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Special Issue

Great Fall or New Normal: China's Economic Restructuring and its Impact on Southeast Asia

Guest Editors: Zhang Miao and Li Ran

International Journal of China Studies

Notes for Contributors

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International Journal of China Studies
Vol. 8, No. 2, August 2017

Contents

International Journal of China Studies
Vol. 8, No. 2, August 2017, pp. 125-138

Introduction: Southeast Asia and China's Growth Deceleration

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Abstract

Because China has experienced unprecedented growth so high and for so long, its recent growth deceleration has become a subject of intense debate. This debate has pitted proponents of "China Collapse" against those who argue for the country's reversion to more balanced growth. For ASEAN member countries which have become increasingly integrated economically with China, the key question is not the above debate but how severe the impact of this slowdown on them will be. For each country this impact depends on the level of economic development and the precise nature of the bilateral economic relationship. Factors unrelated to China also impact these countries, so that blaming China for any adverse developments would not be fair. But untangling causes is not easy. Equally important to remember is that China's "New Normal" is multi-dimensional and a focus on growth deceleration alone is not helpful. The papers in this Special Issue explore these topics in greater detail.

Keywords: *Economic growth, new normal, China, Southeast Asia*

1. China's Growth Phenomenon and the New Normal

Since Deng Xiaoping liberalized the Chinese economy after three decades of central planning, the dominant story has been its economic growth. This growth has been unprecedented, both in terms of magnitude and longevity. Between 1982 and 2012, its GDP grew at and above 7% per annum,[1] an unbroken spell of 30 years. This performance has been built on trade – over the period 1980 to 2010, China's trade (exports plus imports) as a share of GDP had expanded from 12.4% of GDP to 48.9% before easing a little to 47.7% in 2014. Along the way, it overtook Germany to become the world's largest exporter in 2009 and the US as the world's largest trading nation by 2012 (Bloomberg, 2013).

This growth performance has also garnered much attention, especially in Western intellectual circles, because it is built upon an approach to economic

transition – gradualism – that was not favoured by many scholars (e.g. Sachs, 1992), who put their weight behind the "Big Bang" approach of complete liberalization in a single step. Much to these scholars' embarrassment, China's economic performance stood in stark contrast to that of Russia and many eastern European countries, adopters of the "Big Bang" approach, which saw their economies collapse before recovery.

Yet the longer China's economy continued on its "miraculous"[2] growth path, the greater the consciousness that this growth cannot continue forever. This consciousness has been given substance since 2012, when China's growth rate fell from 9.5% a year earlier to 7.9% and further to 6.9% in 2015. The phenomenon itself acknowledged by the Chinese leadership in its reference to the "New Normal"[3], has generated active debate as to its causes. A "New Normal" refers to China's rebalanced economic growth featured by a slower but more sustainable economic development increasingly supported by technological innovation and industrial upgrading, instead of a miraculous double-digit growth rate largely supported by cheap and abundant labour and use of natural resources in the past decade (Rasiah et al., 2013; Zhang and Chen, 2017).

Growth deceleration has on the one hand been predicted by theories of convergence which hold that as economies develop, their rates of economic growth must inevitably decline, allowing economies further down the development ladder to catch-up (Kerr et al., 1973; Ramesh, 1976). More ominous is the argument based on empirical observation that many middle-income countries never progress beyond middle-income, instead falling into a "middle-income trap" (Gill and Kharas, 2007). This is a result of the country not being able to move up the production value-added ladder to compete with more advanced countries while simultaneously losing comparative advantage at the lower end of the value-added spectrum to countries lower down the development ladder.

An entirely different narrative, though reaching a similar but more extreme conclusion, is that of the eventual collapse of China under a system at variance with Western-style liberal democracy. Although couched under different guises ranging from political repression (Shambaugh, 2015), lack of people's voice (Anderlini, 2013), corruption and poor governance (Acemoglu and Robinson, 2012; Pei, 2015), China's slowdown, it has also been argued presages its eventual collapse.

Whatever the explanation for slowing growth, China's economy has grown so large that any change in its overall growth will impact other economies, with deceleration having likely adverse consequences for the latter as well. China's growth slowdown will mean lower imports from the rest of the world, especially in the form of resources imports. It will also mean that Chinese companies will seek to be more aggressively competitive in global

markets even as the domestic market offers fewer opportunities for growth. Proponents of China collapse may yet see the realization of their prediction, but were this indeed to pass, it would prove to be an empty victory as their economies suffer adverse consequences of China's slowdown.

A change of such magnitude in China's economic growth will undoubtedly impact the rest of the world, including Southeast Asia, which is intensively involved in trade and investment with China in the past decades. What of Southeast Asia, all members of ASEAN is the focus of this special issue, for which almost all countries (Brunei being the exception) count China as the largest source of their imports and a top destination for their exports (Table 1). While the slowdown in trade will surely have an economic impact, the structure of economic relations between each Southeast Asian country and China varies. In addition to this structural factor, contextual factors can also be important. As discussed briefly in the next section, it is difficult to generalize for the whole of Southeast Asia.

2. China's Growth Slowdown and Implications

A number of reasons, both domestic and external, have been advanced regarding China's economic slowdown. Domestically, China's major challenges include the after effects of the massive stimulus of RMB4 trillion that, predicted Roubini (2011), led to China "eventually facing immense overcapacity and a staggering non-performing loan problem" and "… after 2013… suffer a hard landing". Another challenge is rising inequality, the

Table 1 China's Importance in the Trade of ASEAN Countries, 2013

Country	*China's Rank as Export Destination*	*China's Rank as Import Source*	*China's Rank as Trading Partner*[+]
Brunei	>5	4	>5
Cambodia	>5	1	2
Indonesia	2	1	1
Laos	1	2	2
Malaysia	2	1	1
Myanmar	2	1	1
Philippines	3	1	2
Singapore	2	1	1
Thailand	1	2	1
Vietnam	3	1	1

Note: [+] Trade refers to the sum of exports and imports.
Source: Salidjanova and Koch-Weser (2015).

result, according to the World Bank, of the realignment of economic activity away from agriculture and towards industry which rapid urbanization helped accelerate (Sharma et al., 2011, p. 3). Other challenges have also emerged, including "demographic challenges of a low fertility rate and rapid population ageing, income distribution, environmental degradation" and so on (Zhang and Chen, 2017, p. 1).

Of these domestic challenges, there is less of a dispute about their presence than about their severity. China collapse proponents argue that these challenges are so severe as to lead to the end of the present system (Kroeber, 2012).[4] Less extreme pessimists predict a "hard landing" that will see China experiencing a depression (Roubini, 2011). Some seasoned China observers (e.g. Lardy, 2015) are more optimistic, arguing that China's "economy can weather a long, slow fall" (Knowledge@Wharton, 2014).

Whatever the pessimists predict, the Chinese leadership (Tiezzi, 2015) for its part, saw the slowdown more as an opportunity to "rebalance" the economy. This rebalance would certainly include shifting away from heavy dependence on exports to domestic consumption as the growth driver, redressing income and asset inequality between the coastal and interior provinces, and between the rich and poor within each location. Economic restructuring would take the form of moving from low cost and low value-added manufacturing, for which China has become renowned, to higher value addition in manufacturing through the use of technology and a shift to services. As wages have been increasing, and as China ramps up its technological capability, this is already occurring. Efforts are also being made to nurture high value-added services, such as finance and insurance.

The external environment has also been none too certain. Of the major industrial powers, only the US has recovered from the Global Financial Crisis despite the Trump administration arguably leaving the nation's future uncertain. Europe continues to be mired in one scandal after another, and the latest, Britain's disengagement from the European Community, a decision taken in June 2016, will impact both for years to come. Japan is yet to find a way to recover from the lost decade that began after the 1986 Plaza Accord. China, of course, is not a bystander to reduced global growth; it has been a key driver of global growth for years.

For Southeast Asia, which has become increasingly trade-dependent on China (although the converse is not true)[5], the most direct consequences are in the area of trade. A slowdown in China's growth should see reduced demand by China for Southeast Asian exports, which will be hurt by both lower volumes and prices. Nevertheless, not all Southeast Asian exports are arms-length exports to which the previous statement applies. A substantial proportion of trade with China consists of process trade from global supply chains. What happens to these chains is difficult to predict. One possibility is

to see process trade also shrink – after all, goods that are finally assembled in China, the end-point of many supply chains, are partly destined for the Chinese market. Another dimension of China-ASEAN economic integration is outflow investment from China. One of the ominous developments following the ever-growing Chinese investment, not necessarily related to the slowdown though, is the likelihood that as China's technological capability grows, it will progressively take over segments of these supply chains. Indeed, "onshoring" – the substitution of imported intermediate inputs with domestic production – is already occurring (Kang and Liao, 2016).

