Maximizing Complementarities, Mitigating Competition in ASEAN-China Trade and Investments: A Philippine Perspective

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Introduction

China's emergence as an economic giant during the past quarter century has dramatically changed the global economic landscape, particularly in East Asia. Between 1995 and 2004 China's economy grew by an average of 9.1 percent (Table 1) and as of 2005 it ranked second to the US in terms of gross domestic product (GDP) measured in purchasing power parity dollars (PPP$).

Table 1. Gross Domestic Product in Six Large Economies

Economy	Average real growth rate	GDP in PPP$	Rank
	1995-2004	2005	2005
China	***9.1***	***8,572,666***	***2***
India	6.1	3,815,553	4
United States	3.3	12,409,465	1
Japan	1.2	3,943,754	3
Germany	1.5	2,417,537	5
Brazil	2.4	1,627,262	9
Philippines		408,637	24
World	3.0		

Source: Table 1.1 of Winters and Yusuf (2006), World Development Indicators database, World Bank

China's global presence is largely felt in manufactured exports (Table 2). During the past twenty-five years the share of China in global manufactured exports increased tenfold and its share of global manufactured imports increased six-fold. As of 2004, China has overtaken Japan in the area of trade in manufactures. The reasons for China's phenomenal growth have been described and analyzed by many experts and are not central to this paper.[2]

Table 2. Share in Manufactured Exports and Imports

	1980		**1990**		**2004**	
	Exports	Imports	Exports	Imports	Exports	Imports
China	0.8	1.1	1.9	1.7	8.3	6.3
US	14.0	15.3	12.4	15.8	9.6	17.3
Japan	8.2	8.5	9.1	4.3	6.6	5.2

Source: Tables 2.1 and 2.2 of Yusuf, Nabeshima and Perkins (2006), Comtrade database.

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[2] For example, see Lall and Albaladejo (2004) and Winters and Yusuf (2006).

This paper examines the adverse and beneficial effects of China's meteoric rise on the economies of Southeast Asia. The analysis then looks at how the adverse effects can be mitigated and how the gains can be maximized, with focus on the Philippines.

China as a Threat

Mainly supported by cheap but productive labor, a huge and diversified industrial sector, a large stock of technical manpower, freer access to the world market and great attractiveness to foreign investors, the burgeoning exports of China has led to apocalyptic vision of losses by its neighbors (Lall and Albaladejo 2004). In particular, neighbors who rely on the same low wage structure for competitive advantage have felt most threatened while prophecies of doom have also been made for more advanced economies like Singapore and Taiwan as China's production is expected to shift into higher level of the production chain.

Taking the Philippines as a case study, four main reasons are cited why China is a threat:

a) China produces cheap commodities which have flooded the Philippine market, resulting in the demise of local firms and loss of employment opportunities.

b) Lower priced Chinese commodities directly compete with Philippine goods in the international market. Specifically traditional goods like garments will find their way in the American, Japanese and European markets while the non-traditional goods will gain ground in the Middle Eastern market.

c) China has been a favored destination for FDI, attracting 22 percent of investment flows into developing economies in 2005 and 8 percent of world FDI inflows.[3]

The threat of competition from China on Philippine exports is considered first. Data shown in Table 3 indicate that China virtually exports none of the top two Philippine export commodities. This advantage may vanish once China's industrial structure becomes more sophisticated. Hence, the Philippines has to exert effort to maintain this advantage and at the same time diversify into other commodities. This, of course, is easier said than done. This issue will be discussed in more detail in a later section.

As for the deluge of Chinese goods into the Philippines and other ASEAN countries, data from the ASEAN Secretariat show a trade surplus in Brunei Darussalam, Indonesia, and the Philippines in recent years. Other countries, however, have a variable but growing trade deficit. The overall deficit in ASEAN trade with China totaled \$3.8 billion in 2000 and \$9.6 billion in 2005.[4] The latter figure is less than 2 percent of combined GNP of the 10

[3] Based on data from UNCTAD 2006 World Investment Report.
[4] This part was lifted from Thitapha Wattanapruttpaisan "ASEAN-China Partnership: A blossoming relationship". Bangkok Post 5 October 2006.

member countries.

