

# Emergence of China as an Economic Power

## What Does It Imply for South-East Asia?

*While in the long run south-east Asia 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. South-east Asian countries have 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 among ASEAN members and a feeling of vulnerability to an increasingly volatile global economy are some of the reasons for heightened concerns about the economic ascendancy of China.*

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With its phenomenal industrial growth over the last two decades, China 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,<sup>1</sup> 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 centre' 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 south-east Asia whose policy-makers 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?'. No doubt Indian policy-makers and those in other parts of Asia are asking themselves the same question.

### China's Impact on South-East Asia's Exports

Bilateral trade between south-east Asia and China totalled US \$39.5 billion in 2002, growing at an annual average of slightly over 20 per cent since 1991 when overall trade amounted to only \$ 7.9 billion. While both south-east Asia'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 south-east Asia (Figure 1). There are signs that this deficit has been on the rise in the last few years as the rate of growth of south-east Asia's imports from China have outpaced that of its exports. In 2000, China was south-east Asia's sixth largest export market accounting for 3.1 per cent of south-east Asia's total global exports.<sup>2</sup>

While this share is still rather small, a recent simulation exercise suggests that the PRC will be east Asia's largest exporter by about 2010, but its largest importer by 2005.<sup>3</sup> This anticipated growth of the PRC's internal market and absorption suggests there exist innumerable opportunities for ASEAN to significantly accelerate their export growth, while also offering a number of lucrative opportunities in the PRC for regional investors. The study finds that an 'east Asian trade

triangle' is gradually developing, with the PRC running a sustained trade surplus with western economies (the US and the EU) and a deficit of about the same magnitude with the rest of east Asia. This in turn suggests the growing importance of the PRC as an import market for the rest of east Asia. Thus, if current growth trajectories persist, China may eventually act as an independent engine of growth for south-east Asia in the long run on its own, or at least could provide a much needed cushion to smaller south-east Asia countries against gyrations in the industrial country economic environment.

Apart from a growing domestic consumer market for south-east 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 south-east Asia and China have been on an increase. While south-east Asia tourists visiting China totalled almost 1.1 million in 1995, the number reached an estimated 1.8 million in 2000. While south-east Asia received about 0.8 million tourists from China in 1995, this number almost tripled to 2.3 million in 2000. The growth in tourists from China was particularly significant in Malaysia and Singapore, where Chinese visitors increased from 10th largest visitor group in 1995 to 4th and 5th positions, respectively in 2001.<sup>4</sup> The recent SARS outbreak has obviously had a dramatic, albeit temporary impact on tourist flows between China and south-east Asia.

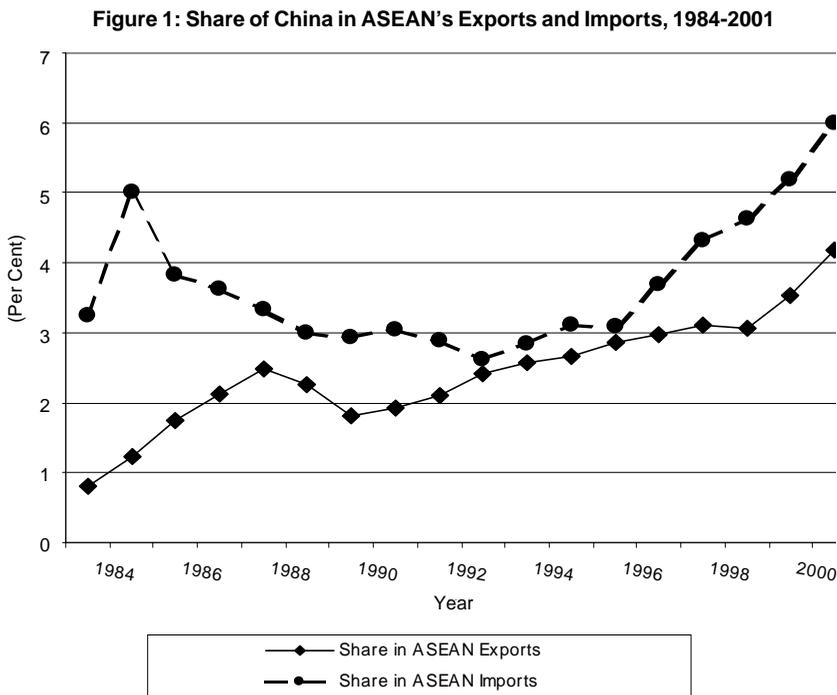
More generally, with China's WTO accession there will be greater scope and demand for services by China, particularly with regard to distribution, professional and infrastructural services (telecommunications and financial). As China continues to rapidly urbanise and industrialise, there will invariably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

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 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.

