

China's Economic Ties with Southeast Asia

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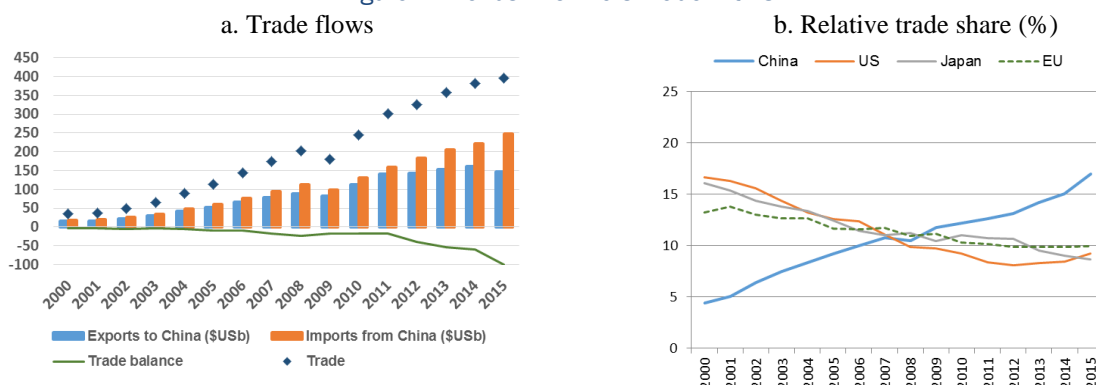
I. Introduction

In the past decade, China has emerged as a key partner of Southeast Asia (SEA) across trade, investment, and infrastructure development. Southeast Asian economies have significantly benefited from the strong economic growth of China over the years, both from high commodity prices driven by strong demand in China and an expanding regional production network where China plays the role of an important processing hub. However, the resulting dependency on China has created a wide range of political and economic vulnerability for regional economies.

II. China's Trade with Southeast Asia

Bilateral trade reached \$395 billion in 2015, accounting for 15 percent of SEA's external trade and making China the region's top trading partner. China became SEA's most important trade partner in 2009 after the global financial crisis, yet the trends for the last 15 years clearly show that China's share has risen constantly whereas the shares of SEA's traditional partners, such as US, EU, and Japan have been on a steady decline (Figure 1). Amid a marked expansion of bilateral trade, Southeast Asia's trade deficit with China is rising fast since 2011. This coincides with the ASEAN-China Free Trade Area (ACFTA) entering into force and the onset of the new wave of investment in the region's electronics sector, especially in Vietnam, which increased the region's imports of intermediate inputs and capital goods from China.

Figure 1. Trends in China's Trade with SEA

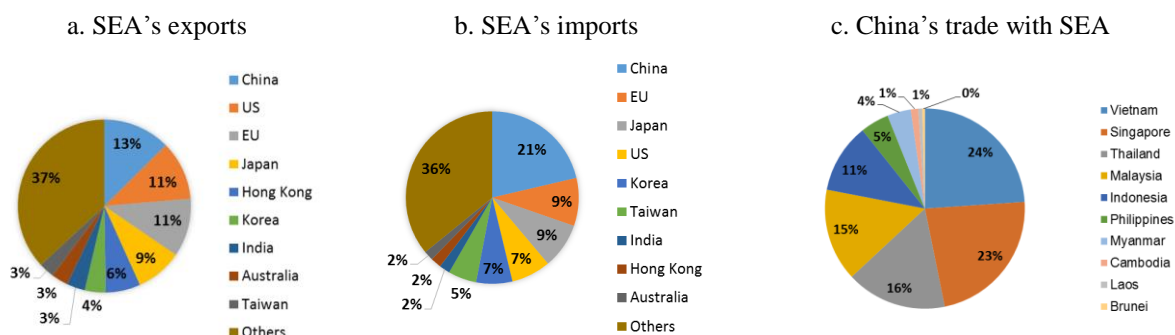


Source: IMF DOTS

This brief is based on the report, *China and Southeast Asia: Expanding Economic Engagement*. See references for further information.

