
CHINA-ASEAN FREE TRADE AGREEMENT

Shaping Future Economic Relations

==== John Wong and Sarah Chan
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Abstract

The China-ASEAN Free Trade Agreement has been hailed as a landmark pact in pushing for freer trade between China and the ASEAN countries. With the establishment of the free trade zone, trade and investment between the Chinese and ASEAN economies are expected to increase significantly; but while the economic benefits are inexorable, the extent of gains derived from closer integration hinges on the Sino-ASEAN economic relationship, which is both complementary and competitive in nature. At the present stage of development, China and ASEAN are more competitive than complementary, given the similarity in their trade and industrial structures. ASEAN and China are also direct competitors for foreign investment, rather than significant investors in each other's economies. Despite these challenges, the prospects for bilateral trade to flourish are bright if both China and ASEAN can interlock their economies through deeper integration in the long term.

At the ASEAN-China Summit in November 2000, then-Chinese Premier Zhu Rongji proposed the creation of a free trade area between China and the Association of Southeast Asian Nations (ASEAN) within 10 years. The China-ASEAN Free Trade Agreement (FTA), if materialized by 2010, is expected to mark a significant milestone in the future development of Sino-ASEAN bilateral economic relations. From China's perspective, an FTA with ASEAN is just one of the few proposals to foster closer economic and regional cooperation between China and the Southeast

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Asian countries. For ASEAN, an FTA with China offers the Southeast Asian states a useful route to overcome the disadvantage of smallness by pooling resources and combining markets. It is anticipated that with the establishment of the China-ASEAN FTA, an economic region of 1.7 billion consumers will enjoy a regional gross domestic product (GDP) of US\$2 trillion, while total trade is estimated to reach \$1.23 trillion.¹

FTAs are not a new phenomenon in today's global trading system, and to date, there are more than a hundred of such regional trading arrangements either in force or under negotiation.² Within East Asia,³ the potential of expanding trade and investment between China and the ASEAN countries through an FTA is huge, but so are the challenges that accompany greater economic integration. The initiative to foster closer economic linkages between China and ASEAN brings numerous opportunities as well as challenges for the prospective member countries. An economically resurgent China in pursuit of an open-door policy would be an engine of growth for the region, but it is also likely to have a disruptive impact on the Southeast Asian states, besides being a locomotive for ASEAN's future economic growth. In fact, the extent of benefits derived from closer economic integration between China and ASEAN hinges on their evolving "dynamic" economic relationship, which is both complementary and competitive in nature. The extent of the impact for China and the individual ASEAN countries resulting from an FTA will differ depending on the industrial and trade structures, factors and resource endowments, as well as stages of economic development of each country.⁴

1. ASEAN's joint experts group estimated that the FTA would increase ASEAN's exports to China by 48% to US\$13 billion while China's exports to ASEAN would expand by 55% to US\$10.6 billion. At the same time, ASEAN's GDP would increase by 0.9% while China's GDP would rise by 0.3%. See "Forging Closer ASEAN-China Economic Relations in the 21st Century," report submitted by the ASEAN-China Expert Group on Economic Cooperation, October 2001, available at <http://www.aseansec.org/newdata/asean_chi.pdf>.

2. Peter J. Lloyd, "Regional Trading Arrangements and Singapore's Interests," seminar conducted at Institute of Southeast Asian Studies (ISEAS) in Singapore, April 5, 2002.

3. East Asia includes Japan, China, the four newly industrialized economies of Taiwan, Hong Kong, Singapore, and South Korea, plus the other ASEAN member countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Thailand, Myanmar, and Vietnam). ASEAN-4 refers to Indonesia, Malaysia, the Philippines, and Thailand. ASEAN-5 includes Singapore. ASEAN-6 includes ASEAN-5 plus Brunei.

4. In trade, complementarity between China and ASEAN exists in the natural resources area since ASEAN countries (with the exception of Singapore) are comparatively richer in agricultural resource-intensive commodities than China. ASEAN would therefore benefit from supplying raw resources needed by China for its industrialization. However, in the manufactured goods category, the lack of complementarity between the Chinese and ASEAN economies limits the capacity that each can absorb of the other's products. This obstructs to a certain degree the economic integration and interdependence of China and the ASEAN countries.

The structure of this article is as follows. The first section studies the modality and theoretical framework of the China-ASEAN FTA. The next section examines the pattern of trade between China and ASEAN. The third section analyzes the economic structures of China and the ASEAN countries, and their underlying implications. The final section contains some concluding remarks on the opportunities and challenges arising from an FTA between China and her Southeast Asian neighbors.

Modality of a Free Trade Agreement between China and ASEAN

An FTA is an arrangement among countries whereby tariffs and non-tariff barriers, for instance, quotas, licensing requirements, and product-safety regulations, are abolished among members. Compared to customs unions and common markets, a free trade area is the least institutionalized form of economic integration, where each member of the FTA retains its own external tariffs and other regulations for trade with non-member countries.

From the standpoint of economic theory, an FTA offers advantages to all member countries. Theoretically, an FTA increases intra-regional trade and enhances competitiveness, productivity, and efficiency. In the case of ASEAN and China, the markets combined would permit the exploitation of economies of scale brought about by an expansion of market size. Firms producing below optimum capacity before integration would be able to reap efficiency gains from lower unit costs as they would now produce for a bigger mass market. The formation of the FTA is also expected to improve productivity of firms, as the abolition of intra-regional barriers would force firms from Southeast Asia and China into closer competition with one another and possibly induce them to be more competitive and innovative.