To be sure, with the major improvements in transportation, coordination and communication technologies, globalisation 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 specialisation and trade, will be beneficial to all parties involved. Thus, over time, free trade ought to be an unambiguously positive-sum game (i.e., allround wealth-creating outcome). This is of particular relevance to east Asia where machinery and electrical equipments constitute a high and growing proportion of intra-regional trade.<sup>5</sup> 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 the issue of the south-east Asia-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 refers to this phenomenon as ‘kaleidoscope’ or ‘knife-edge’ comparative advantage.<sup>6</sup> 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 south-east Asian countries (especially as PRC’s western regions develop and labour-intensive industries



Source: ASEAN Trade Statistics Database, ASEAN Secretariat, Jakarta.

migrate to the inland regions). In relation to this, opportunities for lower income south-east Asian 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. However, offsetting these concerns are the significant potential upside gains noted previously.

In addition to production sharing which usually involves *vertical* specialisation, openness to international trade allows countries to also specialise *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 specialising 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 south-east Asian countries may have complementarities with the PRC in production and export structures (i.e., vertical specialisation) while other parts are simultaneously competitive (horizontal specialisation).

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 Multifibre 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 south-east Asian countries as well as other Asian countries more generally.<sup>7</sup> While the possibility of horizontal specialisation (i.e., trade in differentiated goods) suggests that the above costs are probably overestimated, there are bound to be non-negligible price pressures and adjustment cost effects on other textile and clothing exporting countries.

### China’s Impact on South-East Asia’s Investment Prospects

There have been growing fears that south-east Asia is ‘losing out’ in the intense competition for FDI inflows to China. To the extent that China’s industrialisation strategy, like that of south-east Asia, is fuelled largely by inflows of FDI, there will invariably be a degree of competition involved in terms of attracting FDI inflows.

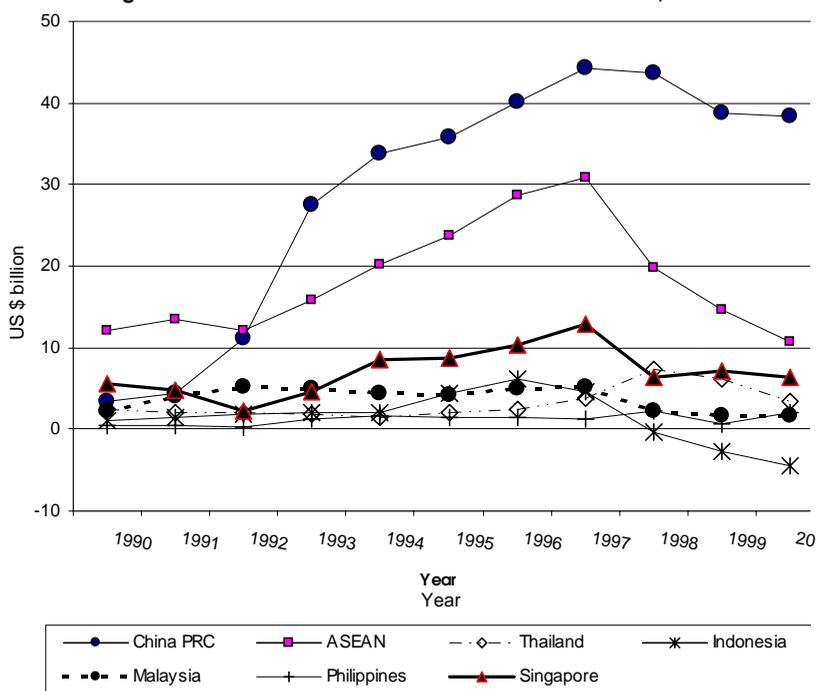
But has the rise and opening up of China actually altered the flow of FDI to Asia? The commonly noted statistic is that in the early 1990s, three-fifths of FDI to Asia were channelled into the south-east Asia countries and less than one-fifth to China. By 1999-2000, over two-fifths went to China (more than two-thirds went to PRC plus Hong Kong) while only about one-fifth found its way to south-east Asia. The share of south-east Asia in global FDI, which averaged about 6.7 per cent during 1993-96, registered a substantial decline since 1997, hovering at around 1.6 per cent during 1999. As a proportion of all developing countries, south-east Asia's share fell from 13.6 per cent in 1997 to 6.8 per cent in 1999 (Figure 2).