Table 3. How Does China Fare with Regard to Top Philippine Exports?				
	Philippines		**China**	
Top Philippine Exports 2003	Value ($M)	Share (%)	Value ($M)	Share (%)
Electronic microassemblies	10145	28	263	.06
Monolithic integrated circuits, nes	3146	8.7	0	0
Parts&accessories of automatic data processing machines&units thereof	2647	7.3	18228	4.2
Computer data storage units	2260	6.2	5766	1.3
Source of Basic Data: PCTAS				

In terms of foreign investment, China has indeed attracted the bulk of FDI flowing to developing economies, almost doubling its share of FDI stock between 1990 and 2000. However, attributing the poor FDI performance of the Philippines to crowding out by China is rather simplistic. The more important question is why the Philippines has not attracted as much FDI as its ASEAN neighbors. For example, a total of $5.1 billion flowed into Viet Nam from 2003-05 compared to only $2.3 billion for the Philippines.

The literature points to the following factors as some of the most important determinants of FDI—market and political factors like market size and level of real income, worker skill levels, availability of infrastructure and other resources that facilitate efficient specialization of production, trade policies, and political and macroeconomic stability (Blomström and Kokko 2003). Compared to Singapore, Thailand, Malaysia, and even Indonesia and Viet Nam, the Philippines lags in many of these aspects.

Table 4. Stock of Inward Foreign Direct Investment			
	1990	**2000**	**2005**
World ($M)	1,789,303	5,802,991	10,129,739
Developing ($M)	370,314	1,756,452	2,756,992
Share of total (%)	11.6	30.3	27.2
China ($M)	20,691	193,348	317,873
Share of world (%)	1.2	3.3	3.1
Share of developing (%)	5.6	11.0	11.5
Philippines ($M)	3,268	12,810	14,028
Source: UNCTAD 2006 World Investment Report			

China as an Opportunity

China's economic threat in the area of the trade seems to be exaggerated. Its rapid economic growth may actually be a boon for developing countries. This is succinctly explained by Dimaranan, et al (2006):

> "…three recent developments have the potential to at least attenuate these stark scenarios of relentless competition. One is the rise of two-way trade in manufactures, which makes the recipient the beneficiaries of improvements in efficiency in their trading partners. Another is the growth of global product sharing, where part of the production process is undertaken in one economy, and subsequent stages are undertaken in another. This process, fuelled by improvements in transport and trade facilitation, and in communications, and frequently involving foreign domestic investment linkages, makes participants in this process beneficiaries from, rather than victims of, improvements in the competitiveness of their partners. A third is recognition that trade expansion does not typically involve more increases in the volumes of exports of products currently exported to existing markets. Rather, developing countries typically expand the range of products they export, improve product quality, and export to additional markets as their exports grow."

Data in Table 5 show that trade of the larger ASEAN countries with China has been growing rapidly between 1995 and 2004. This is true likewise for Japan. The trend reflects the impact of the "rise of two-way trade in manufactures" and the "growth of global production sharing". The rise in electronics exports of the Philippines to China (Table 6) is evidence that the latter's economic growth has benefited the manufacturing sector of the Philippines.

Table 5. Share of China in ASEAN 5 Exports and Imports (%)

	1995		**2000**		**2004**	
	Exports	Imports	Exports	Imports	Exports	Imports
Indonesia	3.8	3.7	4.5	6.0	7.3	8.8
Malaysia	2.6	2.2	3.1	3.9	6.7	9.9
Philippines	1.2	2.3	1.7	2.3	6.7	6.0
Singapore	2.3	3.2	3.9	5.3	8.6	9.9
Thailand	2.9	2.8	4.1	5.3	7.3	8.6
Japan	5	10.7	6.3	14.5	13.1	20.7

Source of basic data: IMF Direction of Trade Statistics (DOTS) CD-ROM, June 2005.

Table 6. Philippine Electronics Exports

Rank	1995		2005	
	Country	Value, $M	Country	Value, $M
1st	USA	1,829	Japan	4,846

2nd	Singapore	640	Netherlands	3,531
3rd	Thailand	597	**China**	**3,502**
4th	Japan	563	USA	3,362
5th	UK	503	Hong Kong	2,855
Total value of Electronic exports		**5,834**		**27,299**
Source: National Statistical Office				

Meanwhile, policy makers in the Philippines should carefully review the country's industrial policy following recent findings that economic diversification leads to higher incomes (Rodrik 2004). Diversification would also enable developing countries to take advantage of new export markets. In Table 3, the highest ranking 6-digit export category of the Philippines comprises 28 percent of total exports. In the case of China, the highest ranking 6-digit category is "Parts & accessories of automatic data processing machines & units thereof " and as shown in the table, it comprises only 4.2 percent of total exports.