Theoretically, the reduction of tariffs and removal of non-tariff barriers would likely facilitate trade and investment flows among member countries by allowing for improved market access to goods and services sectors. Other measures such as streamlining of customs procedures, liberalization of trading rights, or the mutual acceptance and adoption of common standards and practices, would further facilitate trade and investment flows by encouraging more tourist traffic and industrial cooperation, thereby lowering trade friction among the countries concerned. An integrated market brought about by an FTA is also likely to attract foreign investment, creating employment and increasing economic welfare of the member states. However, it should be noted that the establishment of an FTA will not in itself lead to a massive inflow of foreign investment, because foreign capital seems to be attracted to growing markets, not just large ones. If economic integration can stimulate growth, one can expect foreign capital to flow in. An FTA that shows no

sign of growth, but perpetuates stagnation, cannot hope to attract private capital from abroad.⁵

While the economic benefits that integration brings are desirable, there are adjustment costs for countries in the short term if they wish to enter into an FTA with potential trading partners. The FTA scheme inevitably entails an uneven distribution of costs and benefits among different sectors and among different industries. When intra-regional barriers are dismantled, industries will expand in some countries and contract in others, as industries relocate in response to differences in factor endowments. The adjustment costs resulting from such relocation of economic activity can be asymmetrical, since some economies may incur higher costs, in the short run, than others. In the case of the ASEAN countries, it is probable that during rationalization of firms and industries, some firms might be attracted to move to China to benefit from agglomeration economies of nearby suppliers and business services. Compared to ASEAN, which generally lacks an adequate base of supporting industries, China has a huge integrated industrial base and is strongly capable of providing auxiliary items like processing equipment, intermediate parts, and electronic components needed for manufacturing. Given its moderately well-developed basic technology industries such as machinery, China has the potential to develop an extensive network, or clusters, of supporting industries.⁶ Foreign companies could find it conducive to locate in China and benefit from agglomeration economies generated from being close to these supporting industries.⁷

In the short run, China (not merely ASEAN) would also suffer some adjustment costs if it entered into an FTA with its Southeast Asian neighbors. Within China, there would be an asymmetrical imbalance of costs and benefits, since some provinces might gain at the expense of others that are relatively backward. This might arise because manufacturing as a whole tends to

5. Mohd Haflah Piei, "Regional Trading Arrangements for Enhancing Economic Resilience: The ASEAN Experience," MIER National Economic Outlook 2002 Conference, November 6–7, 2001.

6. Although the previous import-substitution policy saddled China with inefficient domestic market-oriented industries, it also left the economy with moderately well-developed basic technology industries such as machinery, which might play a role as supporting industries. See "Industrial Restructuring in East Asia: Towards the 21st Century," eds. Seiichi Masuyama, Donna Vandenbrink, and Chia Siow Yue (Singapore: ISEAS; Tokyo: Nomura Research Institute [NRI], 2001), p. 31.

7. China is fast accumulating a full complement of supporting industries, something that rival production centers in Southeast Asia cannot match. Due to the massive influx of foreign investment over the past decade, China has everything from first-rate plastic molding shops and electronic component makers to giant petrochemical plants. This allows foreign firms to operate supply chains smoothly. See "China and the WTO," *Business Week* (Asia edition), October 22, 2001.

cluster in relatively few locations, de-industrializing the less-favored regions.⁸ Manufacturing activities tend to concentrate in those geographic areas that have locational advantages and can provide well-developed infrastructure and a critical mass of supporting industries, not just low labor costs.

Overall, there are a number of a priori reasons to believe that an FTA would bring intrinsic benefits in the long term despite member countries experiencing transitional economic disequilibrium and other social costs such as drug trafficking and illegal migration as a result of freer cross-border trade. As the FTA scheme is gradually phased in over the years, multinational companies in the region will restructure their supply chains and rationalize their production networks by taking China and ASEAN as a single integrated market. In the long run, both ASEAN and China are expected to become more competitive internally and externally, since FTA membership should stimulate the governments to introduce domestic reforms and spur industrial upgrading. For this reason, it is in the interest of prospective member countries to carefully implement the preferential trading arrangement so that maximum benefits can be derived from the scheme. In view of the complexity of issues involved, negotiations are expected to be protracted and, in some instances, filled with ambiguity, since it is not clear if China's negotiations would be with ASEAN as a regional organization or with each of the individual ASEAN states. Some academics have alluded to the possibility that the proposed FTA between China and ASEAN might preclude certain sectors and might not go beyond the agenda of liberalizing services.⁹ Finally, there is the question of whether the China-ASEAN FTA could be modeled on the Common Effective Preferential Tariff (CEPT) scheme that allows members to reduce their tariff rates at differential paces and intensities.¹⁰ Regardless of how the economic partnership between China and ASEAN evolves in future, it is imperative first to analyze the industrial structure and trade relations of

8. World Bank Policy Research Report, "Trade Blocs" (Oxford: Oxford University Press, 2000).

9. A preliminary step to implementing the China-ASEAN FTA is the "Early Harvest" program that was endorsed in the framework agreement signed between ASEAN and China in November 2002. An integral part of the China-ASEAN FTA, the Early Harvest package provides for liberalization of some 600 agricultural products in early 2004 but excludes rice and palm oil (both major exports of Southeast Asia). The remaining products will be liberalized in 2005. According to the framework deal, negotiations will start on liberalizing the services and investment sectors, beginning in 2003. For more details on the framework agreement, see <<http://www.aseansec.org/13196.htm>>.

10. The CEPT is basically a mechanism of tariff reduction for economies that have wide diversity in tariff structures. The structure of CEPT allows member countries to harmonize their internal tariff rates by providing for fast track, normal track, and temporary exclusion of manufactures and agricultural products. Special and preferential treatment would be granted to the less-developed member countries to allow them to smooth the transition toward a freer and more open marketplace.

the Chinese and ASEAN economies, before making any other specific assessments.

Sino-ASEAN Trade Relations

A salient feature in the economic development of China and ASEAN¹¹ is the important role that foreign trade has played in driving the economic growth of these countries. Over the past three decades, the ASEAN-5, which by nature are very open and outward-looking economies, have become one of the world's most dynamic regions on account of their strong export growth, fueled largely by foreign investment. Though China lags behind the ASEAN-5 in pursuing export-oriented industrialization (EOI), it has experienced phenomenal growth in recent years. For the past two decades, Chinese exports have increased at a hefty annual rate of 15% (or more than twice the world's average), from \$13.7 billion in 1979 to \$325.6 billion in 2002, catapulting China to the rank of the world's fifth-largest exporting nation.¹²

Recent trade relations between China and ASEAN have been influenced mainly by the growth and expansion of both economies, and China's drive toward economic modernization. In the past decade, there was respectable growth in trade and economic relations between China and ASEAN as a whole, with trade value totaling around \$8 billion in 1991, increasing to over \$40 billion in 2001.¹³ As of that year, China's trade volume with Southeast Asia ranked highest with Singapore, followed at a distance by Malaysia, Thailand, and Indonesia, and then trailing far behind, the Philippines (refer to Figure 1). Of the steady growth in bilateral trade, Singapore accounted for the bulk of trade between China and ASEAN. In 2001, ASEAN was China's fifth-largest trading partner, next to Japan, the U.S., the European Union, and Hong Kong.¹⁴ This is reflected in the continuous rise of ASEAN's share in China's foreign trade from 5.8% in 1990 to 8.2% in 2001. Meanwhile, the

