisions in ACFTA. The ACFTA is seen as a catalyst as well as a platform for the creation of a larger free trade area consisting of ASEAN plus 3 countries (China, Japan, Korea) and ASEAN plus 6 (China, India, Japan, Korea, Australia, and New Zealand) (Thangavelu, 2010).

The establishment of a FTA between China and ASEAN created one of the world's largest trade areas. As of January 2010, it encompassed 1.9 billion people, had a combined GDP of U.S. \$6.6 trillion and the total trade amounted to U.S. \$4.3 trillion (Thangavelu, 2010). The lowering of trade and investment barriers will result in an enlarged integrated market, promote specialization and trade according to comparative advantage, and enable exploitation of scale economies, contributing to lower costs and increased economic efficiency (U-ACT), and the harmonizing of technical regulation and standards.

CHINA AS THE DRIVING FORCE OF CHANGE

Economic Profile

Since its market reform began in 1978, China has been experiencing a dramatic transition. China started to move from a centralized planned command economy towards a modified market economy. In politics, the country moved from arbitrary political decision making to the rule of law. Socially, a closed society slowly became a more open society. As China began liberalizing its economy, its national wealth has increased at least ten-fold. Today, due to the efforts of privatizing, the private sector controls over half of China's labor force (Interviews). There may be 200 million people in China's middle class, defined as people with annual incomes of \$4000-\$5000 and a good deal of discretionary income. Annual per capita income is approximately \$3000, up from \$300 in 1988, when the author's first interviews took place.

The current financial crisis has impacted China in significant ways. It has forced dramatic policy innovation. The export driven manufacturing sector collapsed with the onset of the financial crisis causing upward of twenty million job losses in Guangdong province alone. Serious labor unrest has been reported on several fronts (Interviews).

The argument is made that the Chinese leadership has managed its economic crisis brilliantly and innovatively. China actually began to experience an export manufacturing slowdown before the full force of the crisis hit in September 2008 (Interviews). Moreover, China had already established the long term policy goal of trying to shift the economy from dependence on exports and foreign direct investment to domestic demand. This has involved changing the Chinese core value of high savings (over 39 percent of income) to more consumption. The Chinese leadership initiated a \$505 billion stimulus package in November of 2008 and aimed directly at infrastructure development. The idea was to shift workers out of export manufacturing directly into infrastructure building.

Effects on ASEAN

ASEAN nations are attracted by the opportunities brought about by China's economic expansion and trade liberalization. China has become the chief trading partner for most countries in the region. As China becomes richer, it will become a market for the rest of Asia, just as the region will become a bigger market for China (*The Economist*, 2010). Four ASEAN members are already among China's major trading partners: Singapore, Malaysia, Indonesia, and Philippines. Singapore has always been a supporter of trade liberalization, and most of the tariffs were already near zero. Thanks to its raw material exports,

Malaysia has a trade surplus with China. It is different for Indonesia and Philippines. Both countries specialize in producing low-cost manufactured goods. With the removal of the tariff, industries such as textiles and electronics in both countries would be hit hard by low-cost Chinese manufactured goods (Knowledge@Wharton, 2011; Tong, 2010).

The major goods China imports from ASEAN are intermediary goods, such as machinery, materials and fuels, plastic, fats and oils, rubber and organic chemicals. China and many ASEAN members directly compete in exports to advanced countries, such as the U.S. and the European Union (EU). Trade with China and ASEAN countries, except for Singapore, tends to be competitive, rather than complementary. This may prevent significant growth in trade between China and ASEAN. In the short run, some ASEAN countries may face severe competition from cheaper Chinese goods, especially in electronics, foot ware, apparels and textiles (Tong, 2010).

Other Factors

Due to China's historic dominance in Southeast Asia and the economic dominance of existing Chinese communities in much of the region, there is a heightened sensitivity in many countries to the possibility of "economic colonization" by China (Spears, 2009). Although China has achieved strong ties with certain members of ASEAN, many nations in the region, such as Malaysia, Philippines, and Vietnam still maintain a healthy fear of Chinese hegemony (Spears, 2009).