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 south-east Asia. (The FDI decline to China reversed itself in 2001.)<sup>8</sup> Indeed, the relatively sharp decline in south-east Asia's FDI flows and its share of total FDI to east Asia was primarily due to Indonesia which was the only south-east Asian 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 investor uncertainty as opposed to competition from China per se (see the Table).

More detailed analysis of the sources of FDI into south-east Asia 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 south-east Asia 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 south-east Asia 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 the 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

Figure 2: Trends in FDI Net Inflows of China and ASEAN, 1990-2000



Source: Asian Development Bank.

'unstable south-east Asia'. 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 south-east Asia could well intensify diversion of FDI from the PRC to south-east Asia.

As trade barriers in PRC continue to decline and infrastructural and communications facilities improve further, FDI may move from some south-east Asian countries to the PRC, and the south-east Asian 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 south-east Asian countries (such as Indonesia, Thailand, Philippines and Indonesia) is the fact that Japanese investors, who 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 south-east Asian countries remains to be seen. A recent survey of Japanese companies by the Japanese External Trade Organisation (JETRO) in October 2001 suggests that of those planning to relocate operation to the PRC, the distribution will be from Japan (67.5 per cent) and only about 7-8 per cent from south-east Asia.<sup>9</sup> Indeed, insofar as part of the reasons for the recent downturn in investments in south-east Asia was the 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.

Table: Is China Diverting FDI from Other Asian Economies?

Per Cent of Total Asia (ex-HK) Net FDI	1995	2000	Remarks
China	53.0	54.2	Steady rise through 1990s
Taiwan	2.3	6.5	Sharp rise since Asian financial crisis
Korea	2.0	13.6	Surged following liberalisation
Southeast Asia	35.1	18.3	
Southeast Asia excluding Indonesia	28.6	24.4	Adjusted for Indonesia, decline is not huge
Indonesia	6.4	-6.1	Negative numbers skew SE Asian data
Malaysia	8.6	7.3	Remarkably steady – so far
Philippines	2.2	2	Remarkably steady
Singapore	10.7	8.5	Falling modestly in relative terms
Thailand	3.0	3.2	Remarkably steady
India	3.2	3.1	Continues to under-perform

Source: M Bhaskaran, 'China as Potential Superpower: Regional Responses', *Deutsche Bank Research Report*, January 15, 2003.

There are a number of reasons to remain positive about south-east Asia's FDI potential.

First, some multinational enterprises (MNEs), concerned about what might be 'excessive' exposure to China, are considering setting up factories in some other south-east Asian countries as a form of "risk hedging". The need for such risk diversification to ensure minimal disruption to global supply chains has been made especially apparent in recent times with the outbreak of the SARS crisis which has impacted the PRC and Greater China far more than south-east Asia.

Second, China's opening and growth of PRC businesses may lead to Chinese investments in south-east Asia 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 south-east Asian countries.

Third, the lowering of import barriers (both actual trade barriers as well as 'be-

hind 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.

### **ASEAN-China Free Trade Agreement (ACFTA)<sup>10</sup>**

It is a fact that in an increasingly globalised world decisions about production, investment and trade are closely interlinked and often cannot be made independently of one another. From south-east Asia'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 south-east Asian markets.

In relation to this, special mention should be made of the proposed ASEAN-China Free Trade Area (ACFTA) first mooted by Chinese premier Zhu Rongji during the ASEAN-China Summit in November 2001. After a series of negotiations, the so-

called ASEAN-China Closer Economic Partnership Framework Agreement was given concrete shape during the ASEAN Summit in Cambodia in November 2002. A key feature of the ACFTA agreement is the 'early harvest' clause which commits ASEAN and the PRC to reduce their tariffs for certain products within three years, as a reflection of their commitment to tariff reduction. These early harvest products are mainly agricultural products that represent about 10 per cent (or more than 600) of all tariff lines in the Harmonised System (HS) of tariff classification.<sup>11</sup> Tariff reduction/elimination for goods that are not included under the early harvest programme are to be negotiated through the ACFTA, with negotiations to be completed by June 30, 2004.

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 \$ 2 trillion in aggregate GDP and \$1.2 in total trade spanning

11 diverse and heterogeneous economies (both in terms of their size and levels of development).