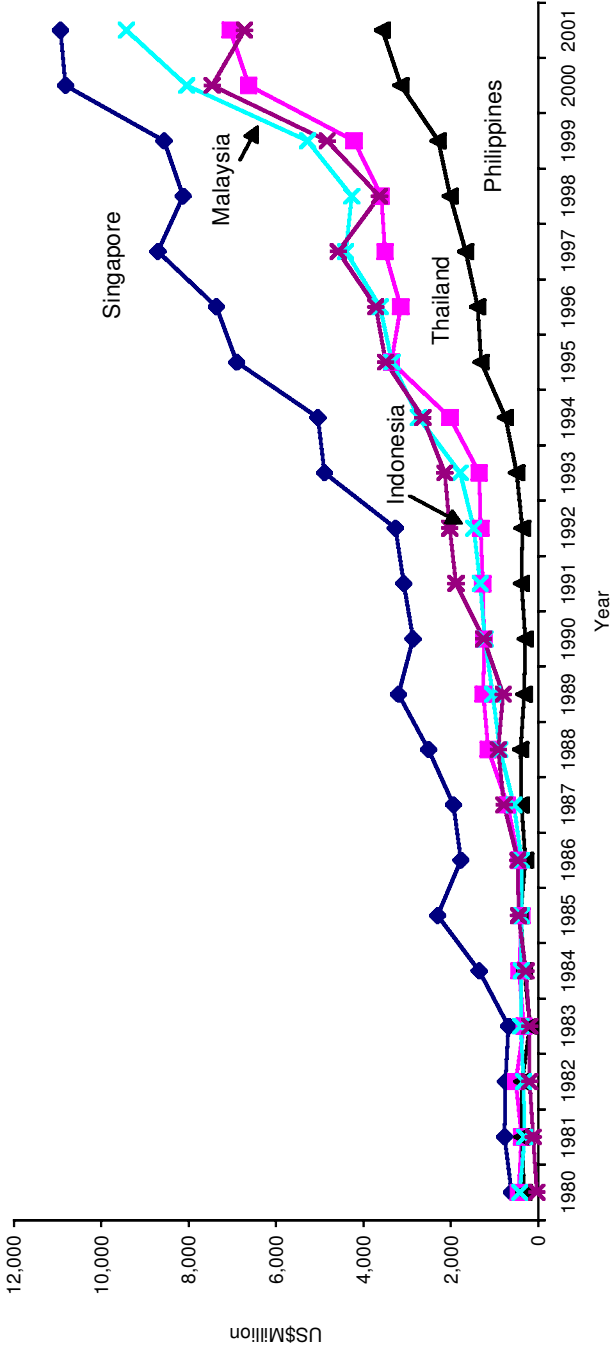
11. Trade between China and ASEAN is broad in scope. China's border trade with countries like Cambodia, Vietnam, Laos, and Myanmar should be seen in the light of overall economic relations with ASEAN. For analysis purposes in this section, the trade structure of ASEAN refers more specifically to the trade structure of the ASEAN-6.

12. China became the largest exporter among the emerging East Asian economies in 2002, accounting for 5% of total world exports. See "EIU Economic Forecast, 2003-04: A High Point," *Business China*, a fortnightly report by the Economist Intelligence Unit, January 20, 2003. The World Bank predicts that China's share of world exports will almost double to between 6% and 7% by 2005.

13. In 2001, trade between China and the ASEAN countries totalled \$41.7 billion, rising 6% over the previous year despite the worldwide economic recession. (Trade figures extracted, and percentage change calculated, from China's official published data in *China Statistical Yearbook*, 2002.)

14. See ASEAN-China Expert Group on Economic Cooperation, "Forging Closer ASEAN-China Economic Relations in the 21st Century."

FIGURE 1 China's Trade with ASEAN-5, 1980-2001



SOURCE: United Nations, *Statistical Yearbook for Asia and the Pacific*, 1991 and 2000.

NOTE: China-ASEAN trade figures for 2001 are obtained from *China Statistical Yearbook 2002*.

share of China in ASEAN's trade expanded from 2.3% in 1991 to 6% in 2000, making China ASEAN's sixth-largest trading partner.

An examination of the pattern of trade between China and ASEAN reveals that the composition of China-ASEAN trade had evolved considerably. Originally, the ASEAN countries (except Singapore) were resource-based economies depending heavily on the export of natural resources and primary goods for economic growth. In the early 1990s, for instance, the top two ASEAN exports to China were mineral fuels and wood (Table 1). Collectively, the share of these products accounted for more than 50% of all ASEAN exports to China. By 2001, however, the order of importance had changed. Two-way trade between China and ASEAN had shifted from commodities toward manufactured products. As seen from Table 1, the share of machinery and electrical equipment grew from 12.4% to 48.3% of China's imports from ASEAN.

Comparatively, China's exports to ASEAN were more diversified, ranging from agricultural commodities, metals, and mineral products to other manufactured goods. In 1993, among the wide variety of products that China exported to ASEAN, machinery/electrical equipment, minerals, vegetable commodities, base metals, textiles, and apparel and footwear constituted the top items in bilateral trade. Collectively, they constituted close to 70% of China's exports to ASEAN. By 2001, machinery and electrical equipment, as well as textiles, clothing, and footwear, continued to be among the top commodities traded, but their share had jumped to 61.7%, or more than half of all China's exports to ASEAN.

It can be seen that over the course of nearly a decade, the trade structures of China and ASEAN show an increasingly important cyclical trend of manufactured products, and a declining share of primary commodities. The composition of trade between China and ASEAN has shifted significantly as it has advanced from the trading of mostly agricultural raw materials to capital-intensive items like machinery and electrical equipment. This significant change is attributed to ASEAN and China pursuing the EOI strategy, which diversifies the composition of their exports. In the early industrializing years of the 1970s, the commodity composition of ASEAN's foreign trade was essentially dominated by primary commodities, but by the end of the 1990s, manufactured products were the predominant items traded.