Individual ASEAN members clearly see FTA with China as a logical step toward partaking in China's growing domestic market. The ASEAN nations may also hope that the FTA can become an instrument for a "balance of power" to deal with China and as result further their own integration (Wang, 2007). The Chinese market offers enormous potential for the mostly small and export-oriented members of ASEAN. The FTA offers the small countries the opportunity to pool resources and combine markets, and possibly forge a comprehensive economic partnership with China.

The FTA may also affect a redistribution of the regional trade flows, as multinational companies may eventually see China and ASEAN as a single market and adjust production and supply chains in the region (Tong, 2010). An increasingly integrated market may also attract more foreign direct investment from developed countries, creating employment and greater economic welfare of member states.

However, the fear of China trying to dominate the region is always present. Asian countries would like to have it both ways: to resist China's power, but to continue trading with it; to maintain American security alliance but without sacrificing Chinese commerce (*The Economist*, 2010). Just as ASEAN nations are attracted to the opportunities offered by trade with China, they also seek to leverage their FTA with China by forging FTAs with important trading partners such as Japan, the EU, and the U.S. (Wang, 2009).

CHINESE INTERESTS

Commentators have offered various explanations for the initiative taken by China to sign a FTA with ASEAN countries. Most of these discussions make the standard economic arguments, e.g., a FTA is perceived as a balance to regionalism in other areas (Europe, North America), or that FTA helps to enhance the growing economic ties between China and ASEAN (Wang, 2007).

The official Chinese line is that the FTA would increase Chinese exports, ensure access to markets and raw materials, and attract foreign investment. China sees Southeast Asia as an important market with tremendous potential to absorb more Chinese goods. ASEAN countries also supply China with raw materials. Indonesia and Malaysia are sources for oil, and Malaysia is also a supplier of rubber and tin, while the Philippines are a source for oil and metals. Beyond that, China is hoping to attract investment from ASEAN nations in the Western region of China (Bello, 2011).

Generally, the assessment of China's motives regarding the FTA takes all the economic reasons into account. Nevertheless, the suspicion remains that the main motivation for China's trade activism is strategic. China's so called "peaceful rise" is seen as a comprehensive long-term strategy leveraging

globalization as a catalyst to accelerate China's growing economic development, but also to elevate China's power and stature (Wang, 2009).

In the case of Southeast Asia, China's FTA with ASEAN is more likely driven by a political logic. The closer economic ties with Southeast Asian countries may alleviate their fears of a rising China, but also help to secure raw materials crucial to China's economic development. At the same time, it will ensure a peaceful and stable environment close to home while increasing China's growing influence in the region and help counterbalance American and Japanese power (Wang, 2009). This trade offensive better achieves China's goals of improving relations with ASEAN countries and expanding influence in Southeast Asia than any previous approach that China had adopted in the past (Wang, 2007).

ECONOMIC SIGNIFICANCE FOR ASEAN RELATIONS TO CHINA

Chinese – ASEAN Trade

The larger countries by size and GDP are the major players in the leadership dynamics of the ASEAN-China economic relationship. It is clear that China has become a major trading partner. According to Chinese data, from 1997-2006, its exports to, and imports from, ASEAN countries grew by 450 percent and 625 percent respectively (Congressional Research Service). There is an important figure to note. In 2010 monthly growth in foreign trade between ASEAN and China was growing over 60 percent (Forest, 2010). ASEAN assets were becoming more valuable to China faster than those from other parts of the world. It is above all that commodities and natural resources were influencing the development of trade (Interviews). [see table 1]