Although China is SEA's top export market, its share is more or less comparable to the other top three destinations: US, EU and Japan (Figure 2). In contrast, China is the overwhelmingly largest import partner for SEA, accounting for 21 percent. As we will see later, the region's imports from China not only include consumer products but to a larger extent intermediate goods for the regional production network. China's largest trade partner in SEA is Vietnam, which accounts for 24 percent of its total regional trade. Given that Singapore, the second largest partner, is a regional hub for trans-shipment and re-export, Vietnam may be more important to China's SEA trade than it appears.

Figure 2. China's Trade Relations with SEA, 2015

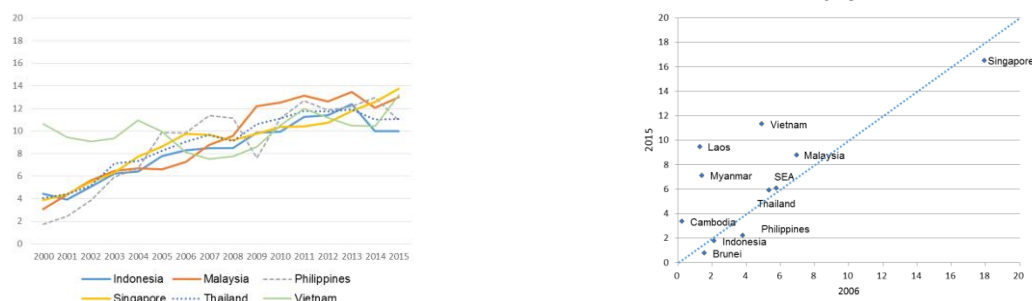


Source: IMF DOTS

Although China is the most important export market for SEA, the cross-country variation in China's share of exports to the total trade is huge. For more developed economies in the region, China's share is concentrated between 10 and 14 percent (Figure 3). For lower-income countries in mainland Southeast Asia, such as Cambodia, Laos, and Myanmar, the variance is huge, ranging from 5 percent (Cambodia) to 38 percent (Myanmar). It is also noteworthy that for most countries in the region, China's share of total trade has been rather stable in recent years. A simple measure of China's share to the country's total export may be misleading since it fails to account for the importance of exports to the country's economy. Thus, an additional measure of export exposure can be calculated where export dependency on a certain country is standardized by its export-to-GDP ratio. This lowers China's share for most countries significantly except for Singapore (Figure 3.b). It also shows that between 2006 and 2015, export exposure to China has risen for Vietnam, Laos, Myanmar, Cambodia, and Malaysia, whereas the average for SEA has remained relatively unchanged.

Figure 3. SEA's Export Dependency on China

- a. ASEAN-6's export dependency on China (%) b. Changes in SEA's export exposure to China, 2006 and 2015

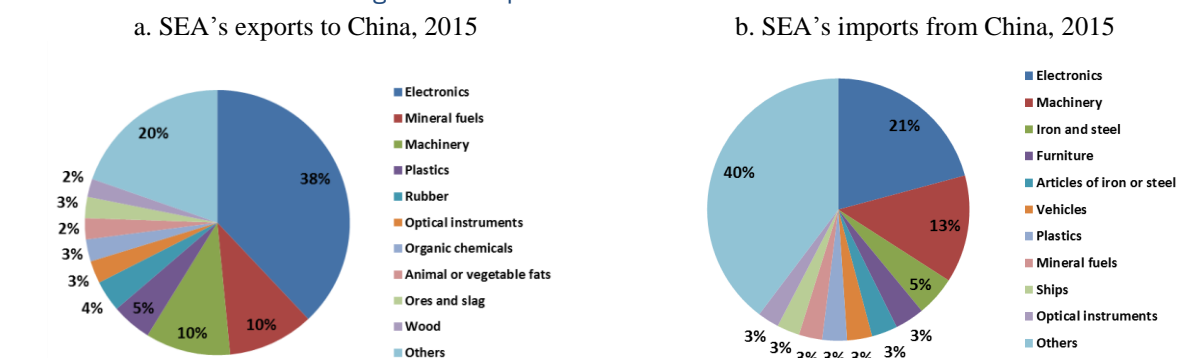


Source: IMF DOTS

III. Global Value Chains across China and Southeast Asia

SEA's trade with China is dominated by electronics and machinery in exports and, to a less extent, imports, suggesting high levels of intra-industry trade (Figure 4). These two sectors account for 48 percent of SEA's exports to and 34 percent of its imports from China in 2015. The exceptionally high shares of electronics and machinery are the result of an extensive regional production network established across East Asia where China is the processing hub for final destinations, although these patterns are changing fast due to China's technological upgrading.