Compared with the ASEAN countries' export structure, China's trade structure has also exhibited significant shifts and rapid changes following China's phenomenal export growth in recent years. Of significance is the fact that China actually accomplished its export diversification more quickly than did ASEAN. The share of Chinese manufactured products rose rapidly

TABLE 1 Structure of Trade Between China and ASEAN

| <i>Major Chinese Imports from ASEAN</i> | | | | | |
|---|------------------------------|----------------|---------------------------------|------------------------------|----------------|
| 1993 | | | 2001 | | |
| <i>Commodity Item</i> | <i>Imports (US\$billion)</i> | <i>% Share</i> | <i>Commodity Item</i> | <i>Imports (US\$billion)</i> | <i>% Share</i> |
| Mineral products | 1.5 | 32.4 | Machinery, electrical equipment | 15.2 | 48.3 |
| Wood and articles | 1.0 | 22.6 | Mineral products | 4.4 | 14.1 |
| Machinery, electrical equipment | 0.6 | 12.4 | Plastics | 2.2 | 6.9 |
| Animal or vegetable fats & oils | 0.4 | 8.4 | Chemicals | 2.1 | 6.6 |
| Plastics | 0.2 | 4.4 | Pulp, paper and paperboard | 1.0 | 3.3 |
| <i>Sub-Total</i> | 3.7 | 80.2 | <i>Sub-Total</i> | 24.9 | 79.2 |
| <i>Major Chinese Exports to ASEAN</i> | | | | | |
| 1993 | | | 2001 | | |
| <i>Commodity Item</i> | <i>Exports (US\$billion)</i> | <i>% Share</i> | <i>Commodity Item</i> | <i>Exports (US\$billion)</i> | <i>% Share</i> |
| Machinery, electrical equipment | 0.9 | 20.8 | Machinery, electrical equipment | 12.1 | 50.9 |
| Textiles, apparel & footwear | 0.7 | 15.7 | Textiles, apparel & footwear | 2.6 | 10.8 |
| Vegetable products | 0.5 | 11.6 | Base metals and metal articles | 1.6 | 6.7 |
| Base metals and metal articles | 0.5 | 10.6 | Products of chemicals | 1.4 | 6.0 |
| Mineral products | 0.5 | 10.5 | Mineral products | 1.1 | 4.6 |
| <i>Sub-Total</i> | 3.1 | 69.2 | <i>Sub-Total</i> | 18.8 | 79.0 |

SOURCE: ASEAN Secretariat, <www.aseansec.org/Trade/Files/AN_CN_PS.htm>.

NOTE: 1993 figures cover only Brunei, Singapore, Malaysia, Indonesia, Philippines, and Thailand (ASEAN-6). The 2001 data cover ASEAN-6 plus Cambodia and Myanmar.

from 47% of total exports in 1980 to 90% in 2000.¹⁵ More importantly, in 1995 non-traditional capital-intensive goods such as machinery and electronics started to displace the labor-intensive items of textiles, clothing, and footwear (TCF). The dramatic shift in China's industrial and export structure by the end of the 1990s owes a great deal to foreign-invested enterprises using China as an assembly platform for components or finished products.¹⁶

From the pattern of China's trade with ASEAN, it appears that the sectors where intra-industry trade is large are machinery and electrical equipment. It is noted from a recent report submitted by the ASEAN-China Expert Group that the machinery and electrical appliances exported by China to ASEAN are mostly for general or special use. On the other hand, a substantial part of the machinery and electrical appliances that China imports from ASEAN are electronic components and devices. For example, Singapore's most important exports to China in 2000 were mainly electronic valves, parts for data processing machines, and other components for industrial electrical equipment.¹⁷ In the same year, industrial manufactured goods, which constituted 57% of the Philippines' total exports to China, were mostly made up of semi-conductors.¹⁸ Imports of transistors, integrated circuits, and other electronic devices similarly account for a relatively high percentage in China's imports of machinery and electrical appliances from Malaysia and Thailand.¹⁹

China vis-à-vis ASEAN: Competitiveness and Complementarities

Trade creation between China and ASEAN would be greater if the industrial structures of the Chinese and Southeast Asian countries were to be complementary after economic integration. At the present moment, despite the steady increase in bilateral trade, the degree of integration and interdependence between the two sides has not increased proportionally. Sino-ASEAN trade does not account for a significant proportion of each other's total trade.

15. John Wong & Sarah Chan, *China's Rapidly Changing Export Structure* (National University of Singapore, EAI, Background Brief, no. 85, April 9, 2001).

16. Many consumer durables manufactured by China in high volumes are produced under OEM (original equipment manufacturing) arrangements whereby large foreign multinational corporations use China as a manufacturing base to process their own products. See John Wong, "Turning a Rising China into a Positive Force for Asia," *Straits Times*, October 1, 2001.

17. Report by the Singapore Trade Development Board, *Singapore-China Trade Trends (1990-2000)*, May 1, 2001.

18. Ellen H. Palanca, "China's WTO Accession and Philippines-China Economic Relations," paper presented at the International Conference on "Economic and Political Development in Southeast Asia at the Beginning of the New Millennium," organized by the Center for Southeast Asian Studies at Xiamen University, Xiamen, Fujian, China, September 20-23, 2001.

19. ASEAN-China Expert Group on Economic Cooperation, "Forging Closer ASEAN-China Economic Relations."

Mutually competitive, rather than complementary, structures of China and ASEAN prevented significant growth in trade, with the possible exception of China and Singapore.²⁰

The relative trade interdependence between China and ASEAN is illustrated in Table 2. The ASEAN countries do not constitute a major market for China. In terms of China's exports to ASEAN-5, from 1980 to 2000, China shipped an average of 3.1% of its total exports to Singapore, followed by Thailand (0.9), Malaysia (0.8), the Philippines (0.7), and Indonesia (0.6). Altogether, the ASEAN-5 received only an average of 6.4% of China's total exports from 1980 to 2000.