TABLE 1
CHINESE AND U.S. TRADE WITH ASEAN

	1997	2005	2006	2005-2006 % Change	1997-2006 % Change
China's Exports to ASEAN (\$ millions)	12,698	55,459	71,325	28.6	450.0
U.S. Exports to ASEAN (\$ millions)	48,271	49,637	57,307	15.5	18.7
China's Exports to ASEAN as a Percent of Total Exports (%)	7.0	7.3	7.4	-	-
U.S. Exports to ASEAN as a Percent of Total Exports (%)	7.0	5.5	5.5	-	-
China's Imports from ASEAN (\$ millions)	12,357	75,017	89,538	19.4	624.6
U.S. Imports from ASEAN (\$ millions)	71,013	98,915	111,201	12.4	56.6
China's Imports from ASEAN as a Percent of Total (%)	9.0	11.4	11.3	-	-
U.S. Imports from ASEAN as a Percent of Total (%)	8.2	5.9	6.0	-	-

Another aspect in the relationship is China's foreign direct investment in the region. From 2002-2006 China's FDI totaled \$2.3 billion or 1.3 percent, making China the tenth overall source of ASEAN's FDI. Below, tables 1 and 2 give an overview of trade between ASEAN, China, and the U.S.

TABLE 2
ASEAN TRADE WITH THE UNITED STATES AND CHINA FOR 1995, 2000, AND 2006
AS A PERCENT OF TOTAL TRADE

ASEAN Imports (% of total)			
	1995	2000	2006
United States	14.6	14.0	10.3
China	2.2	5.2	11.4
ASEAN Exports (% of total)			
	1995	2000	2006
United States	18.5	18.0	13.9
China	2.1	3.5	8.9

Sources: ASEAN Secretariat, *2005 and 2006 ASEAN Yearbook* and International Monetary Fund, *Direction of Trade Statistics*, June 2007.

Notes: Data for 2006 do not include Laos and Myanmar (Burma); ASEAN trade data differ from that reported by its trading partners.

Leadership Dynamics by Country

Each country in ASEAN brings its own unique contribution to the relationship with China. In the following country profiles of the major players in ACFTA their relationship with China will be described and thus will add to the overall understanding of the emerging dynamics.

Among the ASEAN countries, Singapore and Thailand have been the most proactive in pursuing a regional FTA with China. The Philippines initially was a reluctant participant in the ASEAN 10 + China FTA, because its trade with Japan and the United States was much larger and more important. Eventually the country turned around and embraced the FTA to show willingness to have closer ties with China (Zhang, 2006). Myanmar, Cambodia, and Laos are the least developed countries of ASEAN and have, therefore, received special arrangements within the FTA. Due to their geographic proximity, Cambodia, Laos and Vietnam are more directly affected by China's development and China is paying special attention to these countries in its development activities of the Greater Mekong Sub-region (Zhang, 2006).

THE SINGAPORE ROLE

In order to understand trade and investment dynamics in the region, one must understand the Singapore story. Under the leadership of Lee Kuan Yew, the city-state of Singapore became a very successful international business entity and the first "Asian Tiger" in the post-World War II era.

The Singapore model was and is based on the rule of law (particularly in commercial terms, inward foreign direct investment, and free and open trade) (Interviews). Singapore has continued to move up the value chain increasingly emphasizing financial services, information technology, and bio-medical sciences (Interviews). Particularly relevant to China is that Singapore is a 76 percent Sinic society and therefore the cultural correlations with China are strong (Interviews).

Singapore's leadership has always believed that as a small country in Asia (5 million people) the best policy was to rely on and advance the rule of law and treaties (Interviews). The leadership has long sought trade liberalization, foreign direct investment, the rule of law, and more integration with China in the region. As a growing prosperous cutting edge international business entity with a growth rate over 7 percent, it is an effective leadership model (Interviews).

MALAYSIA

Malaysia represents an important country in the leadership dynamics of ACFTA. As already mentioned above, ASEAN countries are important suppliers of commodities as well as intermediate goods. Malaysia will be in the lead selling rubber, palm oil, and fruits and vegetables in China. China may also purchase certain electronics from Malaysia's high technology sector (Interviews). Malaysia, a country of 29 million people about the size of New Mexico, is positioned to benefit directly from China's dramatic growth and insatiable demand of food and resources.