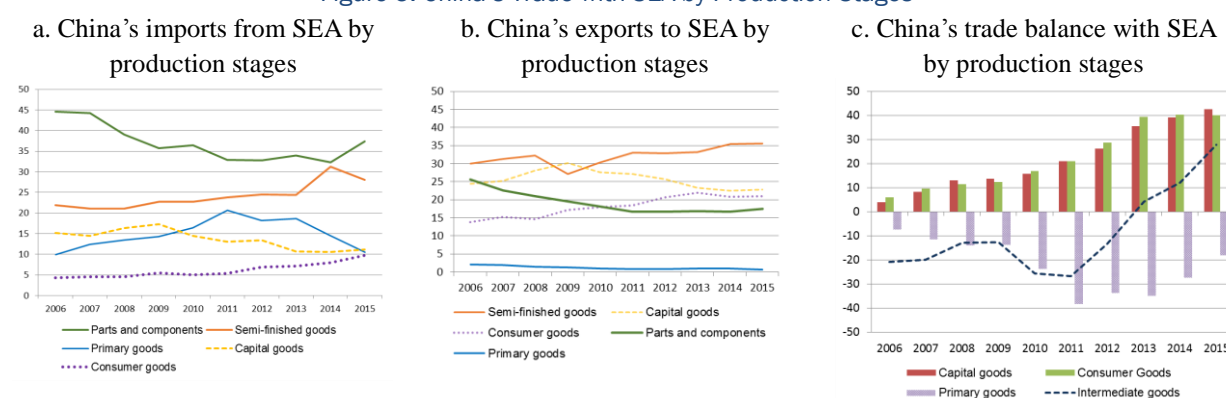
Figure 4. Composition of SEA's Trade with China



Source: UN Comtrade

A more detailed examination into SEA's trade with China by stages of production reveals further patterns. Intermediate goods account for more than 50 percent of both SEA's exports and imports with China. Among intermediate goods, the shares of semi-finished goods have risen in both SEA exports to and imports from China (Figure 5). At the same time the shares of parts and components, which usually are higher value-added than semi-finished goods, have declined in both directions. This may suggest that China may be producing more parts and components domestically, thus relying less on imports. China now has a strong electronic components industry, especially for commonly used and medium- and low-end components. On the other hand, the decline of parts and components of Southeast Asia's imports from China also suggests that Southeast Asian economies may be sourcing them domestically or diversifying imports of parts and components away from China. The trends over the last few years show that SEA now has a trade surplus with China only in primary goods. The region's trade balance in intermediate goods turned to a deficit in 2013 (Figure 5.c).

Figure 5. China's Trade with SEA by Production Stages



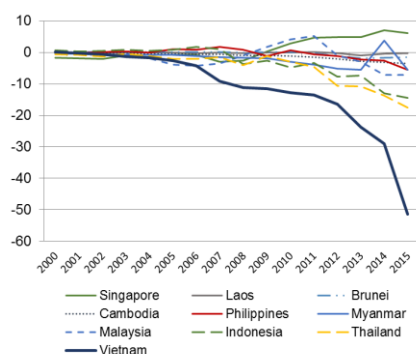
Source: UN Comtrade

Note: Intermediate goods consist of semi-finished goods and parts & components.

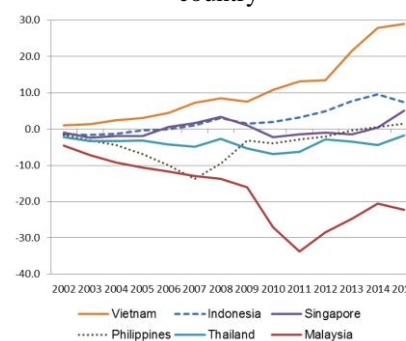
Vietnam plays an increasingly important role in SEA's regional production network. It has not only emerged as the largest SEA trading partner for China in the region but also accounts for almost half of SEA's trade deficits with China as of 2015. In fact, SEA's increasing trade deficit with China over the recent years has been largely driven by Vietnam (Figure 6.a). Vietnam's trade deficits are most pronounced in intermediate goods, which reached almost US\$ 30 billion in 2015 (Figure 6.b). Only Malaysia maintains a substantial trade surplus in intermediate goods with China, which is largely credited for its strong semiconductor exports.