From the perspective of the ASEAN-5 countries, imports from China also do not constitute a large proportion of their total imports. From 1980 to 2000, imports from China accounted for only 4% (on average) of Singapore's total imports, while Chinese imports accounted for 3.2% of Thailand's overall imports, with the same percentage for Indonesia. Malaysia and the Philippines each imported a meager 2.5% of their total imports from China. That China's potential as a market for ASEAN is not being tapped significantly can be seen in that during the same period, Singapore shipped only an average of 2.2% of its total exports to China. For Thailand, the export share was 2.7%, for Indonesia 2.5%, and for Malaysia, 2%. The Philippines shipped only a minuscule 1.3% of its exports to China. In fact, one can note that for ASEAN, China is much more important as a source of supply for imports, rather than as an outlet for ASEAN's exports.²¹

The fact that China and ASEAN are not each other's major export markets suggests that their trade structures are fundamentally competitive rather than complementary. Both sides are economically oriented toward the industrialized countries of the West and Japan for their export markets, as well as for sources of capital and technology. In 2000, for instance, 56% of China's total exports and 57.4% of ASEAN-4's, on the average, were destined for the industrialized countries of the United States, Japan, and the European Union (EU).²² Another indication for the currently low degree of economic interdependence of Sino-ASEAN trade is their small investment inflow toward each other. ASEAN and China are direct competitors for foreign direct investment (FDI), rather than significant investors in each other's economies. Hong Kong, Japan, Taiwan, and South Korea account for an overwhelming share of FDI inflow into China; in 2001, these countries' share of FDI in China was

20. For the past decade since 1990, Singapore has accounted for approximately two-fifths of ASEAN's external trade with China.

21. Zhang Zhaoyong and Ow Chin Hock, "Trade Interdependence and Direct Foreign Investment between ASEAN and China," *World Development* 24:1 (1996), pp. 155-70.

22. John Wong and Sarah Chan, "China's Emergence as a Global Manufacturing Center: Implications for ASEAN," *Asia Pacific Business Review* 9:1 (Autumn 2002).

TABLE 2. Chinese Trade Interdependence with ASEAN-5

| | Exports to China as % of the Exporting Country's Total Exports | | | | | | | | | | | |
|-------------|--|------|------|------|------|---------------------|------|------|------|------|------|---------------------|
| | 1980 | 1986 | 1990 | 1994 | 2000 | Average (1980-2000) | 1980 | 1986 | 1990 | 1994 | 2000 | Average (1980-2000) |
| ASEAN | 3.5 | 3.5 | 5.7 | 5.9 | 9.8 | 5.5 | 1.0 | 1.9 | 2.1 | 2.4 | 5.4 | 2.4 |
| Singapore | 1.1 | 1.3 | 1.6 | 2.1 | 2.2 | 1.7 | 1.6 | 2.5 | 1.5 | 2.2 | 3.9 | 2.2 |
| Thailand | 0.7 | 0.7 | 1.3 | 0.8 | 1.9 | 1.0 | 1.9 | 3.1 | 1.2 | 2.0 | 4.3 | 2.7 |
| Indonesia | 0.1 | 0.8 | 1.6 | 1.4 | 2.0 | 1.3 | — | 1.0 | 3.3 | 3.3 | 4.5 | 2.5 |
| Malaysia | 1.2 | 0.4 | 1.6 | 1.4 | 2.4 | 1.2 | 1.7 | 1.2 | 2.1 | 3.3 | 3.1 | 2.0 |
| Philippines | 0.4 | 0.3 | 0.2 | 0.2 | 0.7 | 0.3 | 0.8 | 2.1 | 0.8 | 1.2 | 1.7 | 1.3 |

| | Imports from China as % of the Exporting Country's Total Imports | | | | | | | | | | | |
|-------------|--|------|------|------|------|---------------------|------|------|------|------|------|---------------------|
| | 1980 | 1986 | 1990 | 1994 | 2000 | Average (1980-2000) | 1980 | 1986 | 1990 | 1994 | 2000 | Average (1980-2000) |
| ASEAN | 6.6 | 6.1 | 6.2 | 5.3 | 6.1 | 6.4 | 2.8 | 3.5 | 2.6 | 2.5 | 4.4 | 2.6 |
| Singapore | 2.3 | 3.9 | 3.2 | 2.1 | 2.3 | 3.1 | 2.6 | 5.6 | 3.4 | 2.8 | 5.3 | 4.0 |
| Thailand | 1.7 | 0.5 | 1.4 | 1.0 | 0.9 | 0.9 | 4.5 | 2.9 | 3.3 | 2.6 | 3.1 | 3.2 |
| Indonesia | 0.1 | 0.5 | 0.7 | 0.9 | 1.2 | 0.6 | 1.8 | 3.1 | 3.0 | 4.3 | 6.0 | 3.2 |
| Malaysia | 1.0 | 0.7 | 0.6 | 0.9 | 1.0 | 0.8 | 2.4 | 3.6 | 1.9 | 2.3 | 3.9 | 2.5 |
| Philippines | 1.4 | 0.5 | 0.3 | 0.4 | 0.6 | 0.7 | 2.7 | 2.2 | 1.4 | 1.4 | 2.4 | 2.5 |

SOURCES: IMF, *Direction of Trade Statistics*, 1983, 1990, 1996, and 2000; U.N., *Statistical Yearbook for Asia and the Pacific*, 1997 and 2001; National Bureau of Statistics, *China Statistical Abstract*, 2002.

NOTE: Calculations are by authors, adapted from "Trade Interdependence and Direct Foreign Investment Between ASEAN and China," *World Development* 24:1 (1996), p. 163.

54%. On the contrary, the FDI share of the ASEAN-5 in China had been rather small, accounting for only 6% in 2001. Of the ASEAN share, Singapore is actually responsible for about three-quarters of FDI flows to China.