Malaysia and palm oil is a key to understanding why Malaysia can play a leading role in the ASEAN-China economic development relationship. Malaysia supplies 60-65 percent of the world's palm oil. China has an insatiable appetite for palm oil and cannot supply it from any other source. Thus, on this reality alone, Malaysia will play a lead role in economic integration with China (Interviews).

VIETNAM: IMPORTANT AND COMPLICATED

Left isolated by the U.S. Embargo in 1979, followed by a decade of rigid communist central planning that left the country bankrupt and starving, Vietnam finally made a breakthrough with market reforms in 1986 (Doi Moi). In the mid 90's the leadership signed a bilateral trade agreement with the U.S. and later became an active member of the World Trade Organization (WTO). Since then, one American interviewee living and working in Ho Chi Minh City (Saigon) described it as a miracle decade with seven percent unprecedented growth (Interviews). Part of their motivation for growth comes from their realization of the market reform advances of China and the original Southeast Asian Tigers such as Singapore and Thailand. The Vietnamese saw themselves being left behind (Interviews).

Vietnam is not only an economy in transition but also a nation in transformation. Evidence of this economic and social group growth is visible everywhere. The country's 87 million people have new levels of wealth and freedom. There is increasingly a middle class buying everything from condos to motorbikes, from iPhones to entertainment systems (Interviews).

Vietnam's profile in terms of competitive advantage represents a mixed picture. One advantage is a huge enthusiastic workforce. 70 percent of its population is under 35. An impressive 93 percent of the population is literate, but only 32 percent are "skilled." Agriculture still accounts for one fifth of the economic output and employs over half the workforce (Interviews).

Foreign direct investment from China and other countries like the U.S. will not only support general economic development but will also aid skill development (Interviews). Foreign direct investment continues to develop the vast majority of new jobs. Vietnam's competitive advantage is still in low-cost labor. A lack of "skills" in Vietnam makes Thailand and China more attractive to investors looking for higher tech production (Interviews). Infrastructure is better than in most developing countries. But public services continue to be lacking as the government struggles to play catch up (Interviews).

Vietnam is a leader in the China-ASEAN economic relationship but it is a uniquely complicated relationship with China. Part of this clearly relates to history, China having dominated Vietnam for 900 years in a past era. At the same time China and Vietnam both manage single-party so-called communist regimes. Vietnam is wary of China but seeks more economic cooperation due to China's dramatic advance. In fact, Vietnam has adopted many aspects of China's political-economic model (Interviews). Competition arises from the fact that both countries compete for foreign direct investment as low-wage countries, but Chinese labor costs have been rising, a trend that will continue. On the other hand, China sees Vietnam's growth and therefore many opportunities for direct investment. Beyond that the emerging consumer middle class becomes a market for Chinese goods (Interviews).

THAILAND: THE BIGGEST MARKET

Thailand, a country of 63 million, is a clear leader in China-ASEAN economic relationship. It has become the largest single market for Chinese goods. The country purchased about \$40 billion worth of

goods in 2010. The Thai government forecast the value of exports to China will more than double in the next two years (*Christian Science Monitor*, 2011). One analyst observes that Thailand is well-positioned to take China's place at the lower end of the production network (*Time World*, 2011).

Thailand sees China's business opportunities and is making necessary adjustments to benefit from mutual trade. One example of policy changes is in Thailand's handicraft industry, where government encourages product differentiation. Government also put policies in place to simplify procedures and processes for setting up and doing business. The country has also closely cooperated with China for the development of transport and economic corridors, to achieve improvements in competitiveness and a more integrated regional market.