Also the level of economic development and the nature of economic relations between each ASEAN member country and China vary. For instance, while countries like Malaysia which has a trade surplus with China will see that surplus shrink, countries like Vietnam which has a trade deficit with China may see this deficit grow. At the same time, countries like Cambodia and Laos are recipients of Chinese economic aid which may not be severely affected by the China slowdown. For CLMV countries, there is hope that China's attempt to upgrade its industries may see a relocation of labour-intensive industries from China to these countries. There is no certainty for this development, however. First, China may opt, as part of its rebalancing, to move its industries westward away from the coastal region.[6] Second, China's increasing deployment of robotics in production may see jobs being eliminated in China without production relocating (Willliams-Grut, 2016).[7] The effect of factories in China replacing humans on the manufacturing line with robots in a new automation-driven industrial revolution is increasingly felt around the globe (Bland, 2016). Perhaps, as wages in China rise, whether for economic or policy reasons, other foreign invested enterprises that counted on China's cheap labour may shift their operations out of China. For example, Vietnam can potentially benefit from this development.

The discussion so far assumes that China's growth deceleration is the single major factor impacting Southeast Asia. This is of course not true. Other major developments, some attributable to China while others not, are clearly germane to what happens to Southeast Asian nations even as China's economy slows.

The first of these, in which China not only has a hand but plays a pivotal role, is the global economic initiative called "Belt and Road Initiative" (BRI). Launched in 2013[8], it consists of a land component – the "Belt", or the "Silk Road Economic Belt" – that involves the development of a number of corridors that link China to Central Asia and Eastern Europe, and the "Road", or the "21st-Century Maritime Silk Road" – that involves the development of ports as nodes to newly created shipping routes connecting Chinese ports to their European counterparts. The motives for this massive undertaking have been extensively commented upon, falling broadly into economic and

geopolitical imperatives. Economic motives include fostering closer economic ties with Eurasia and countries along the Maritime Silk Road, securing continued access to energy sources, better use of the huge reserves China has built up than simply investing in low-yield US treasuries, and to absorb excess output of steel and construction materials that resulted from China's fiscal stimulus in response to the Global Financial Crisis of 2008. Geopolitical motives are said to include reduced vulnerability to disruptions to existing trade and supply routes to China, and challenging the existing world economic order orchestrated by the US in the Bretton Woods Agreement of 1946. To move from strategy to implementation, a Silk Route Fund of US$100 billion has been established to provide seed money for projects.

Whatever the motives, Southeast Asia stands to benefit from this global initiative. The ASEAN region is targeted by China as part of its Maritime Silk Road, with Chinese investments in logistics and transportation infrastructure expected. Many ASEAN-mooted plans, such as the ASEAN Master Plan for Connectivity (AMPC) 2025 and the Lancang-Mekong Cooperation Initiative, that seek to integrate the diverse region through networks of high-quality infrastructure could find a possible synergy in China's BRI.

ASEAN countries also stand to benefit from the separately established but BRI-related Asian Infrastructure Investment Bank (AIIB). This bank, established in October 2014 and capitalized at US$100 billion, intends to provide investment lending for infrastructural construction in Asian countries for which there is huge unmet demand. Its establishment is seen as reflecting China's dissatisfaction with what it perceived to be the inadequacy of World Bank reform that did not fully recognize the country's economic heft. It also sees infrastructure as a major investment gap with growing demand largely unmet by existing multilateral institutions like the World Bank and the Asian Development Bank. Thus Wolf (2015), in a commentary supporting Britain's decision to be a founding AIIB member, noted: "Developing countries in Asia are in desperate need of such (infrastructure) investment. Private funding of risky and long-term projects is often either expensive or non-existent. The resources of the World Bank and Asian Development Bank are grossly deficient, relative to the needs." Operating in parallel to the AIIB but also called upon to provide financial support to BRI is the China Development Bank (CDB) and the Silk Road Fund. Adding to it, bank alliances by China's traditional policy banks and state-owned commercial bank would also present an opportunity to the Southeast Asia countries to carry out their ambitious projects across the region.[9]

A third area, this time of tension, in which China plays a central role is its territorial claim over much of the South China Sea through its "nine-dash line" on its maps. While China stakes its claim on its reading of history, Vietnam disputes China's historical interpretation, citing its own historical

records, while the Philippines contests China's claim on the geographical grounds that China claims waters too close to its shores (BBC, 2016). Other claimants are Brunei, Malaysia and Taiwan. While some countries would like ASEAN to mediate or an international tribunal to rule on China's claim, China is opposed to both, preferring bilateral negotiations. These contests are not helped by a partisan (Western) media insisting on "freedom of navigation", with the US sending warships through the area to challenge China's claim (see, for instance, Ku et al., 2016). The situation, although with no immediate settlement in sight, is dynamic. Despite the Philippines winning its case at the International Tribunal, its new President was prepared and did meet with his Chinese counterparts to downplay the dispute. Vietnam has likewise agreed to bilateral negotiations with China. The economic impact of this dispute appears not to have been large so far, since it has not spilled over into economic sanctions or other measures by the disputing parties, and, as indicated, the parties in greatest conflict have attempted to mend fences. Nevertheless, despite China's acquiescence to ASEAN leadership in its region (Kuo, 2016), ASEAN members are split on how the dispute is to be settled, hence posing a major challenge to ASEAN's touted centrality in the region.

Important as China is, Southeast Asian countries themselves are affected by other developments, both external and domestic. Examples of non-China developments external to Southeast Asia are the sharp fall in oil prices and softening of natural resource prices, the slowdown in global trade, leading some to ask if we have reached "peak globalization".[10] The former has hit natural resource producers hard, while the latter would have impacted countries dependent on trade. ASEAN countries themselves have domestic challenges that affect their economic growth. For example, Malaysia has been plagued by scandal around missing billions from the sovereign wealth fund called One Malaysia Development Bhd (1MDB) that has seen investigations in five countries outside Malaysia (the US, Singapore, Switzerland, the UK, and Australia) (Adam and Sam, 2016). Within Malaysia, civil society groups clamoring for accountability have been met by government crackdowns on civil liberties and incarceration of its critics (for a good summary, see Ramesh (2016)). These developments, unfolding since the Fund asked for an extension to file its annual report in 2013, have eroded investor confidence; foreign (portfolio) investment outflow has been significant and the Malaysian Ringgit has taken a beating the likes of which have not been seen since the 1997-98 Financial Crisis.

Another example is Thailand, where the death of King Bhumipol Adulyadej rendered a tense political standoff between the ruling junta which strongly supports the King and to an extent is aligned with Bangkok's middle-class elites against the rural population, which ex-Prime Minister Thaksin Shinawatra had leveraged to gain power in 2001. Thaksin was ousted in a

military coup in 2006, his group making a return of sorts as his sister Yingluck became Prime Minister in 2011, but she was herself ousted by the military that continues to run the country today. This uncertainty has risen because some believe the Crown Prince who would succeed Bhumipol views the Thaksin group more favourably (*The Economist*, 2016). The consequences of this turmoil is summarized by Suthiwart-Narueput (Knowledge@Wharton, 2015) noting "Thailand's economy seesawing between lackluster and negative growth." "Weak exports, tepid public and private spending, falling prices in farm goods and falling domestic consumption" have dashed hopes of a return to pre-Asian Crisis growth.

These instances demonstrate the complexity of factors that impact Southeast Asian countries' performance. They render the task of distilling the impact of China's "New Normal" a most challenging one. And they call for, at a minimum, critical review at the country level. The papers assembled in this issue seek to do precisely this. Beginning life as conference papers under the theme "Great Fall or New Normal: China's Economic Restructuring and Its Impact on Southeast Asia" held at the Institute of China Studies, University of Malaya, Kuala Lumpur on 28 July 2016, they reflect the authors' thoughts on what China's "New Normal" means for their respective countries. Because they were left to develop their ideas freely under the broad theme, they have focused on a range of issue they believe to be important. Beyond editorial changes, no effort has been made to harmonize the papers' contents. We believe that in this instance, diversity serves the discussion of the topic better than uniformity of content structure.

3. Structure of this Issue

The papers in this Special Issue examine the issue of China's slowdown and its impact on ASEAN countries from both the Chinese and ASEAN countries' perspectives. Using research methodology that range from quantitative to qualitative, they explore this issue's many dimensions, reaching conclusions with major implications. Six papers appear in this Special Issue – three written from the China and regional perspectives and three from country perspectives.

The first paper by Li and Quan frames the issue from a China perspective, broadening the definition of China's "New Normal" to include major structural shifts the economy has been undergoing. They argue, correctly, that focusing exclusively on growth results is a myopic view that ignores other major developments. Arguing further that the growth slowdown has thrown up economic vulnerabilities that had been hidden by spectacular growth, they proposed several remedies.

The next paper by Tong and Kong deals with China-ASEAN trade, the most direct channel of transmission of China's slowdown. Instead of focusing

on the negative impact, they adopted a long-term view of the evolution of China's trade as China adopts a more pro-active stance in outward economic ventures as well as regional economic cooperation. They argued optimistically that despite periodic tensions, bilateral economic ties will continue to improve. The authors also see that the more resource-abundant countries will likely benefit more than countries less well endowed. If economic integration is successful in producing a more prosperous region, it will be possible to envisage the evolution of a common development strategy.