Figure 6. SEA's Trade Balance with China

a. SEA's trade balance with China by country



b. China's trade balance in intermediate goods by country



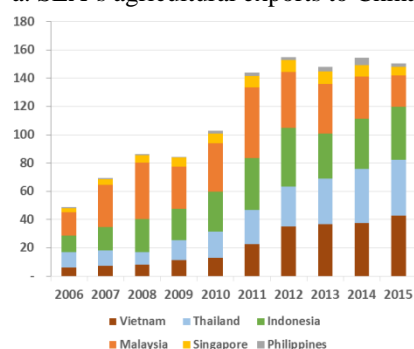
Source: UN Comtrade

IV. Agricultural Exports to China

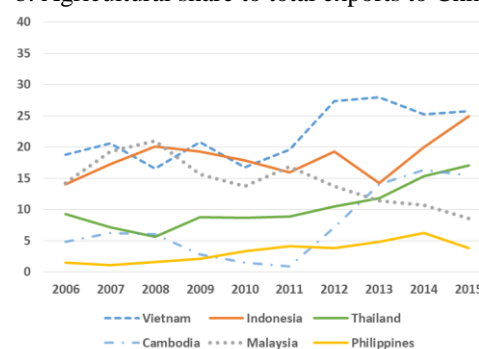
Although smaller in share to the total trade, agriculture is a strategic area for bilateral economic relations, especially in the form of Southeast Asian agricultural exports to China. Agriculture is a critical sector for most Southeast Asian countries, with a large share of employment and major political importance. With the demand for food rising rapidly, China's food imports from and investment in the agricultural sector of Southeast Asia is likely to increase. This creates both market opportunities and challenges of unpredictable external factors for the region's countries. Vietnam and Thailand are the largest exporters of agricultural and food products to China, accounting for almost half of the region's exports. Indonesia and Malaysia come in next, yet their primary exports are palm oil and related products.

Figure 7. SEA's Agricultural Exports to China

a. SEA's agricultural exports to China



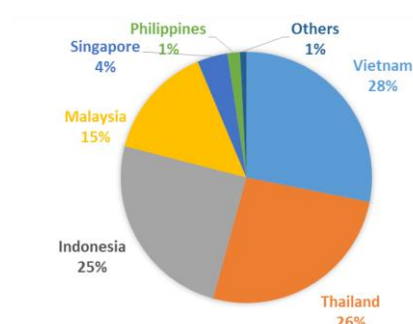
b. Agricultural share to total exports to China



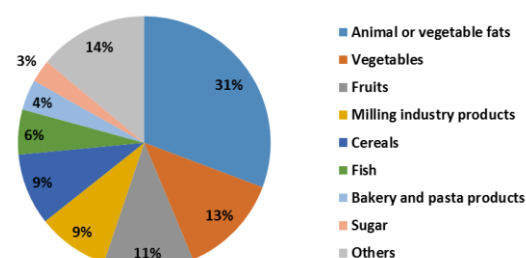
Source: UN Comtrade

Figure 8. Composition of SEA's Agricultural Exports to China, 2015

a. SEA's agricultural exports to China by country



b. SEA's agricultural exports to China



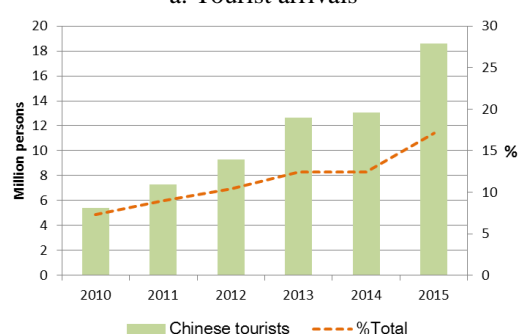
Source: UN Comtrade

V. Trade in Services: Tourism

When it comes to trade in services, tourism is one of the key sectors for China and Southeast Asia. China now accounts for 17 percent of tourist arrivals in SEA, and Thailand has emerged as the top destination in recent years (Figure 9). As of 2013, 33 percent of Chinese tourist arrivals in SEA was concentrated in Thailand, followed by Vietnam (15%) and Cambodia (14%). For Thailand, a 2016 figure shows that Chinese tourist arrivals reached about 8.8 million, with this accounting for 27 percent of total tourist arrivals. The growing number of Chinese tourists to Southeast Asia has created a tourism boom in local economies, but has also presented risks as well as challenges.