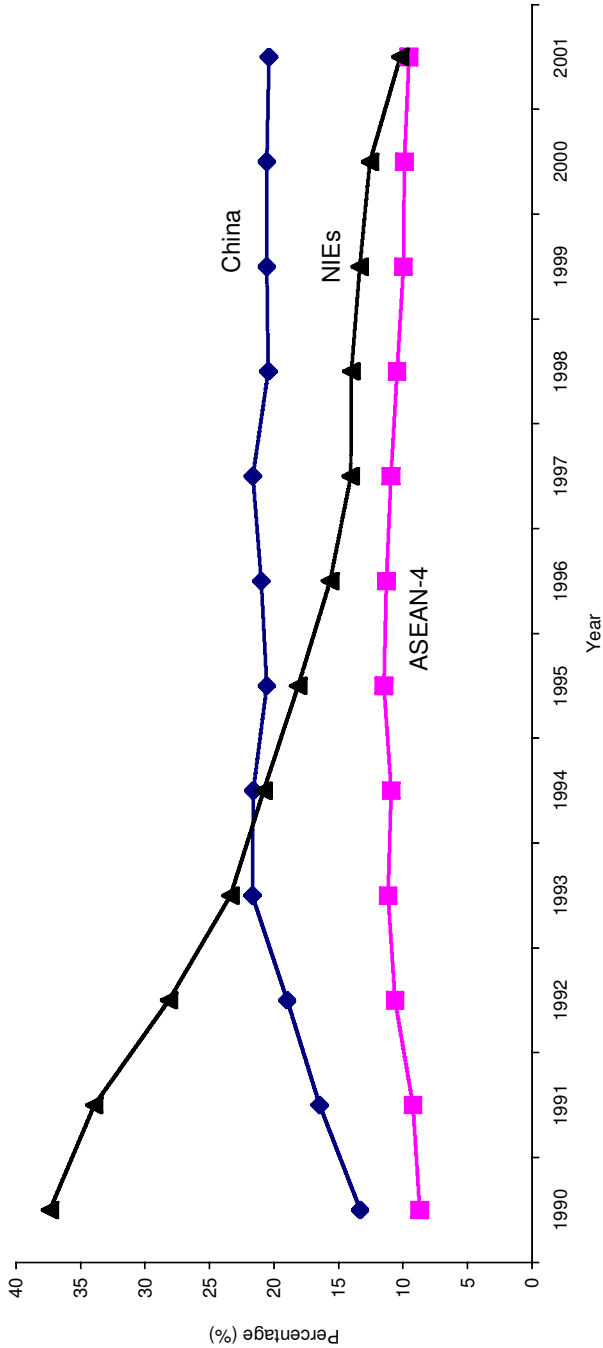
An important implication arising from the lack of complementarity between the Chinese and ASEAN economies is that ASEAN will compete head-on with China in the developed countries' markets in the export of both traditional and non-traditional manufactured goods.²³ China-ASEAN rivalry in the international market for manufactures cannot be entirely ruled out, given the similarity of industrial and export structures in these Asian economies. As China rapidly industrializes and integrates into the world trading system, its trade expansion will intensify competition with, or even displace, the ASEAN economies' exports in the markets of developed countries. As is already occurring, ASEAN economies are facing competitive pressures from China, which is fast becoming a manufacturing threat to many Asian countries, not just in low-tech areas but also in some high-tech sectors.

In the area of traditional labor-intensive industries like textiles, clothing, and footwear, China's gains have come at the expense of ASEAN's. While the newly industrialized economies (NIEs) are viewed as less vulnerable because of their move up the value-added ladder, the ASEAN-4 countries are somewhat apprehensive of China as a formidable rival in the trade of labor-intensive goods. As illustrated in Figure 2, China-made TCF now accounts for one-fifth of the U.S. market share, compared to a mere one-tenth market share by the ASEAN-4 economies. In the wake of China's World Trade Organization (WTO) accession, ASEAN nations will find it increasingly tough to compete with China, which is already export-competitive in labor-intensive manufactures. Come 2005, China will boost considerably its share of TCF exports when the U.S. and Europe are required to drop all remaining import quotas on garments and shoes.²⁴ According to the World Bank, the

23. Much of the competition in manufactured exports occurs in the markets of the major industrialized countries, notably the United States. The U.S. is the main destination, followed by Japan and the EU, in that order, for most Chinese light manufactures, except travel goods, articles of plastic, toys, and sports equipment, for which the EU is the main market. For Chinese textiles and clothing exports, the U.S. is the main market; it is also the single most important market for Chinese capital goods. See United Nations Conference on Trade and Development (UNCTAD), *Trade and Development Report 2002*, at <<http://www.unctad.org>>.

24. The large increase forecast in China's exports of textile and apparel may not materialize if the United States and other major advanced industrial countries invoke the transitional product-specific safeguard to block China's exports of these goods. According to the Agreement on Textiles and Clothing (ATC) that governs world trade in textile and apparel, countries imposing quotas on textiles and apparel imports are required to phase out all restrictions by December 31, 2004. However, WTO members would still be able to restrain textile and apparel imports by invoking the safeguard mechanism. Based on the terms of the U.S.-China WTO bilateral agreement, two "safeguard measures" were imposed. First, a transitional safeguard will be put in place for 12 years on China's admission into the WTO (this is to minimize the risk of widespread

FIGURE 2 East Asian Exports of Textiles, Clothing & Footwear to U.S. Market, 1990-2001



SOURCE: U.S. Census Bureau, U.S. Department of Commerce.

phasing-out of quotas on textile and apparel exports could enable China to accelerate its share of global apparel exports from 20% to 47%.²⁵ Inevitably, that will send shock waves through Mexico, India, the ASEAN-4, and other nations whose exports rely mainly on cheap labor.

For non-traditional and more capital-intensive manufactures like consumer and industrial electronics (e.g., computers, printers, disk drives, etc.), the growth of China's exports is far more dynamic in terms of market expansion. In fact, over the years from 1996 to 2000, machinery and electronics grew to dominate China's export structure, rising from 32% of total exports in 1996 to 42% in 2000, and gradually displacing the traditional items of TCF.²⁶ China is fast claiming the dragon's share of U.S. electronics imports at the expense of other Asian countries. This brings to the fore the adverse impact on ASEAN of the onslaught of China's non-traditional exports to the world market. As illustrated in Figure 3, although the electrical and electronic exports of the ASEAN-4 and the NIEs combined are significantly higher than China's, China is rapidly taking on these Asian competitors, as is evident in its increasing share over the years of the U.S. market for these products, particularly since the mid-1990s. In 1990, for instance, China's share of the U.S. electronics market was only around 2%, but this share increased to 11.8% by 2001, comparable to 9% for Korea and 8.2% for Taiwan, and higher than the shares of the ASEAN-5 economies—10.2% for Malaysia, 5.8% for Singapore, 1.3% for Indonesia, 4.1% for the Philippines, and 2.8% for Thailand. China is rapidly overtaking the ASEAN-5, whose export competitiveness is fast being eroded by China's growing strength in these non-traditional items.

Clearly, China's growing share of the U.S. market for electronics confirms China's emergence as a major outsourcing center for the global electronics industry.²⁷ China's integration in the global production networks of transnational corporations has a lot to do with foreign investment flowing to China to exploit its vast, buoyant market and abundant supply of low-cost labor.