The third paper by Zhang and Li takes a regional perspective of China's other major channel for economic ties with ASEAN – its outward foreign direct investment (OFDI) in Southeast Asia. Noting the growth of OFDI despite China's slowdown, the authors explained this apparent contradiction through China's geo-economic imperatives, the desire to secure natural resources to hedge against uncertainty and Chinese enterprises relocation of their production to lower labour cost Southeast Asia as Chinese wages rise. Increasingly too, they recognize ASEAN countries as growing markets that can provide higher returns for Chinese enterprises than they could secure at home.

With China as Malaysia's largest trading partner, any slowdown in China's growth reflected in diminished trade should be bad news for Malaysia. The first of the three country papers, contributed by Cheong and Wang, argues that this statement needs to be qualified. First, Malaysian exports of palm oil to China, the price and volume of which had shrunk, is not the most important export item, that honour belonging to intermediate goods in the process trade. Second, Chinese investment in Malaysia has surged even as FDI from other countries has diminished. And finally, Malaysia's woes, including problems created by the scandal surrounding the sovereign wealth fund 1MDB, the collapse in oil prices as a result of a supply glut, cannot be blamed on China. They conclude that Malaysia's "New Normal" of uneven growth is the consequence of a host of factors of which China's growth deceleration could be the least of Malaysia's worries.

Like Malaysia, the Philippines also experienced no more than a modest impact from China's slowdown. By the time China's slowdown began, the Philippines has already experienced poor export performance, made worse by the Global Financial Crisis of 2008. These reverses had enabled the Philippines to bolster domestic demand. That trade between China and the Philippines has not been substantial also helped cushion any shock from a China slowdown. Thanks to the efforts to normalize relations with China, the Philippines should see a future rise in Chinese FDI. However, Lim, who authored the Philippines paper, warns of the importance of governance given China's none too stellar record of investments there.

The last of three country papers is that of Laos by Kyophilavong and his colleagues. Employing a computable general equilibrium model, they

estimated the impact of Chinese investment on the Lao economy. The authors found the short-run impact not only positive for growth but also that it is beneficial for income distribution. However, because Chinese investment is in the resources sector, the downside is the negative long-run impact on the environment and on natural resource depletion. The simulations also show that the threat of "Dutch disease", which is believed to be harmful to the non-resource sector as a result of an appreciating exchange rate, is very real.

4. Conclusion

After decades-long miraculous growth, China's economic development, which was largely supported by cheap labour, exploitation of natural resource and low-cost investment in the past, has entered a period of "New Normal" with a slower but more sustainable growth of 6-7% since 2015. While the slow-down of the Chinese economy in no way signals a hard landing as China has, in many ways, demonstrated new momentum to sustain its economy, the magnitude of China's economic slow-down has undoubtedly impacted Southeast Asia which has engaged substantially in trade and investment with China. These uncertainties lead to several major questions on which this special issue attempts to shed some light. The questions the six papers in this issue address are: 1) Is China failing or adjusting to a new normal? 2) What are the economic implications of China's growth deceleration? And (3) what factors besides developments in China, are impacting and will impact countries in ASEAN?

What are the takeaways from the analyses emanating from the seven papers in this Special Issue? First, if we take a broad view of China's "New Normal", its arrival can have consequences for ASEAN economies that are increasingly integrated with it. Second, in terms of trade, a major transmission channel, while the short-run impact of China's "New Normal" is a reduction in bilateral trade, the longer-term impact – a change in the nature of China-ASEAN trade as China transits from trade-led to consumption-driven growth and from low to high value-added output – is likely to have greater significance for ASEAN countries. Third, Chinese OFDI, another key transmission channel, is driven as much by geo-strategic as by geo-economic imperatives. China's "New Normal" has not only not diminished Chinese OFDI but has also seen the opposite occur. With China's proposed BRI, activities of the AIIB and the "Going Out" policy gathering momentum, this trend should continue. Fourth, although Chinese OFDI is to be welcomed, care should be taken to ensure that projects reap immediate economic gains but do not damage the economy in the long-run. At the same time, governance of these projects needs to be carefully monitored, given the

checkered history of Chinese projects in the Philippines. Finally, it is not easy to untangle the impact of other factors affecting ASEAN country economies from the impact of China.

As with most studies, this study has some limitations. A study based on a general discussion and three selected Southeast Asian countries cannot claim to speak to the overall impact of China's New Normal on the entire Southeast Asian region. The great socio-economic diversity among the Southeast Asian countries has made it extremely difficult to generalize or to give a uniform answer of such question. Nevertheless, this special issue represents an initial contribution that should lead to future explorations of this broad topic that is multi-dimensional and cross-disciplinary. Indeed, the dynamism that has characterized ASEAN-China relations will most certainly render further study mandatory.

Notes

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1. Data from World Bank database: <http://data.worldbank.org/indicator>.
2. The World Bank's 1993 report *The East Asian Miracle* did not include China among its "miracle" economies, because by that year, China's growth had lasted no more than 15 years. China more than deserves this accolade because it has outgrown every single one of the countries in the report.
3. Chinese President Xi Jinping in a speech to 1,500 business leaders in the APEC CEO Summit in November 2014 referred to China's growth reduction as its "New Normal" to indicate that the people should no longer expect continued high growth (Xinhuanet, 2014).
4. Kroeber (2012) not only alleged that China's "political system is built on a principle of unfairness" but goes further to label Chinese society as "second rate".
5. In 2013, ASEAN as a whole accounted for 10.7% of China's trade while the EU accounted for 13.4% and the US 12.5%. China's trade with other Asian countries accounted for 32.1% of the country's total that year (Salidjanova and Koch-Weser, 2015: 6).
6. This has indeed been happening. The growth rates of China's western provinces have outstripped those of its eastern provinces since the onset of the Global Financial Crisis that began in 2008, thanks to China's massive RMB4 trillion stimulus (Ma and Summers, 2009: 7).

7. Citing a study by Michael Parker and Alberto Moel for the global manager firm Berstein, Williams-Grut noted: "China is not getting rid of the work. It is just getting rid of the workers."
8. The Silk Road Economic Belt concept was introduced by Chinese President Xi Jinping during his visit to Kazakhstan in September 2013. A month later, in a speech to the Indonesian Parliament, he proposed "building a close-knit China-ASEAN community and offered guidance on constructing a 21st Century Maritime Silk Road to promote maritime cooperation" (Xinhuanet, 2015).
9. According to ADB, ASEAN region requires US$60 billion in investment per year in road, rail, power, water and other critical infrastructure. However, the ASEAN Infrastructure Fund (AIF) has a total equity of only US$485.3 million, far below the necessary amount to make big loans each year.
10. Braga (2015) noted that the elasticity of trade with respect to world GDP (the % increase in trade with respect to a 1% change in world GDP) has fallen from a high of 2 in the 1990s.

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The Logic of Long-term Growth of China: From New Normal to Supply-side Reform

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Abstract

Unlike most scholars, who believe that "new normal" means a decline on China's economic growth rate, we argue that the interpretation of the "new normal" has more comprehensive meanings. China had experienced a reduction of about 2% in its annual growth rate in the seven-year period before 2007 compared to the same period after 2007, which signalled a slight slowdown but not a severe recession. In the long run, the economic fluctuation is still in the normal range accounting for the scale effect of China as a major economy. Furthermore, expanding Internet penetration becomes a new catalyst for growth. But on the other hand, economic distortions are concealed during the high growth period which have surfaced to constrain growth, among which the distortion of the relative factor prices could be used to explain the slowdown of the economic growth. The problem of dual track of the factor prices stemming from the institutional settings should be paid more attention on. The changing of the relative factor prices is the core variable to optimize resources allocation when a country develops from a lower level to a higher level. The way to reduce these distortions including resources misallocation is the reform of the supply-side in the "new normal".

Keywords: *new normal, economic slowdown, relative factor prices, supply-side reform*

1. Overview

The Chinese economy has experienced an average 10% growth from 1978 to 2007. This long high growth period seemed to have been interrupted by the shock of the global financial crisis in 2008 as China had to react through economic restructuring. Some concealed economic distortions in the high-growth phase emerged to the surface when Chinese economic growth slowed down. Economic growth shifting to a sub-high gear is accepted as the new economic development stage or so called "new normal" officially defined by President Xi Jinping.

On May 2014, President Xi Jinping enunciated the concept of "new normal" which he regarded positively as a strategic opportunity. At the opening ceremony of the APEC Business Leaders Summit in November of the same year, President Xi elaborated on the "new normal" formally with three features such as lower growth rate, economic restructuring and innovation-driven growth. A month later, in December, at the Economic Work Conference of 2014, Xi provided a comprehensive explanation of "new normal" and expanded its notable features from three to nine (Guo, 2016).