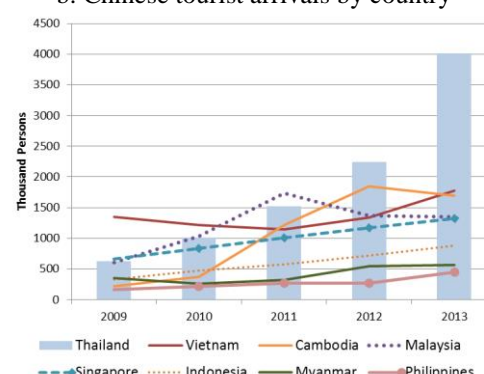
Figure 9. Chinese Tourist Arrivals in SEA

a. Tourist arrivals



Source: ASEAN Tourism Statistics Database

b. Chinese tourist arrivals by country



Source: CEIC

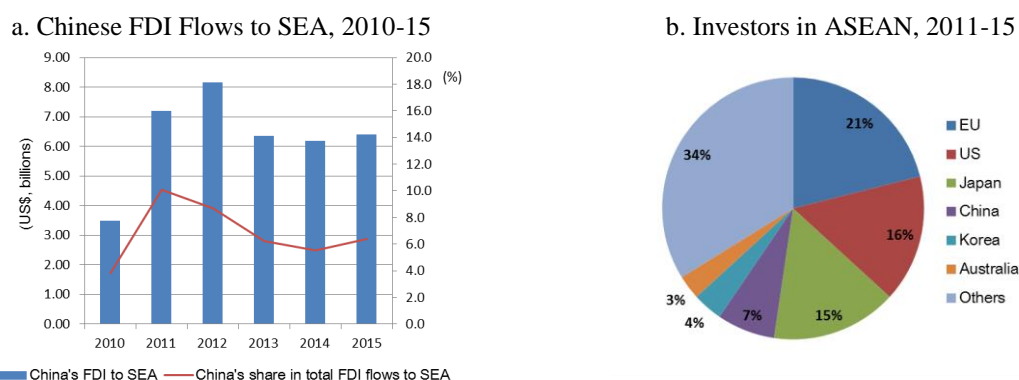
VI. Chinese FDI in Southeast Asia

China's FDI in Southeast Asia is growing fast from a low base. Its FDI flows to the region reached \$6.4 billion in 2015 (Figure 10).¹ China is the fourth-largest investor in Southeast Asia, following the EU, Japan, and US, although it only accounts for 7 percent of SEA's inbound FDI flows in 2011-2015. The growth rate of Chinese FDI in SEA is higher than the top three investors but it will take some time for China to match the others. Its FDI in the region rose sharply after the global financial crisis but has contracted in most countries since 2013 except for Vietnam. Singapore is the top destination for Chinese FDI in the region (Figure 11.a). The relative importance of Chinese FDI varies significantly across countries, depending on their level of economic development.

¹ Significant discrepancies exist among various sources of data for Chinese FDI in SEA. For instance, the gaps between China's outbound FDI to the ASEAN, as released by the Chinese Ministry of Commerce (accessed through CEIC for this analysis), and ASEAN's inbound FDI from China released by ASEAN governments, are significant for 2015 data. Even between ASEAN sources, the figures differ between the ASEAN Investment Report and online ASEAN Statistical Database.

While China is not a dominant investor in the wealthier countries of the region, its presence is indeed overwhelming in lower income countries.