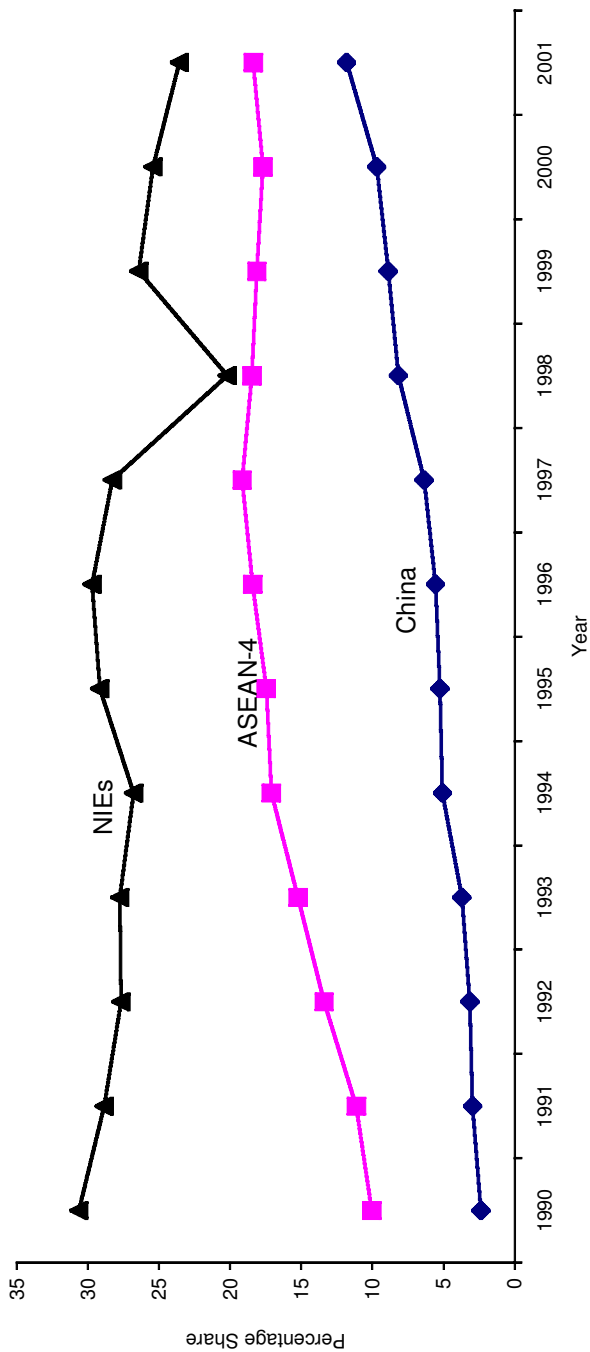
market disruption caused by a surge in imports). Second, for assessing anti-dumping charges, the U.S. would continue to apply the "non-market economy" (NME) methodology for another 15 years from the time of China's WTO accession. Nicholas Lardy, *Integrating China into the World Economy* (Washington D.C.: Brookings Institution, 2002).

25. "China Coping with Its New Power," *BusinessWeek* (Asia edition), April 16, 2001.

26. Wong and Chan, *China's Rapidly Changing Export Structure*.

27. The computer industry provides a good example. By the mid-1990s, China emerged as a major production base for Taiwanese companies, producing computer keyboards, PC mice, switch power supply units, motherboards, and monitors. Taiwan's dominant world market position for many of these computer hardware items was attributed to offshore production. The major offshore production locations for Taiwanese PC hardware firms were Malaysia, Thailand, and after 1990, increasingly China. Lardy, *Integrating China into the World Economy*, pp. 51–52.

FIGURE 3 East Asian Electrical & Electronics Exports to U.S. Market, 1990–2001



SOURCE: U.S. Census Bureau, U.S. Department of Commerce.

China's attractiveness as an investment destination has seen much of the regional FDI diverted from ASEAN in favor of China; China now captures about half of FDI in Asia, excluding Japan.²⁸ This is in sharp contrast to the early 1990s, when the ASEAN countries—particularly the ASEAN-5—were attractive hosts, and annual FDI inflows to the five ASEAN economies surpassed the total amount flowing to China (refer to Figure 4). This trend, however, quickly reversed as China, for most of the 1990s, emerged as the world's second-largest recipient of FDI, following the U.S.²⁹ In view of China's ability to attract massive FDI compared to ASEAN countries, whose FDI inflows have remained fairly stagnant, we can expect China's export momentum to be further sustained, with WTO accession being a further catalyst for growth as barriers to foreign investment fall.

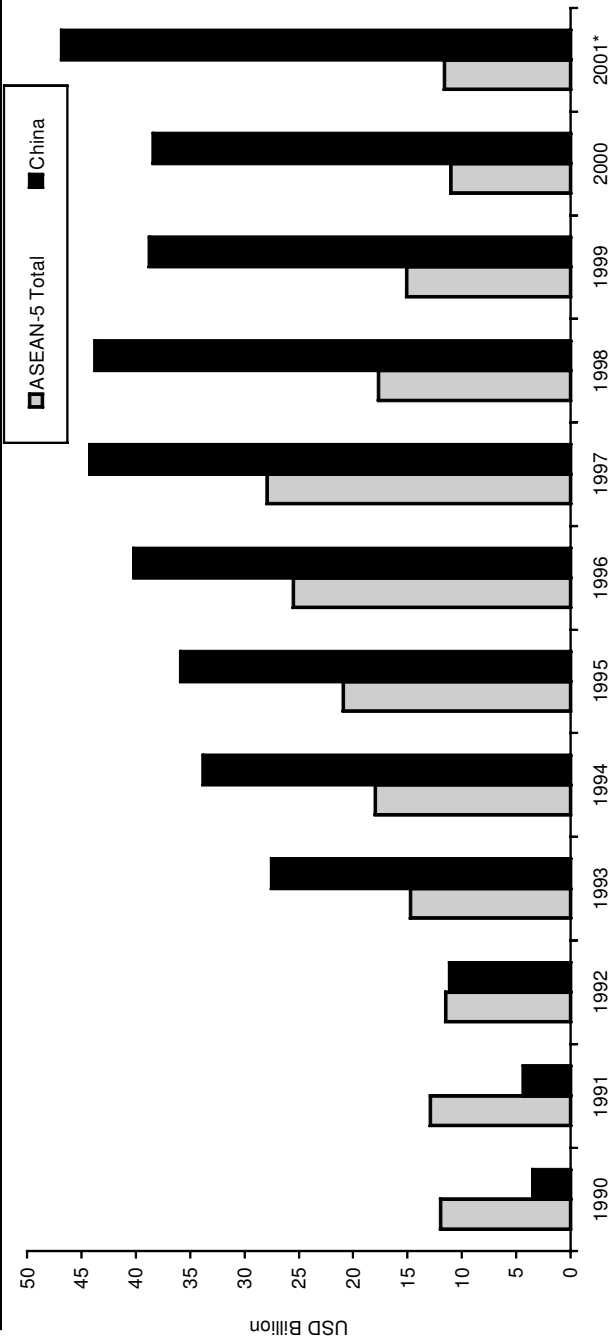
Future Prospects and Challenges for Deeper Economic Integration