The nine changes now occurring in China are as follows. First, consumption demand becomes more diversified. Second, investment is switched to new areas with new techniques, products, industries and business modes. Third, China's exports and balance of payments now reflects both inflow of foreign capital and outflow of domestic capital synchronously. Fourth, novel industry organizations are characterized by miniaturization, artificial intelligence and specialization. Fifth, economic growth depends more on human capital and technical progress than on the quantity of physical inputs. Sixth, market competition has transformed from quantity-oriented to quality-oriented. Seventh, resource and environmental constraints require changing the way of economic development and emphasizing more on environmental friendly and sustainable development. Eighth, various types of hidden risks gradually emerge in line with economic slowdown, but remain under control. Ninth, the mode of macro-control has to change from demand stimulus to balancing the relationship between supply and demand; a more scientific mode of macro-control labelled supply-side reform or supply-side structure reform. Hence, given these characteristics of China's development in current stage, also fitting the trends of the world economy, the "new normal" in nature reflects the aspects of Chinese economic restructuring. To capitalize on the logic of China's long-term growth, policy makers should recognize and adapt to the "new normal", then take proactive action in the new development stage. These are the basic tasks of China's economic development in the current and coming periods.

In theoretical terms, what is the nature of the "new normal"? Why do these changes happen and what is the difference between the "new normal" and the old one? Under the circumstances of the "new normal", what have changed, and what have not? What is the logic that links the "new normal" to the supply-side reforms in China? This paper tries to answer these challenging questions.

The following parts are organized as follows. Section 2 discusses the main performances and some stylized facts of Chinese economic slowdown in the long run. Section 3 explains why and how Chinese economic growth slows down in pace with restructuring process after the crisis shock occurred. The paper intends to show that economic scale plays an important role in

the process of recovery which is fuelled up by Internet penetration. Section 4 focuses on the nature of the "new normal". Rapid change of relative factor prices when a country transits from the low-level development to the high-level maybe the key to understand the logic of long-term growth. The argument that the relative comparative advantages hold constant may not be correct and could mislead the country slipping into the "middle-income trap"[1]. Dynamic comparative advantages are from the flexible price system without any distortion. Hence, the distortion of the relative factor prices is the Achilles heel of high-growth and may arise from some institutional problems. Section 5 points out that the supply-side reform is to reduce the distortions by the forces which come from the market. Resources can be re-allocated or utilized more efficiently under a real signal of the factor prices changing without any disturbance. The reduction of the distortion is also part of the process of economic reconstruction and in line with the spirit of the supply-side reform. Section 6 is the conclusion.

In addition, this article also adheres to the theoretical framework of development economics, tracking the stylized facts on growth to the changes in structure and even to the problematic institutions, which can be explained by the "Iceberg Model"[2].

2. The New Normal and Economic Slowdown

Once the idea of "new normal" was formed into a shape, most academic research focused on the topic of growth rate falling, which is also a concern of the central government. China's economic growth rate dropped from 14.2% in 2007, after a slight recovery in 2010, and sharply fell to 6.7% in 2016, less than half of that in 2007. Incidentally, China had experienced a five-year super-high growth from 2003 to 2007 when the growth rate was over 10% in each year, benefiting from further opening to the outside and plunging into the globalization.

How can the process of economic slowdown in China after 2008 be explained? There are at least four hypotheses about when and why fast-growing economics slow down significantly, which may help to understand the Chinese economy in the "new normal".

First, the *economic convergence hypothesis* argues that when a country's GDP per capita reaches round US$17,000 in year-2005 constant international prices, or 58% of that in the leading country, its growth rate downshifts by at least 2 percentage points (Eichengreen et al., 2011). But in 2008, Chinese GDP per capita reached only US$7,145 in year-2005 constant international prices, one sixth of that in US, the technology frontier country, using the data from Penn World Tables (PWT Version 8.1[3]). So this hypothesis hardly explains the China case.

Second, the *external shocks hypothesis* attributes the slowdown to the influence of the global financial crisis in 2008. This seems reasonable because China's exports had experienced a precipitous drop in the eastern coastal areas. The ratio of export dependence had dropped from 85% to 65% in Guangdong province and from 40% to 30% in Fujian province temporarily. Both provinces are located in the southeast coastal area. But why does such a decline was sustained for so long and resulted in an L-shaped economic development pattern and which kind of mechanism can better account for the missing of the recovery? Thus, the shocks hypothesis can explain why the slowdown happened but cannot explain why the slowdown was sustained for so long.

Third, the *world business cycle theory* argues that the recession inside China is subjected to the "bad climate" outside China. International organizations like IMF had lowered their economic growth forecasts in recent years. According to the "World Economy Outlook" published by IMF in April 2015, the growth rate forecast for 2016 is down from 2.6% to 2.4% in the US, flat in Euro area, and 0.5% in Japan, much lower than expected, combined with mild growth in emerging economies. World business cycle theory seems to work because almost all the developed countries and most developing countries are suffering growth slowdown. However, with the deepening integration of the Chinese economy into the world economy, China has become the second largest economy in the world and its outward foreign direct investment (OFDI) is now ranked among the top three in the world. With its economic weight increasing, China should be able to influence the world more than be influenced by it as China used to be. Even in the slower growth years, China is still the locomotive of the world economy especially among the emerging economies. Why couldn't China grow anti-cyclically under its new strategies such as "innovation-driven" and "Belt and Road Initiative"? China could and should be the pioneer to recovery.

Fourth, the *growth accounting framework* shows that if the output uses technology and human capital, together with traditional inputs, Chinese-style high growth can benefit from large investment, high total factor productivity (TFP), demographic dividend and low labour cost advantages since opening-up. Perkins and Rawski (2008) showed that the growth rate of the Chinese economy reached 9.5% from 1978-2005, when capital grew by 9.6%, contributing to 44.7% of GDP growth, labour grew by 2.7% contributing to 16.2% of GDP growth, and TFP grew by 3.8% contributing to 40.1% of GDP growth. After 2008, traditional competitive advantages began to shrink while new competitive advantages had not emerged, making investment more difficult. For example, most capital appear to escape from the real economy to the virtual economy in the recession because of low investment return in the real industry. Private investment also suffered a lot, attaining 3.9%

growth in the first five months of 2016, much lower than expected. But this hypothesis relies too much on the technical and data analysis, which leaves the economic mechanism and dynamic analysis behind. It also does not tell us what mechanism inhibits the new economic momentum from springing out[4]. An analogous hypothesis paid much attention on TFP and contributes the economy slowdown to TFP decreasing (Li, 2013). But we are supposed to open the black box of TFP, not to replace the economic growth with TFP.

All these hypotheses have caught some typical features and stylized facts of the "new normal" from some aspects, but not completely and constitutionally. Our viewpoint is that the economy's slowdown cannot portray the full context of the "new normal". If we pay too much attention to the growth rate, any policy response will naturally gravitate towards a strategy of maintaining growth, instead of considering economic restructuring and institutional strengthening, that may actually leave the economy worse off.

3. China's Economic Growth in the Long Run

In this paper, we believe that the current slowdown is not severe as China's economic growth still fluctuates near the lower bound of the normal range.

3.1. Definition and Criterion of the Economic Slowdown

According to Hausmann, Pritchett and Rodrik (HPR in brief) (2005), GDP growth slowdown should satisfy three conditions.

(1) $g_{t-n,t} \geq 3.5\%$

(2) $\Delta g_t = g_{t,t+n} - g_{t-n,t} \geq 2\%$

(3) $y_t > 10,000$

where the growth rate $g_{t-n,t}$ is the least squares growth rate of y (per capita GDP in 2005 constant US$) from year $t - n$ to t, Δg_t is on behalf of the *change* in the growth rate at time t, equal to the difference between $g_{t,t+n}$ and $g_{t-n,t}$, representing the least squares growth rate from year t to $t + n$ and from year $t - n$ to t respectively. Condition (1) means that the growth is rapid before the slowdown occurs. Condition (2) measures the extent of the slowdown and it identifies a growth slowdown with a decline in the seven-year average growth rate by at least 2 percentage points, shaped the normal fluctuation rate for growth. Condition (3) limits slowdown to cases in which per capita GDP is greater than 10,000 in 2005 constant US$. Following HPR (2005), we set several values to the parameters and take $n = 7$ and $t = 2007$ as the benchmark.

Table 1 Growth Changes Before and After the Crisis

t	n	$g_{t-n,t}$ %	$g_{t,t+n}$ %	Δg %	y_t
2007	7	8.590	6.489	2.101	US$7079
2007	5	8.885	6.284	2.601	US$7079
2008	7	8.383	6.738	1.645	US$7260
2008	5	8.249	6.835	1.414	US$7260

Data on per capital incomes before 2011 are from Penn World Tables Version 8.1. Per capita incomes from 2012-2015 are calculated based on annual growth of per capita GDP from World Bank database.