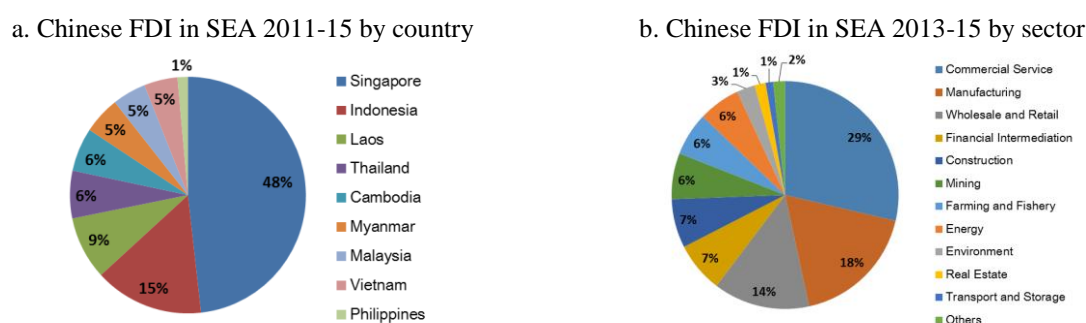
Figure 10. Chinese FDI in Southeast Asia



Source: ASEAN Secretariat Database

The sectoral distribution of Chinese FDI in SEA suggests that manufacturing, retail, finance are important sectors (Figure 11.b). Yet this information should be examined with caution. The largest sector appears to be commercial services linked to offshore financial centers such as Singapore where second-stage investments are common. It should also be noted that the sectoral distribution according to the data released by ASEAN Database differs from what is calculated by using data from the Chinese Ministry of Commerce as in Figure 11. China's investment in manufacturing is limited compared to other investor countries in SEA, but the share of manufacturing to its regional investment is still much larger than its investment in Africa and Latin America, which tends to be concentrated in natural resources and construction. With labor costs rising and competition becoming fierce in domestic markets, Chinese manufacturing firms are relocating to or expanding in SEA. The Thai-Chinese Rayong Industrial Zone in Thailand and the Sihanoukville Special Economic Zone (SEZ) in Cambodia are considered success cases of China-led SEZ development in SEA. Chinese private companies, especially in the garment and footwear sector, are well represented in these SEZs and could lead to the next phase of China's economic engagement with SEA with China-led regional production networks.

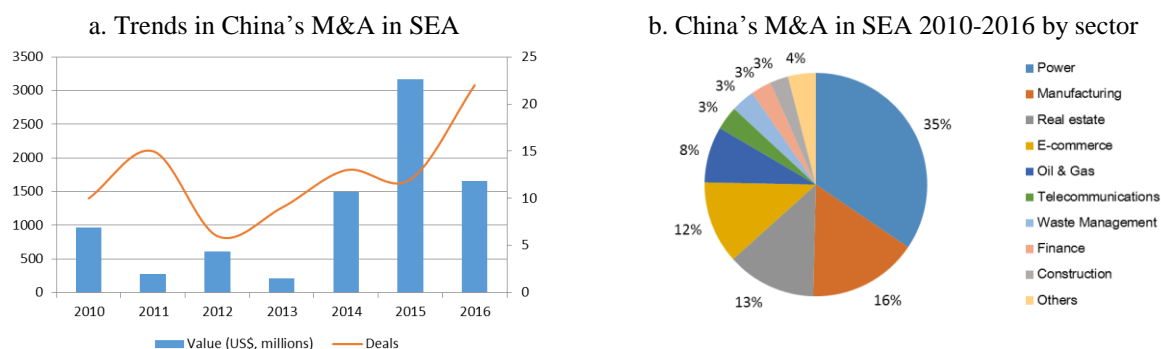
Figure 11. Composition of Chinese FDI in SEA



Source: CEIC

China's mergers and acquisitions in Southeast Asia are heavily concentrated in three countries: Singapore, Malaysia and Indonesia (Figure 12). In 2010-2016, the majority of its M&A deals took place in the power sector (35 percent), but China also acquired SEA companies in manufacturing (16 percent) and real estate (13 percent). Recent mega deals include Alibaba acquiring a majority stake of Lazada, a Singapore-based e-commerce company, for \$1 billion in 2016, which further diversified the industries for China's M&A investment in SEA.