The timetable for the formation of the ACFTA in goods for the older ASEAN members (ASEAN-5 plus Brunei) is 2010, and that for the others (i.e., Cambodia, Myanmar, Laos, PDR, and Vietnam, so-called CMLV countries) is 2015. In other words, newer members (some of which are not yet WTO members) have been offered more time to adjust to the requirements of the ACFTA. The framework agreement also commits both parties to commence negotiations for the liberalisation of services and investment by 2003. Besides these, the framework agreement identified five priority areas for economic cooperation apart from trade liberalisation and facilitation measures. These are agriculture, human resource development (HRD), information and communication technology (ICT), investment and the Mekong River basin development. It has agreed to implement capacity building programmes and provide technical assistance for the CMLV members to help catch up with the more advanced ASEAN members and increase their trade and investment cooperation with the PRC.

While the ACFTA ought to speed up the growing mutual interdependence between south-east Asia and China, its impact on individual south-east Asian 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 south-east Asian 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 south-east Asia. All of this in turn has offered south-east Asia 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 domi-

nance in the south-east Asian region.

At the same time, it is imperative that south-east Asia 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. A related concern for ASEAN is how to manage the tensions within the heterogeneous alliance given the existence of a two-tier ASEAN (older six ASEAN members versus the CMLV ones).<sup>12</sup> There are no easy answers to this hard question, but it is one that the alliance needs to give more serious thought to if it is to remain cohesive and effective and continue to be seen as such by the rest of the world.<sup>13</sup>

## Conclusion

While there is little doubt that in the long run south-east Asia 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'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. South-east Asian countries have 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 among ASEAN members, and a 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 south-east Asia is not the economic ascendancy of China 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. This lesson rings

equally true for India as it continues on the path of economic reforms. [EJW](#)

## Notes

- 1 For instance, see Economist Intelligence Unit (EIU), 'Does Anyone Believe China's Numbers?', *EIU Viewswire*, March 28, 2002 and J Berthelsen, 'China's GDP Figures: Are They Bogus?', *Asia Times*, February 6, 2003.
- 2 Data used in this essay is based on a longer working paper by the author entitled 'Implications of the Emergence of the PRC as an Economic Power for ASEAN: Threat, Opportunity, or Both?' for the Asian Development Bank, April 2003.
- 3 D Roland-Holst, 'An Overview of PRC's Emergence and East Asian Trade Patterns to 2020', Research Paper No 44, Asian Development Bank Institute October, 2002.
- 4 F Wu, M H Toh, T S Poa, K W Seah and T K Lim, 'Potential of the Chinese (PRC) and Indian Tourism Markets for ASEAN', *Economic Survey of Singapore*, Second Quarter 2002, Ministry of Trade and Industry, Singapore.
- 5 F Lemoine and D Ünal-Kesenci, 'China in the International Segmentation of Production Process', Working Paper No 2002-02, CEPII, 2002.
- 6 J Bhagwati, 'The Global Age: From a Sceptical South to a Fearful North', *The World Economy*, 20, 1997, pp 259-83.
- 7 See W Martin and E Ianchovichina, 'Implications of China's Accession to the World Trade Organisation for China and the WTO', *The World Economy*, 24, 2001, pp 1205-19 and J Francois and D Spinanger, 'With Rags to Riches but then When?', paper presented at the Fourth Annual Conference on Global Economic Analysis Purdue University, Indiana, June 2001, pp 27-29. There are, however, some safeguard measures in place to phase in the transition and minimise disruption.
- 8 F Wu, T S Pao, H S Yeo and K K Phua, 'Foreign Direct Investments to China and South-East Asia: Has ASEAN Been Losing Out?', *Economic Survey of Singapore*, Third Quarter 2002, Ministry of Trade and Industry, Singapore.
- 9 W McKibbin and W T Woo, 'The Consequences of China's WTO Accession on Its Neighbours', mimeo, October 2002.
- 10 ASEAN refers to the Association of South-east Asian Nations. All the countries in the south-east Asian region except for East Timor are members of ASEAN.
- 11 The early harvest products belong to the following categories: Live animals. Meat and edible meat offal, fish, dairy produce, other animal products, live trees, edible vegetables, and edible fruits and nuts.
- 12 In fact, one could probably further sub-divide the six ASEAN members into two sub-tiers – for instance, Singapore, Malaysia and Thailand in first tier and Indonesia, the Philippines and possibly Brunei in the next tier. The same concerns with regard to large and growing income gaps between various regions plagues the PRC as well.
- 13 Conversely, in view of the heterogeneity of ASEAN in terms of development and economic structures, it makes sound sense for non-ASEAN countries like the PRC, India and Korea to engage strategically with ASEAN as a whole while simultaneously doing so with individual interested ASEAN members on a bilateral basis (assuming that these countries have sufficient negotiating capacities to do so).