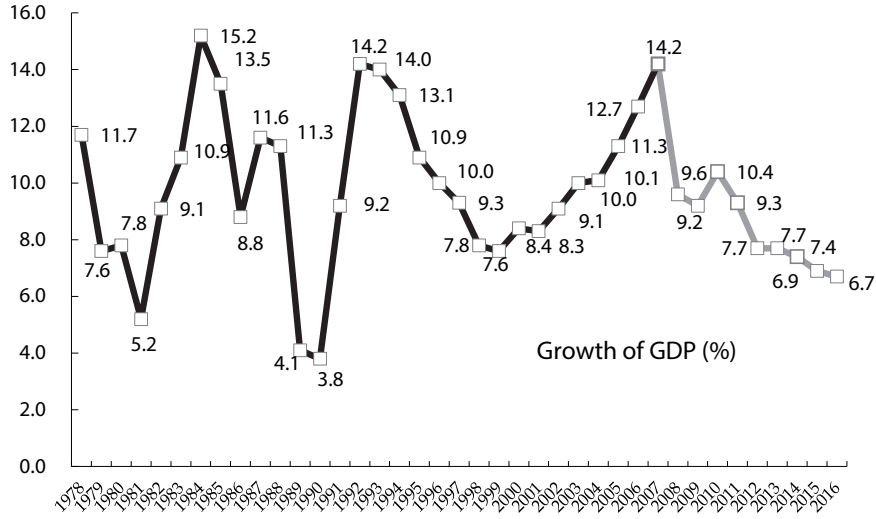
From Table 1, condition (1) is clearly satisfied. Condition (2) also holds for the difference in growth that is a bit more than 2% when t is 2007 regardless of n. Condition (3) is not satisfied but it does not matter. But this result is not concrete when t moves to 2008. Comprehensively speaking, that China is suffering a heavy economic slowdown has been shown to be not statistically robust[5]. If we shorten the duration of the shock, the economic slowdown will become more serious and vice versa.

3.2. Economic Fluctuations in the Long Run

When we look back to 1978, the beginning of the reform and opening up, there are three and a half small business cycles in that period determined by peaks and troughs (Figure 1). The first cycle is from 1978 to 1984 lasting nearly 6 years, second from 1984 to 1992 for 8 years, third from 1992 to 2007 for 15 years and now we are in the first half of the fourth business cycle. It is obvious that the growth rate has changed more slightly and the business cycles lasted longer after 1992 due to effective counter-cyclical policies. The growth rate in 2016 is 6.7%, below the previous lowest point of 7.6% in 1999 when the Chinese economy was affected by the Asian Financial Crisis, but still above some extreme lower growth rates such as that in 1989 (4.1%) and in 1990 (3.8%). In the long run, Chinese growth rates move up and down within a normal range between 6% and 14%. By calculation, there are 39 dots of growth rates altogether from 1978-2016 and 33 are within that range, accounting for 84.6%. Furthermore, the expectation of the growth rate of 2017 is 6.55%, also within that range.

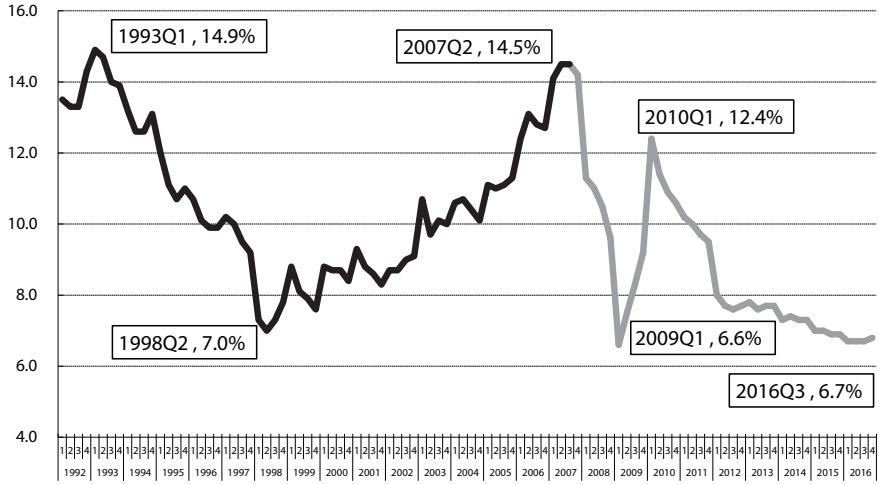
When we look at the quarterly frequency data in detail from 1992 to 2016, there is a complete business cycle from 1993Q1 to 2007Q2 (Figure 2). Since then, the global financial crisis began and China has turn into another development track under the external shock. It is clear that the down slope from 2010-2016 was much like that in 1993-1998 which started with an

Figure 1 China's GDP Growth Rate from 1978-2016



Source: National Bureau of Statistics of China.

Figure 2 China's Growth Rate Volatility by Quarterly Data from 1992Q1-2016Q4



Source: National Bureau of Statistics of China.

overheated economy following a series of reforms implemented by Premier Zhu Rongji. It is very interesting to have a comparison between these two periods because the declining ranges of the economic growth are much alike. The cause of the decline in the mid-1990s was to relieve high inflation and to avoid a dramatic slowdown in growth rate. Reforms were in the fields of price system, financial development, labour market and the relationship between the government and SOEs at that time. The growth during the period looked like U-shaped, with the downward segment bottoming out when China adopted more liberal foreign policies and integrated deeper into the world economy to reflect its entry into the WTO in 2001. In contrast, the cause of the decline this time is the global financial crisis which began in 2008 and became more severe because of excess production capacity around the world. It is marked by deflation showing a recession of the real economy. The trail of the growth rate is much like a combination of V+L-shapes symbolizing a rough recovery because it may be much harder to resolve the excess production capacity with traditional macro policies.

3.3. Scale Effect in the Economy

In fact, no economic textbook would argue that 6% or 7% is an abnormally low growth rate. It is believed that the growth rate now appears low because China has enjoyed a much higher growth rate nearly or over 10% after the 1980s for more than three decades. In our opinion, 6-7% is still a much higher growth rate, second only to the rate experienced by catch-up growth (Quan, 2015). The world growth rate is only 3%-3.5% on average and 3.21% in the US from 1948 to 2016, 1.60% in the euro area from 1995 to 2016 and 1.33% in Germany, a leading country in the EU, from 1992 to 2016 (data from trading economics).

Furthermore, the same growth rate may represent different increments of economic scale at different development periods. In terms of the absolute growth increments, 6.7% growth in 2016 is much larger than 12.7% growth in 2006 (Table 2). Nevertheless, it is subtle and much difficult to make a distinction between economic convergence and growth reduction without theoretical analysis.

Unlike Japan, South Korea and most other Asian emerging countries witnessed a slowing growth rate when GDP per capita reached US$7,500, China definitely has a larger territory and more space to absorb the influence caused by shocks from outside. From the view of quantitative analysis before and after the financial crisis, we calculate the growth of consumption patterns in different regions in China, which are relevant to the individual welfare directly. It is found that the eastern coastal region suffered a decline of about 3.73% in the growth rate of non-food consumption, followed by

Table 2 Increment in GDP from 2005 to 2016

Year	*Growth rate (%)*	*Increment in GDP*	*Year*	*Growth rate (%)*	*Increment in GDP*
2005	11.3	446.63	2011	9.3	708.30
2006	12.7	554.28	2012	7.7	644.97
2007	14.2	698.46	2013	7.7	687.11
2008	9.6	544.86	2014	7.4	693.22
2009	9.2	579.23	2015	6.9	703.07
2010	10.4	714.57	2016	6.7	729.80

Note: Increments in GDP are calculated in billion RMB based on 1978 constant price.

Table 3 Growth Rate of Non-food Consumption for China and its Regions

Regions	*Growth rate of non-food consumption (%)*		*Difference Pd2% – Pd1%*
	Pd1:2001Q1-2007Q4	*Pd2:2008Q1-2012Q4*	
Whole Country	8.68	7.65	-1.03
North	9.28	6.91	-2.37
Northeast	10.77	9.56	-1.21
Eastern Coastal	10.24	6.51	-3.73
Central	8.56	7.58	-0.98
Southwest	6.96	8.75	1.79
Northwest	6.45	8.62	2.17

Source: Li (2016) p. 212.

North and Northeast regions by declines of 2.37% and 1.21% respectively. Nevertheless, non-food consumption grew faster than before in the Southwest and Northwest region, increasing by 1.79% and 2.17% respectively (Table 3). That is to say, the influence of financial crisis on the western region is rather weaker than the eastern coast areas.

Regional divergence intensified not only in consumption and welfare but also in investment and industrial development since 2008. Industrial shift from eastern area to western area gave the Chinese economy more space to absorb the negative influences caused by the exogenous shock. The industries coming from eastern coast areas have brought employment and development opportunities to western regions, especially in the fields of infrastructure constructions and transportation facilities, which will help China to keep the advantage of a large economy during the "new normal". Hence, large

economic scale is helpful in blocking the transmission mechanism of the crisis and the population mobility between different regions will act as a balancer for growth.

3.4. New Power in the New Normal

Another argument suggests that it is hard to evaluate the modest magnitude of the growth deceleration because the GDP growth rate is likely to be underestimated as the new economy emerging with the rapid penetration of the Internet is out of the current statistics. The new economy, full of energy, characterized by higher R&D and human capital inputs and a high share of services with information technology, is distinguished from the traditional drivers of growth, which paid much attention on factor quantities. As part of the new economy, "internet plus", networking, big data, cloud computing and other emerging formats, involving customized manufacturing, and intelligent manufacturing, are regarded as the factors to accelerate the growth rate.