The other area which provides great opportunity for ASEAN countries is investment. For example, Filipino investments are contracted in China specifically in the areas of real estate which includes resorts, shops, and villas; commerce such as shopping malls; and manufacturing such as brewage, glass and chemical fiber. Investments in financial services are similarly expanding with the establishment of Philippine Metro Bank in Xiamen and Beijing.

More importantly, China is slowly emerging as a major source of FDI and foreign aid in Southeast Asia.[5] Data in Table 7 show that there was a surge in outward FDI from China in 2005. Meanwhile, China's FDI to ASEAN rose from $137 million in 1995 to $226 million in 2004 although this is a small share of the $25 billion investment into ASEAN in 2004.[6] A few months ago, the Philippine government announced a package of $2 billion every year for the next three years from China's Exim Bank. This has been earmarked to support the ambitious infrastructure program laid out by President Macapagal-Arroyo in her 2006 State of the Nation Address.

China's eagerness to help its neighbors in their economic development has led some analysts to suggest that it is reviving Ancient China's tributary system which was started under the Ming Dynasty and perfected under the Qing (Cheow 2003). The basic idea then was that the Chinese Emperor would give more favors to the tributary states or kingdoms than he would receive from them. For this generosity the Chinese emperor would get their respect and goodwill and it also helps China establish its external security environment. Whether this is an emerging trend and how it affects the geopolitical balance would be an interesting issue to monitor.

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[5] See for example Jane Perlez "China Emerges as Major Player in Asian Aid", International Herald Tribune September 18, 2006,

[6] Data was obtained from the ASEAN Secretariat Website.

Table 7. FDI Outflows ($M)			
	2003	2004	2005
World	561,104	813,068	778,725
Japan	28,800	30,951	45,781
Developing	35,566	112,833	117,463
China	-152	1,805	11,306
Hong Kong	5,492	45,716	32,560
Korea	3,426	4,658	4,312
Source: UNCTAD 2006 World Investment Report			

The third area where cooperation with China provides a valuable opportunity for ASEAN is regional economic integration in East Asia. In this context, an important argument is that the primary objective of efforts toward greater economic integration is political in nature but the economic windfall from these political gains is substantial (Yap 2005). For example, a free trade agreement (FTA) among countries in the region will boost the political bargaining power of the countries involved by signaling they have agreed to band together to pursue common interests. Having China on its side will definitely enhance the political stature of ASEAN and vice-versa. One area that can be revived through advocacy by a China-ASEAN front is the reform of the international financial architecture. Efforts toward such measures were regrettably sidelined by indifference of the US Treasury.

Another important area that could be addressed jointly is the trans-Pacific macroeconomic imbalance. Currently, the policy proposals to correct this imbalance that is played up in the media is focused on revaluing East Asian currencies, particularly the yuan. A united East Asian front could throw its weight towards a solution that emphasizes fiscal consolidation by the US, which makes more economic sense. For example, imposing a 50 percent fuel tax in the US will address many outstanding problems: 1) the surge in international fuel prices and depletion of oil reserves; 2) instability of international capital flows; 3) the US fiscal deficit; and 4) the trans-Pacific macroeconomic imbalance itself.

But this still begs the question of how to secure these political gains since it is likely that establishing a region-wide FTA—or closer economic integration in general—and actually securing political gains will both require political rapprochement, especially among the "plus three" countries. This is similar to the view that East Asian countries still lack sufficient political will to promote economic integration (Wang 2005). The essential issue then becomes how to achieve political rapprochement or political reconciliation, or how to build the political will. The road towards this state of affairs definitely goes through China.

Maximizing Complementarities

The role of China in shaping global events is more prominent than ever, and expected to continue in the coming years. With the most direct impact notable on trade and investment activities, China's development will almost certainly change the global environment and affect other countries, be it small or big, in their economic decisions. Countries will respond depending on their incomes and resources as these are the primary determinants of interaction in the world economy. A country with a healthy investment climate, sound infrastructure and deep human resources will mostly likely weather the competitive pressures mounted by China (World Bank 2006).