Greater economic interdependence between the Chinese and ASEAN economies would be required to boost inter- and intra-industry trade between China and ASEAN. Given the broad similarity in trade structures and the fundamentally competitive nature of Sino-ASEAN economic relations, there are more possibilities that China and ASEAN would compete, rather than complement one other. At present, there are apprehensions among the ASEAN countries that a closer economic embrace with China through an FTA will bring intense competition rather than opportunities. In many ways, the economic resurgence of China carries very serious implications for Southeast Asia. China's economy as an entity is much larger than all the ASEAN economies put together. By virtue of its practically inexhaustible supply of both low-cost skilled and unskilled labor, China can still retain its comparative advantage in labor-intensive products even though it is moving up the manufacturing chain, producing technologically advanced goods. China's prowess in manufacturing an unprecedented range of items poses a formidable challenge to ASEAN, whose domestic markets are already being swarmed with

28. In the early 1990s, investment flows to China comprised only 18% of flows to Asian developing countries, while ASEAN economies received 61%. By the end of the 1990s, the proportions were reversed. China received 61% of the flows and the ASEAN countries only 17%. See "Foreign Investors Desert Southeast Asia for China," *Financial Times*, October 13, 2000.

29. By the end of the 1990s, the total stock of FDI in China accounted for almost one-third of the cumulative FDI in all developing countries. Cumulative foreign investment in China exceeded the total stock of such investment in countries like Mexico and Brazil, which opened their doors to foreign direct investment decades before China did. See *World Development Report 1999/2000: Entering the 21st Century* (New York: Published for the World Bank, Oxford University Press, 2000), p. 38.

FIGURE 4 Foreign Investment in China and ASEAN-5, 1990-2001



SOURCE: IMF, *Balance of Payments Statistics Yearbook*, 1998 and 2001.

NOTE: ASEAN-5 refers to Singapore, Malaysia, Thailand, Philippines, and Indonesia; *FDI figures for ASEAN-5 as estimated by Economist Intelligence Unit (EIU); FDI in China stood at an official record of US\$47 billion in 2001.

China's cheap and quality products. China's emergence as a global manufacturing base has apparently also resulted in most ASEAN economies experiencing a severe hollowing out of their industries. The difficulties that ASEAN nations face could negate any potential benefits from having improved access to the Chinese market as a result of trade liberalization through an FTA.

Despite similarities in China and ASEAN's trade structures, there exists a lot of potential for trade expansion if both China and ASEAN can harness the synergies and comparative advantage of their own economies to create complementarities among themselves. China and ASEAN could enhance trade and investment linkages with one another by specializing in what they produce and by developing niches and core competencies in agriculture, machinery, and services such as tourism. ASEAN, for instance, would benefit if it could increase agribusiness exports (for example, grains and meat) to China and capitalize on China's increasing demand for services in areas such as consulting, finance, education, infrastructure management, and urban planning. ASEAN countries would also gain if they could upgrade their manufacturing activities to higher ends of the value chain, as China has its own industrial base to rely on for low-tech products.

Likewise, China would reap efficiency gains if it could seek division of labor with the ASEAN countries according to comparative advantage. In agriculture, China could be a dominant supplier to ASEAN for crops like walnuts, apples, citrus, strawberries, grapes, asparagus, and processed tomatoes, because China has a strong comparative advantage in the production of many fruits, vegetables, and flowers, given its factor endowments.³⁰ China could also help ASEAN with its agricultural machinery and jointly develop with the Southeast Asian countries new areas or industries like food processing or traditional Chinese medicine. There exists a lot of potential and scope for enhancing economic linkages if China and ASEAN can harness the comparative advantage of their own economies and foster greater cooperation in wide areas like finance, tourism, e-commerce, forestry, energy, human resources development, or infrastructure building.³¹

30. Lardy, *Integrating China Into The World Economy*, p. 114. See also Frederick W. Crook, "The WTO's Impact on China's Agricultural Sector," *China Business Review*, March-April 2002, p. 16. China's large reservoir of labor gives it a comparative advantage in producing labor-intensive products such as vegetables and fruits. Conversely, China's limited arable land (approximately 100 m² per capita) gives it a comparative disadvantage in producing land intensive crops like wheat, corn, oilseeds, and sugar.

31. The Kunming-Singapore railway is an example to illustrate regional cooperation between China and the ASEAN states. The rail link, which will stretch from Kunming in Yunnan Province to Singapore via Vietnam, Laos, Burma, Thailand, and Malaysia, will play a major role in increasing trade in the region once it is completed by 2006. See "Regional Engagement," *China Economic Review*, April 2002.

China's integration into the world economy would see China increase its investment in ASEAN as Chinese businesses grow more savvy and outward-oriented. At the moment, Chinese investment in the region remains modest in absolute terms but is reported to be accelerating fast.³² Some Chinese enterprises like the oil and chemical firm Sinopec are actively exploring overseas opportunities and investing in resource-rich states like Indonesia and Malaysia. There are also other indigenous Chinese firms like Haier and TCL that have made forays into Southeast Asia by establishing manufacturing facilities in Indonesia, Vietnam, and the Philippines. In any case, as Chinese enterprises emerge more competitive as a result of domestic restructuring, they could spearhead Chinese overseas investment in Southeast Asia, rather than diverting foreign investment from their ASEAN neighbors.

To conclude, trade and investment are by no means zero-sum games, and it is possible for China and ASEAN to mutually benefit if closer economic relations among them are fostered. If China and ASEAN can interlock their economies through deeper integration in the long term, both would become more competitive as a region and would attract foreign investment into their integrated market. This would further promote economic growth and welfare, and more importantly, augur well for the peace and stability of the region.

32. In 2000, the Chinese government approved \$108 million in new investment to the ASEAN region, a 50% jump over 1999. Actual Chinese investment totals are almost certainly significantly higher than Beijing's reported approved investment totals, because Chinese companies increasingly circumvent official foreign-currency controls by investing through offshore entities. See Sadanand Dhume and Susan V. Lawrence, "Buying Fast into Southeast Asia," *Far Eastern Economic Review*, March 28, 2002.