From scattered reports from the National Bureau of Statistics, the high technology manufacturing industry has experienced a growth of 9.8% in the first five months of 2016, 3.8% higher than that of traditional manufacturing industries, especially in the fields of aviation and aerospace equipment, chemical production, electronics and communications, pharmaceutical manufacturing (Xu, 2016; Table 4). New services have also achieved impressive performance, with online retail sales among the growth leaders in services (Table 4).

The trade-off between the new economy and traditional economy represents two opposing powers of growth. If the new economy dominates, the growth rate will rise. And if the traditional one dominates, the growth

Table 4 Growth Rate of New Economy in China from January to May, 2016

Industries	*Growth rate (%)*
High technology manufacturing	9.8
– Aviation and aerospace	28.0
– Chemical production	20.9
– Electronics and communications	11.4
– Pharmaceutical manufacturing	10.2
Online retail sales	27.7
– Non-service	25.9
– Service	36.0

Source: Xu (2016), speech on "New economy: the challenges of government statistics".

rate will fall. Now, the question is how to convert the new economy skeptics to allow the new economy to absorb more production factors and be more efficient. It should be remembered that growth is determined not only by the amount of inputs but also by resource allocation. Unfortunately, the size of the new economy is hard to estimate, bringing challenges to the government's department of statistics, including defining the basic concept, investigation method, GDP accounting principles and price index methodology.

4. Relative Factor Prices and Resource Misallocations

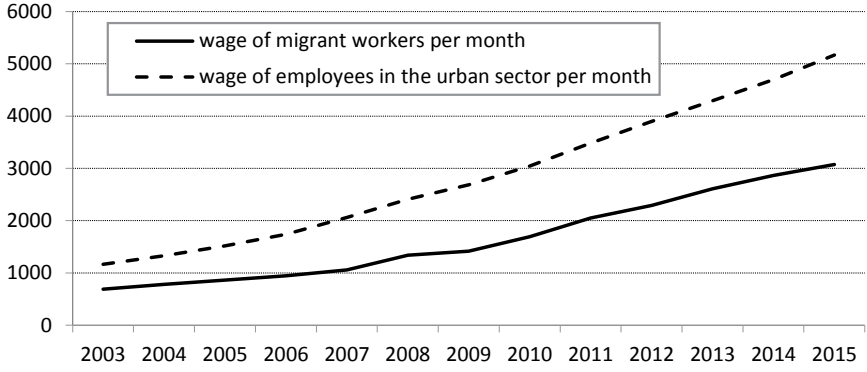
Literally speaking, "new normal" means a certain condition that did not appear before, but appears now and will continue to last in the next period. Within the development of an economy, changes in relative factor prices become more important and it is the key to understanding the meanings of China's "new normal" and the logic of long-term growth.

4.1. Labour Costs Increasing and Capital Costs Decreasing

Labour costs in the manufacturing sector are rising, but capital costs are declining compared to the early period of the reform and opening, leading to the changing of the relative factor prices.

Two obvious examples illustrate the rapid growth of labour cost. The first example comes from the wages of migrant workers, more than 277 million people, and a main source of low labour cost advantage of China. The wage of migrant workers has experienced a rapid increase from 690RMB per month in 2003 to 3072RMB per month in 2015, at over 10% annually, with the pace of the wage increase of employees in the urban sector much higher than the growth of labour productivity in manufactory (Figure 3).

Figure 3 Wage Growth of Migrant Workers from 2003 to 2015



Source: National Bureau of Statistics of China and Lu (2012).

Another example comes from the minimum wage. A minimum wage is the lowest remuneration that employers may legally pay to workers and it is also a hard constraint for the SMEs in the low-end labour market. China has implemented a minimum wage adjustment system since 1993. Shanghai, one of China's modern metropolises, has experienced adjustments of minimum wage every or every other year, from 210 RMB per month in 1993 to 2190 RMB per month in 2016 (Table 5), with a nominal annual growth rate of 10.4% before the global financial crisis and 11.2% after that. Even though the fast increasing minimum wage compresses the profit of the SMEs in the labour-intensive industries and services gradually, it seems reasonable that the ratio of minimum wage (MW) and social average wage (SAW) keeps around 30-35%, which shows that the social average wage in Shanghai is also increasing quickly.

On the other hand, with the rise of economic development, the cost of capital becomes much cheaper than before. Looking at the official nominal loan interest rate, the price of capital is moving in the opposite direction with the labour cost. We may be facing an era of lowest loan interest rate since the mid-1990s. The one-year loan interest rate is about 4.35%, less than half what it was 20 years ago (Figure 4).

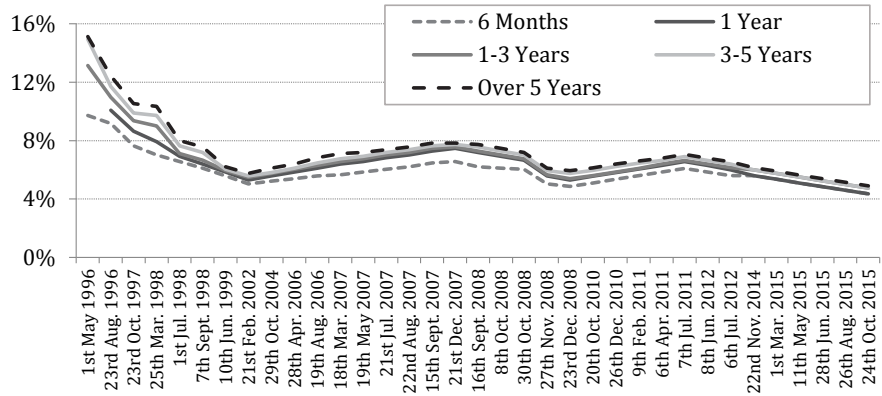
Table 5 Adjustment of Minimum Wage in Shanghai from 1993 to 2016

Time to Apply	1/6/1993	1/7/1994	1/4/1995	1/4/1996	1/4/1997
MW per Month, RMB	210	220	270	300	315
Ratio of MW and SAW %	44.60	35.67	34.92	33.76	33.09
Time to Apply	1/4/1998	1/4/1999	1/7/1999	1/12/2000	1/7/2001
MW per Month, RMB	325	370	423	445	490
Ratio of MW and SAW %	32.34	31.38	35.88	34.63	33.10
Time to Apply	1/7/2002	1/7/2003	1/7/2004	1/7/2005	1/9/2006
MW per Month, RMB	535	570	635	690	750
Ratio of MW and SAW %	32.97	30.87	31.23	30.87	30.44
Time to Apply	1/9/2007	1/4/2008	1/4/2009	1/4/2010	1/4/2011
MW per Month, RMB	840	960	960	1120	1280
Ratio of MW and SAW %	29.04	29.16	26.92	28.74	29.56
Time to Apply	1/4/2012	1/4/2013	1/4/2014	1/4/2015	1/4/2016
MW per Month, RMB	1450	1620	1820	2020	2190
Ratio of MW and SAW %	30.91	32.17	33.39	34.01	33.83

Note: MW and SAW are abbreviations for minimum wage and social average wage respectively.

Source: Shanghai Municipal Human Resources and Social Security Bureau.

Figure 4 Loan Interest Rate Adjustment from 1996 to 2015



Source: People's Bank of China.

At the same time, changes in relative factor prices can also constrain future development. Beyond all doubt, after the rapid growth in the nearly past four decades, China has changed from a country with abundant low-cost labour and lack of capital to a country with substantial capital and lack of intelligence or high-level labour. The economic structure is supposed to be reconstructed based on these changing stylized facts.

4.2. Labour Misallocation between Manufactory and Services

The changes of relative factor prices can trigger a series of chain reactions if correctly perceived. First, rational entrepreneurs will tend to use relatively cheaper factors (capital) to replace the relatively more expensive factors (labour). Such kind of calculation has been described by Karl Marx as "machine replacing manual labour". Thus in this sense, innovation is a kind of endogenous behaviour and rational reaction by those who have the entrepreneurial spirit, facing the relative factor price changes.

Second, labour is supposed to be crowded out from manufacturing to services or from the low-level industries to high-level industries. However, the reemployment transfer channels between manufacturing and services or low-level and high-level industries are not smooth in China. Only about 10% of industrial workers can shift from manufacturing to services freely, due to the lack of education and skills, leading to mismatch of labour skills. Briefly speaking, redundant workers in the low-end labour market cannot easily change to be knowledge workers that new industries need in urgent.

One reason for the difficulty in the transfer of workers from manufacturing to services is the fast economic growth that compresses the transition into a very short period. Therefore, the workers do not have enough time

Table 6 Change of Economic Structure between China and US

Country	Year	Added Value Ratio of Service	Period
China	1997	35.0%	N.A.
	2015	50.5%	18
United States	1890s	38.0%	N.A.
	1947	53.0%	48-58
	2009	77.4%	62

Source: National Bureau of Statistics of China; US Bureau of Economic Analysis.

to acquire the knowledge and mindset needed. China took only 18 years to increase the added value of the tertiary industry from 35% of GDP in 1997 to 50.5% in 2015. By way of contrast, the United States took nearly half a century to complete this process[6] (Table 6), allowing enough long time for its workers to acquire new knowledge from one generation to the next. But in China, this process was compressed within one generation. Therefore, it is reasonable to deduce that a large number of industrial workers would be unemployed in the process of economic restructuring from manufacturing dominated to service dominated. In short, the unemployment rate will rise with the pace of industry upgrading in such a short time.