The foregoing discussion yields important message. The Philippines—and other ASEAN member countries for that matter—has to set the conditions for faster economic growth in order to take advantage of the opportunities provided by China's emergence as an economic superpower. This argument of course extends to the opportunities provided by globalization. The Philippines cannot afford to miss this opportunity as it did in the 1980s when Japan sharply increased its outward FDI. Many of the conditions necessary to benefit from China's economic expansion are internal in nature. This would include providing better conditions for domestic and foreign investors, a more strategic and coherent industrial policy, and better governance. The latter is particularly necessary in order that the huge ODA inflows will be effectively and efficiently utilized.

Domestic Reform Measures[7]

Significant strides have been achieved in integrating the Philippines in the global economy as a result of economic reforms undertaken in the past decade. However, there are still much to be done in order for these reforms to translate into effective measures for development.

For example, trade and industrial reforms have been inadequate in fueling faster GDP and employment growth and economic transformation in the Philippines as shown by data in Table 8. Compared to China, Indonesia, Korea, Malaysia, and Thailand, the share of manufacturing value added in the Philippines is lower in 2002. Moreover, the share actually fell between 1990 and 2002 in the Philippines while it increased in the other countries.

The structure of domestic manufacturing value added and manufactured exports is quite revealing. The Philippines has the highest share of medium-or-high technology products in manufactured exports among these counties in 2002. However, it also has the lowest share in terms of domestic manufacturing valued added in the medium-or-high technology sectors. The variance indicates a dichotomy between the domestic manufacturing sector and export sector. Unless these sectors are integrated, the Philippines may not sustain its technological advantage over China—as reflected in Tables 3 and 8—in the export sector.

[7] Lifted from Balboa, Medalla, and Yap (2006).

Table 8. Indicators of industrial performance (1990 and 2002)

	Share of manufacturing in total output (GDP) (percent)		*Share of manufacturing in total exports (percent)*		*Share of medium-or-high-technology production in MVA (percent)*		*Share of medium-or-high-technology products in manufactured exports (percent)*	
	1990	*2002*	*1990*	*2002*	*1990*	*2002*	*1990*	*2002*
China	33.1	34.5	76	91.6	51.6	57.3	34.4	45.6
Indonesia	20.7	27	58.6	76.9	30	43.4	10.5	31.3
Japan	26.5	25	97.5	93	66.5	68.1	83.9	86.3
Korea, Republic of	28.8	33.9	96.2	96.5	55.1	64.1	52.9	70.6
Malaysia	26.5	35.9	78	93.3	52.3	65.1	50.6	76.2
Philippines	24.8	24.2	52.7	96.2	31.2	38.3	30	81.8
Singapore	28.6	28.2	93.2	96.8	78.8	87.6	62.3	78.9
Taiwan Province of China	32.7	28.1	95.8	98.3	52.2	58.6	51.6	71.2
Thailand	27.2	33.6	80.6	87.4	23.7	42.6	33.3	60.3

Source: UNIDO Industrial Development Report, 2005

What are the major factors that have prevented the Philippines from maximizing its gains from globalization? A number of these factors can be traced to policy shortcomings, foremost of which are:

1. Low investments in infrastructure – According to World Bank estimates, a middle income country in East Asia will need to spend at least 5 percent of GDP on infrastructure to meet their needs in the next 10 years. Infrastructure expenditures in the Philippines is much below this benchmark as it only accounts for 2.8 percent of GDP. In addition, resource allotted for infrastructure development is also spent inefficiently. Infrastructure improvements are necessary to improve economic performance of the country as it would attract more investments and reduce production costs. The lack of infrastructure program is largely related to the fragile fiscal situation of the government.