INDONESIA

As a huge country of over 238 million people comprising over 17,000 islands south of the Malay Peninsula, Indonesia plays a major role in the China-ASEAN relationship. Indonesia is the largest economy in ASEAN, making it a natural leader. The economy is growing. The banks are sound. The political system is stable (Interviews). But this role is more problematic for Indonesia than the somewhat clear cut case for Malaysian relationship with China. Indonesia is a source of great natural resources for the huge and growing Chinese demand. In 2005 PRC President Hu Jin Tao and Indonesian President Yudhoyona signed a declaration proclaiming "strategic partnership" that was accompanied by a promise of preferential loans worth \$300 million (CRS Report for Congress).

Both countries are clearly interested in maximizing financial and business benefits. As China may use foreign direct investment to shape and further enhance its sphere of influence, Indonesia needs to develop its huge offshore crude oil resources, coal fields, natural gas, and other commodities (Interviews). Nevertheless, Indonesian leadership has questioned some of the aspects of the rapid pace of trade liberalization with China and tried unsuccessfully in 2010 to delay tariff cuts on 200 items including textiles, machinery, iron and steel (*Christian Science Monitor*, 2011).

CONCLUSION

Since the 1990's, China has increased efforts for a closer relationship with ASEAN. The formation of a free trade area, ACFTA, is a fundamental shift in the relations between China and ASEAN. Forming the free trade area has resulted in increased trade and development, improved rules and regulations, and success has served as a model to follow.

Benefits derived by China include export markets for its goods as well as participation in the growth of ASEAN markets. Very important to China is securing access to raw materials and commodities vital to the Chinese economy. China has taken on the leadership role and become the driving economic force aiming at stabilizing markets and avoiding future crises.

Generally, ASEAN members are major exporters of raw materials and intermediate goods in China. The countries expect that FTA will give them the opportunity to partake in China's tremendous growth and lead to increased exports to China. Individual ASEAN members see ACFTA as a logic step to benefit from China's growing domestic market.

However, there is the ever present fear that China is trying to dominate the region. There is a certain ambivalence: on one hand the countries want to increase trade with China, on the other they wish to maintain alliances with the U.S., Europe, and Japan. Although China is stressing economic reasons for furthering the relationship with ASEAN, there always remains the suspicion that China's main motivation for trade activism is strategic. China's so called "peaceful rise" is seen as a comprehensive long-term strategy leveraging globalization as a catalyst to accelerate China's economic development, but also to expand China's power and stature in the Pacific.

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APPENDIX

Interviews:

Interviews were conducted in Shanghai, Beijing, Hong Kong, Singapore, Washington D.C., New York, London, and other sites.

Examples of institutions, where interviews took place, are Institute of Asia Pacific Affairs, Hong Kong Trade Development, U.S. Embassy Beijing, Hong Kong Monetary Authority, Royal Institute of International Affairs (London), School of Oriental and African Studies (London), Council of Foreign Relations (New York).

In addition, organizations such as Economist Group in Hong Kong, Shanghai, and London, the old Bear Sterns Investment firm, Goldman Sachs, Chase Investment Bank, U.S. Chamber of Commerce, U.S. Department of Commerce were consulted.

Sample Questions for the Interviews:

1. What are the most important countries and why in the ongoing evaluation of the legal, treaty, and economic development of the region?
2. What is your view of prevailing changes in organizational and corporate culture in the ongoing evolution of the region?
3. What has been the evolution of trade patterns in the region and the relationship to China?
4. What is your assessment of the impact of Chinese economic development on your country?
5. What is your assessment of macroeconomic development in your country in the last ten years?
6. What is the impact of Chinese political influence on economic development in the region?
7. What has been the impact of the financial crisis on your development?
8. What has been the influence of the financial crisis on China's economic development and how might this relate to regional relations?
9. What has been the evolution of the trade treaty with China and related treaty developments?
10. What is the significance of outward and inward foreign direct investment on relations among ASEAN countries?
11. What is the influence of outward and inward foreign direct investment on relations with China?
12. What is your perception of the threats and opportunities to your business presented by the evolving legal framework given the problems of corruption and lack of transparency?
13. How has regional legal and political development changed your business strategies?
14. What is the future of trade patterns and further treaty-related developments?