However, Zhang (2016), using China's Urban Household Survey data, showed that labour-force participation in China actually increased slightly after 2008, as the proportion of workers exiting the labour market decreased. It was found that China's urban investigation unemployment rate, at 10.7%, was quite high in 2005 and it had dropped over the last decade, reaching 7% in 2012. That puts the annual average for the period of 2005-2012 at 8.5%. This phenomenon is against the deduction and makes a hint on the contention that the Chinese labour market experienced severe misallocations of its labour force.

Of late, evidence of dislocation did emerge. "Zombie enterprises" most of which were state-owned enterprises (SOEs) illustrate the misallocation in the labour market. These enterprises absorbed a large number of the redundant labour, with the help of the soft budget constrain, causing overcapacity and bearing the huge social costs of unemployment, which can partly explain the coexistence of a shrinking growth rate and growing employment rate.

4.3. Capital Misallocation and Dual Track Financial System

When we talk about the dual track of Chinese economy, it used to refer to the dual track of commodity prices in the economic transition and reform. The price of planned commodity is determined by the government while

the price of additional outputs is decided by the market. This mechanism can be shown to be Pareto-efficient (Lau et al., 2000). After economic transition, both tracks of prices had been merged in the middle of the 1990s. In consistent with the strategy of gradual reform, the dual price track now still exists implicitly in the factor prices of which the reform has postponed at the beginning and leads to the distortions and misallocations in the process of economic transition. New dual tracks come up and become almost the first important part in the "new normal" because the relative factor prices are changing and dual tracks partly increase the price stickiness and incur losses on the economic restructure. So the reform on the dual price track in the factor of production can relief the economy from the distortions and misallocations and release more institutional bonus in the "new normal".

Taking the dual track of the financial system for example, it means different prices of capital for different enterprises (He and Wang, 2012; Ji et al., 2016). Due to regulation of the loan interest rate and credit rating, there are at least two financial markets. One is the officially regulated financial market and the other is the unregulated financial market. Most resources from the official financial market flow to the SOEs (Cull and Xu, 2003) while most non-SOEs take loans from the unregulated financial market (Allen et al., 2005). According to the "2014 China Wealth Management Report: Prospects and Strategies" published by CreditEase and SEEC Research Institute, about 1.66 million households borrowed from private lenders to the tune of 750 billion RMB and at an average annual interest rate of 36.2%, 8 to 9 times the loan interest rate on the official markets. Ji et al. (2016) believed that the interest rate under the official track is below the market equilibrium and intended to reduce the cost of lending to the SOEs. But the interest rate in the unregulated track is so much above the market equilibrium. The dual track financial system is harmful to economic restructuring because it renders arbitrage not only possible but also likely, and with political power wielded by interest groups benefiting from this arrangement, transition costs will rise and any reform will be resisted.

Other factor prices are facing the same problems, only in varying degrees. Sometimes wages and public services are also split into different institutional framework not for the abilities, experiences and contributions the workers possess, but for their identities, such as rural and urban registration.

4.4. Deterioration of Investment and Over-monetization

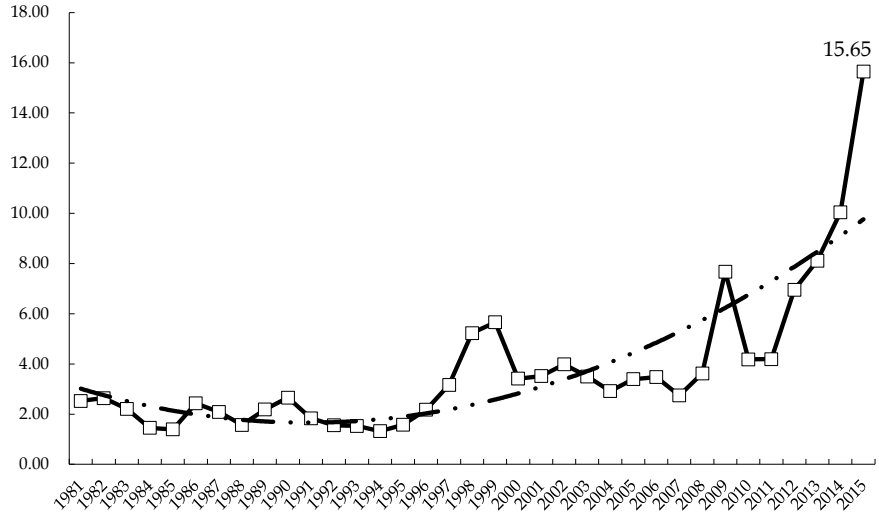
Although the nominal loan interest rate is rather low, the return of investment on the real economy is even lower due to overcapacity, which is perhaps a negative consequence of the 4-trillion-yuan (620 billion US dollars) stimulus

package in 2008. The rationale then was that pouring money into public works, principally infrastructure projects such as highways, railways and airports would create jobs and stimulate demands for construction materials like steel and cement. Wages paid to workers would also have a multiplier effect. But while such kinds of stimulus can keep an economy afloat in times of crisis, it can produce problems such as overcapacity and rising home prices when the crisis is over. In doing so, not much attention would have been paid to investment efficiency while profits are made through price arbitrage from the dual track financial system rather than investing to the real economy.

Thus, the Incremental Capital Output Ratio (ICOR), a vital indicator of investment efficiency, deteriorated rapidly after the financial crisis (Figure 5), reflecting the fact that China's economy is facing a challenging problem of overcapacity and low efficiency of investment.

All the above has produced different feelings and signals to different groups. It shows a deflation phenomenon with rather low Purchasing Managers' Index (PMI) and unsold commodities from the perspective of the producers while an inflation fever with increasing housing prices and over-issue of money from the consumer side. It seems contradictory, but really in line with the features of the "new normal".

Figure 5 ICOR Reflects the Deterioration of the Investment Efficiency



Source: Calculated by using data from National Bureau of Statistics of China by the authors.

5. Supply-side Reform Adapt to the New Normal

If the inference that the relative factor prices are much more important in the "new normal" is correct, China needs to get rid of the institutional constrains on the relative factor prices so as to reduce the resource misallocations by the enterprises forwardly. Supply-side reform injects new idea to deal with long-term growth and economic restructuring of China's economy, not in the quantitative sense but in the qualitative sense. Distinct from the strong stimulation measures in the previous years, structural reform aims to solve the misallocation and distortion problems by leveraging the power of the market. It is described as but not limited to "three cuts, one reduction and one improvement", which is an abbreviation of the central government guidance line to tackle the economic slowdown and includes cutting overcapacity, inventories and high-leverage debt, decreasing the business cost especially by tax reduction and improving processes to overcome weaknesses. These aspects, as a whole, can be considered as "structural" reform because they allow relative factor prices, a kind of market mechanism, to play a decisive role in the resource allocation.

The growing discussion on the supply-side reform in recent years shows that such reform is both crucial and urgent. The further question of who should promote the reform or where the powers of reform has been dealt with by Wu Jinglian, a famous Chinese economist, who pointed out that structural reform should be distinguished from the structural adjustment. To a certain extent, the former is generated by the market while the latter is implemented by the government. Structural reform is not only to adjust the economic structure but also to implement a series of measures to relieve the misallocations of factors and to remove the distortions that impede economic development. Wu (2016) believed that the government should "pull by the nose, but not lift the legs", meaning that the supply-side reforms should obey the rules of the market and thus take full advantage of the power from the market, while structural adjustment, he indicated, was dominated by the government through some administrative methods. As far as the current stage of China's economy, excess government interventions are supposed to exit.

According to the findings and analysis in this paper, we believe that structural reform is the right way to diminish the misallocation and boost the growth in the "new normal", with several dimensions.

First and the most important, the core of the supply-side reforms is to promote the reform on the factor markets in order to merge the dual track and cut down the arbitrage space under the "one price" principle, eliminating the extraction rents of the economic restructuring or diminishing the potential costs of the economic transition. It is necessary to accelerate the marketization process of factors including capital, labour, land and others

for a sensitive factor price mechanism in the context of comprehensively deepening the reform. Besides, it is also wise to promote decentralization of the market and combine the decentralization with management and service together, to create a fair and convenient competitive environment constantly.

Second, it is crucial to optimize the combination of the fiscal and monetary policies to strengthen the macroeconomic regulation and control power. The direction of the reform is to use more fiscal policies, substituting floating-type monetary policy, and carrying out a comprehensive taxes and fees cut. The changes of fiscal policy will give out two results. One is to decrease the costs and tax burdens of the enterprises and to enrich the households and expand the size of the middle-income group. Less cost burden motivates the spirit of the enterprises to do more innovations. And a larger income budget enlarges the feasible consumption set, which promotes the quality of product and industrial output, rendering investment more effective. Another result is to slim the governmental organizations and improve the administrative efficiency through the new fiscal policy in the "new normal".