2. Lack of political will to implement a sustained and credible fiscal reform program – Weak fiscal institutions created policies that increased debt burden and inherently put bias to deficit-spending. They are also responsible for the fiscal blunders created such as politicized spending and delayed fiscal consolidation during crises. Fiscal reforms, to be effective, should aim at creating stronger fiscal institutions that adhere to rules and do not easily give in to populist demands. Reforms should also create accountable and more transparent institutions that will implement the revenue generation programs and include capability enhancement measures to reinforce technical capacity of these institutions to fully mobilize revenues for the country's needs (Canlas 2005).
3. High Transaction Costs – Transaction costs refer to market-related

infrastructure, facilities and services needed to conduct business. It also includes costs in acquiring information and exchanging information in transactions and contract enforcement. If transaction costs are high, these become a disincentive to the producers to participate in any market exchange. It has been argued that the relatively poor performance of Philippine export may be explained by high transaction costs in the country rather than market access issues. Logistical cost disadvantages hindered domestic industries from taking the full benefits of trade liberalization and discouraged foreign investors to consider the Philippines in their production and logistical networks.

4. Lack of a coherent industrial policy – This is an area that has been overlooked because of the controversy it generates. However, recent work has attempted to provide a pragmatic approach that eschews ideological prescriptions and instead looks more closely at historical experience (Rodrik 2004, Hausmann and Rodrik 2006). The basic argument is that industrial policy is as much about eliciting information from the private sector on significant externalities—primarily information and coordination externalities—and their remedies as it is about implementing appropriate policies. However, the capacity to apply industrial policy is also important, which leads to the importance of governance and institutions. Since 1972, Philippine economic managers followed a program that largely mimicked the Washington Consensus and did not allow for strategic intervention on the part of the government.

5. Low priority given to basic social services – Effective delivery of basic social services is the most cost-effective way of combating poverty and inequity. At the World Summit for Social Development held in Copenhagen in 1995, the 20/20 Initiative was crafted. This Initiative proposed that in order to achieve universal coverage of basic social services, 20 percent of budgetary expenditure in developing countries and 20 percent of aid flows should on average be allocated to social services. Basic Social Services account for only 8.6 percent of the Philippine national budget in contrast to the combined debt service and defense budget which account for 40.6 percent of the national budget. Greater social spending also implies a higher level of education, which is necessary to encourage FDI and enhance the technological capability of the economy.

There were also gaps in the implementation of reforms and this is related to failure to address issues in good governance. This focuses on anti-corruption initiatives and institutionalization of corporate governance practices. The Philippines has always been cited as a country whose potential for growth has been eroded by corrupt institutions. In 2005, it ranks 117th in Transparency International Survey of countries with the least corrupt government. According to World Bank figures, 20 percent of annual government budget is lost to corruption. This is equivalent to 3.8 percent of the GNP at an average.

It is of utmost importance that measures to curb corruption are undertaken. Acorruption strategy should be reinforced by a committed leadership and able management skills to implement the programs and sustain the progress made. Continued reengineering of the bureaucracy is necessary, with reforms focused not only on achieving efficiency and effectiveness, but also instilling a culture of adherence to rules (Balboa and Medalla 2006).

Maximizing Gains from the China-ASEAN Free Trade Area

The significant outcome of China's liberalization policy is increased market access. In the ASEAN region, it entered into various trade agreements with a commitment to open its doors to foreign players through lower trade barriers. One of the major agreements is the China-ASEAN Free Trade Area (CAFTA) which is considered to be the biggest free trade area involving 1.7 billion consumers and a trade value of approximately $1.2 trillion. The agreement involves 10 nations with the goal of deepening regional integration, reducing dependence on the US market and sustaining Asia as a choice investment destination.

The formulation of CAFTA began in 2001 with efforts to establish a bilateral free trade area between ASEAN and China by 2010. The following year, the Framework Agreement on Comprehensive Economic Cooperation was signed to form the free trade area between China and ASEAN6 by 2010, and China-ASEAN4 by year 2015.

In the Philippines, the Early Harvest Program under CAFTA took effect after Executive Order No. 485 was issued on 29 December 2005. The program, mainly covering agricultural products, effectively eliminated tariffs on 214 tariff lines on goods coming from China. There will be reciprocal action to the benefit of ASEAN. The year 2006 is the actual implementation of the normal track for the free trade with the following tariff conditions;

As earlier argued, an FTA's primary benefit is that it pushes countries closer towards greater political harmony. This should make member-countries more mindful of the development gap in the region. However, the bigger task is to build political rapprochement in the East Asian region. This issue is beyond the scope of this paper.

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