Figure 12. China's M&A in SEA



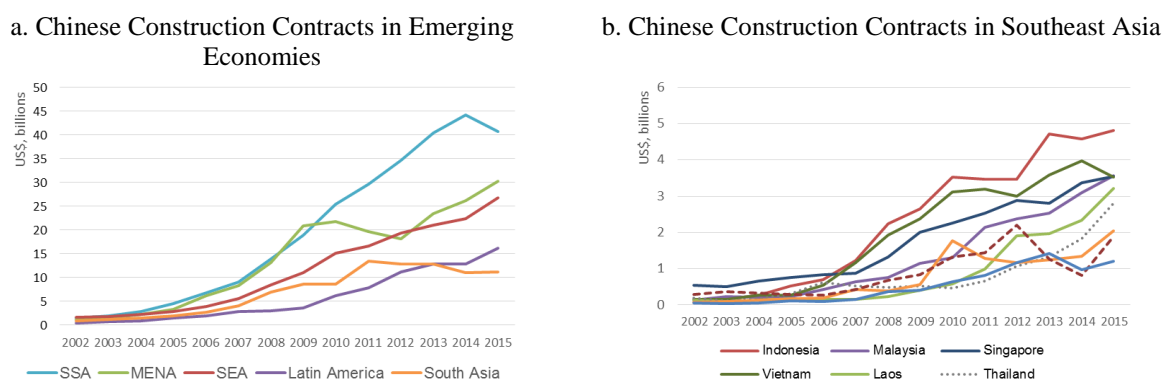
Source: Thomson Reuters Eikon

VII. China's Infrastructure Development in Southeast Asia

Infrastructure development is the most visible area of China's rising economic influence in Southeast Asia. Inadequate infrastructure is the major obstacle to accelerated and sustained economic growth in the region. China's infrastructure development initiative provides a new and unprecedented momentum for tackling this challenge. China is implementing large-scale development projects under the Belt and Road Initiative in transport and energy infrastructure and developing special economic zones across the region. For instance, China is building high-speed rail lines in Laos and Indonesia and negotiating one with Thailand as part of the "Pan-Asia Railway Network," also known as the "Kunming-Singapore Railway." This is an ambitious regional transport infrastructure project proposed two decades ago by Southeast Asian governments but now taken up by China. Despite high costs and substantial financial risks, if completed, it could integrate China's Southwest with mainland Southeast Asia to an unprecedented degree. The Asian Infrastructure Investment Bank, formally proposed in 2013 and established in 2015, is a major instrument for China's Southeast Asia strategy focused on infrastructure development in wider region. Yet China faces considerable risks in its infrastructure investments in SEA. It should be remembered that infrastructure gaps remain large in the region due to the poor business environments that made private investors, both domestic and international, reluctant to make risky investments. The challenge for China is whether it can overcome such obstacles.

As a proxy for China's infrastructure development, its overseas construction contracts statistics show that SEA is the major region for China's infrastructure projects (Figure 13.a), and its construction activities are on a rapid rise in most SEA countries (Figure 13.b). It is interesting to note that the only country in the region where China experienced sudden fall in its construction activities is Myanmar, where a civilian government upon coming to power in 2011 made major foreign policy changes to its China policy.

Figure 13. Chinese Overseas Construction Activities



Source: CEIC

Note: SSA for Sub-Saharan Africa, MENA for Middle East and North Africa

Source: CEIC

VIII. Conclusion

The next phase of China's engagement with Southeast Asia will depend on its investment in manufacturing. The extent to which China, especially its private companies, invests in the region's manufacturing will have a large impact on Southeast Asia's development. China's investment in the manufacturing sector of Southeast Asia is limited compared to other investor countries, but it is on the rise. Although China's state-owned enterprises (SOEs) and policy banks are capturing global attention with their large infrastructure projects and massive loans, it may be Chinese private companies who will play a more important role in transforming the regional economic relations. China used to function largely as a major processing hub in the global value chain but has increasingly expanded into the role of a supplier of intermediate inputs for assembly operations in other developing economies. It may also be moving toward establishing its own production chains led by Chinese lead firms.

External partners need to respond to the changing economic landscape in Southeast Asia proactively and constructively. China's deeper engagement in Southeast Asia may place competitive pressures on other foreign businesses and development partners, yet this may create expanded market opportunities and better infrastructure for everyone. External partners also need to pay greater attention to labor and environmental standards compliance in its FDI and infrastructure development in the region, taking lessons from some of the backlashes against China's investment activities. Finally, external partners and Southeast Asia should remember that they share mutual interests in diversifying their economic relations away from over-dependency on China, as recent economic and security events have clearly suggested. **KIEP**

References

- Oh, Y., M. Shin, M. Kim, and S. Lee. 2017. *China and Southeast Asia: Expanding Economic Engagement*. KIEP Policy Reference 17-05 (in Korean).