Third, it is also very important to continue the opening to market forces, such as reducing excessive protection to SOEs and let the zombie enterprises cut employees, promoting the mixed-ownership reform of SOEs, and reducing the threshold for market access of private capital in the fields of telecommunications, infrastructure, energy, environmental protection, education, culture and other state-owned monopolistic sectors. On the other side, China has been seeking the win-win cooperation in the international communities, especially proposing the Belt and Road Initiative in 2013. Infrastructure along the Belt and Road is going to make more substantial progress in the near future, facilitating trade and people-to-people exchanges.

Fourth, to deal with the potential unemployment in the industry during the transition from manufacturing to services, it is vital to emphasize public education and training for reemployment. The government has the responsibility to augment the supply of workers with the requisite skills in the "new normal", so that the demographic dividend China currently enjoys can yield a talent bonus. Another way forward is to encourage people to start their own businesses and to make innovations, which will not only create jobs and increase personal incomes, but also improve upwards social mobility and equalization of opportunities.

Last but not least, with the rise of the Internet Plus strategy, the Chinese economy is being elevated to a new level, which calls for new statistical indexes and methods of measuring the scale and structure of the new economy, including E-commerce, internet finance, sharing economy, creative industries and so forth.

It could be expected that some new competitive advantages and underlying growth engines will emerge under the supply-side reforms. That institutional change leads to restructure and reallocation of the economy, following a promising growth rate performance, is the logic of long-term growth of China and other developing countries as well.

6. Conclusion

This paper has tried to account for China's "new normal" from the aspect of the economies of scale and the changing relative factor prices rather than from the perspective of growth deceleration. Economies of scale is a unique advantage of China and the changing relative factor prices is a new challenge for China. In the "new normal", the large scale of the Chinese economy will be unchangeable while the relative factor price will change dramatically. Compared to the beginning of the reform and opening to the outside world in 1978, China has grown from an underdeveloped country to a middle-income country with some areas even more advanced. As a result, China has more capacity to resist exogenous shocks and more ability to recover from a global crisis.

On the other hand, cost of labour is becoming more and more expensive while cost of capital is becoming cheaper and cheaper. The changing relative factor prices is the key to understanding China's economic restructuring. Through the reallocation of the still limited resources, an opportunity has arisen for China to grow from a lower level to a higher level development, and from investment-driven to innovation-driven growth. This will trigger a dynamic evolution of the competitive advantage, from labour to intelligence or from physical capital to human capital. Due to distortions stemming from the inherent institutional settings, relative factor prices cannot change flexibly, which may bring about both market failure and government failure, the impact of which is magnified in times of global depression. This is why we need supply-side reform to eliminate the misallocation of the primary factors like labour and capital.

Supply-side reform represents a new approach to deal with China's long-term growth and economic restructuring, not only in the quantitative aspects but in the qualitative aspects as well. Different from the strong stimulation like monetary incentives in the previous years, supply-side reform aims to solve the misallocations and distortions by leveraging the power of the market. China is expected to carry out a transformation in response to the macro-economic policies to reduce relative factor price distortions. A series of reform measures described as "three cuts, one reduction and one improvement" has been proposed to be the main contents of reform in the "new normal". This involves cutting overcapacities, inventories and high-

leverage debt, reducing business cost especially through tax reduction, and improving processes to deal with weaknesses. It cannot emphasize too much on the importance to protect the entrepreneurial spirit. Besides that, it is also necessary to implement reforms on the factor market, opening-up, education and technological revolution as well. It is expected that new competitive advantages and new growth engines will spring out from such reforms.

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1. The middle income trap is a theorized economic development situation, where a country which attains a certain income (due to given advantages) will get stuck at that level.
2. The Iceberg Model says that the growth performance is just like the part of the iceberg above the sea and determined by the structural elements which are the body of the iceberg under the sea. The shape of the body of the iceberg reflecting the economic structure is also dependent on the temperature of the water. The water refers to the economic institutions framing economic behaviour. In this sense, only the institutions have the ultimate power to drive economic growth.
3. The Penn World Table (PWT) is a set of national-accounts data developed and maintained by scholars at the University of California, Davis and the Groningen Growth Development Centre of the University of Groningen to measure real GDP across countries and over time. Also see <http://www.rug.nl/ggdc/productivity/pwt/pwt-releases/pwt8.1>.
4. For example, the mechanism of "clean effect", generated by the power of the market, will help economic restart at the bottom of the recession.
5. In Russia, the growth rate dropped from 10.886% to 1.962% during seven years before and after 2007, which resulted in 8.924% difference in growth rate, much larger than 2%.
6. A better method to evaluate the development is to use the data of employment in the secondary industry and tertiary industry, but not the data of added value.

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The Changing Pattern of China's Trade and Implications for Southeast Asia

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Abstract

Since 2008, when a global financial and economic crisis erupted, the Chinese economy has encountered increasing difficulties and, in recent years, experienced considerable growth deceleration. Meanwhile, the structure of China's trade has undergone significant changes. The structural changes in China's trade are consistent with the country's objectives in post-2008 development. China aims to transform the economy from investment-driven and export-oriented toward technology-driven and domestic consumption oriented. More importantly, since 2013, the government has also formulated accommodating policies to support the transformation. These include a strong emphasis on innovative development, as well as policies to further enhance economic opening, including setting up Pilot Free Trade Zones and promoting the "Belt and Road" initiative. These will have important implications for Southeast Asia. China's economic interaction with Southeast Asia has grown rapidly and significantly, even during the rather turbulent post-2008 period. Although bilateral trade is still unbalanced, structural changes in China's economy and trade are expected to narrow the gaps by generating more opportunities for ASEAN countries. Understandably, given the differences among ASEAN countries regarding their level of development, the impact of China's changing dynamics will differ considerably. For example, China's efforts to upgrade its industry and trade will benefit the relatively less developed ASEAN members, while intensifying competitive pressure on those at a similar development level.

Keywords: *China's transformation, China's trade, economic interaction, Southeast Asia*

1. China's Trade Experiences Dramatic Changes

Economic opening constitutes an essential part of China's overall development strategy since the late 1970s and, consequently, contributed considerably

to the country's remarkable growth and transformation. Since 2008, when a global financial and economic crisis erupted, the Chinese economy has encountered increasing difficulties and, in recent years, experienced considerable growth deceleration.

In 2016, China's economy grew by 6.7%; a further decline from 6.9% in 2015, 7.3% in 2014, and 7.7% in 2013 and 2012. As global economic recovery remains weak and uncertain, China's economic deceleration is accompanied by considerable contraction in total trade, amounting to 8.1% in 2015 and 6.8% in 2016. Indeed, world economic recovery has been slow and lopsided. In 2016, exports fell by 7.7% and imports by 5.5% (General Administration of Customs of the PRC, 2016). Since rich countries still accounted for a large majority of the world economy and overall export demand, their poor growth prospects cast doubt on the strength and the resilience of the world economy. According to the World Trade Organisation (WTO), world trade is expected to expand by a mere 1.7% in 2016 (WTO, 2016a). This is a key constraint to China's trade growth.

Being the world's largest trading nation and largest exporter (13.8% of the world total in goods exported and 10.1% in goods imported in 2015) (WTO, 2016b), China's further export expansion above the world average would naturally face challenges. In fact, Chinese products are facing growing competition from both the advanced and developing countries. Chinese products also face various restrictions imposed by importing countries. Between 1995 and June 2016, nearly 1,200 anti-dumping complaints were initiated against Chinese products (23% of world total). In 2016, China's trade partners launched 119 investigations in its exports, according to China's Ministry of Commerce.

On the one hand, investment-driven expansion is no longer sustainable due in part to over-capacity in many industries and the slump in the housing market. On the other hand, increase in consumption is insufficient to serve as the new engine for growth. The poor demand for China's exports in turn affects China's import demand, a considerable portion of which is used for export processing.

Nonetheless, sustaining trade development remains important for the country's economy. While net exports form part of the final demand, trade and trade-related activities also contribute to the economy by stimulating investment and generating employment. In recent decades, trade and trade-related foreign investment have cultivated the emergence of key exporting industries and enhanced the overall competitiveness of Chinese products. Continued development of these sectors is essential for the country's future growth and employment.

Meanwhile, the structure of China's trade has undergone considerable changes. At the aggregate, growth in total trade has decelerated since 2008.

Meanwhile, the trade surplus in goods dropped significantly, but has since 2014 rebounded strongly. This is due partly to the relative decline of process trade, indicating a reorientation by exporters toward domestic sourcing for parts and components. The importance of state-owned enterprises and foreign investment enterprises have also gradually declined. Another important trend is the rising significance of trade in services. Having become sizable in total amount and in its deficit, service trade helps to offset China's large trade surplus in goods. Trade in the so-called mechanical and electrical products and high-tech products have performed somewhat better than those of low-end labour-intensive products.

The structural changes in China's trade are consistent with the country's objectives in post-2008 development. China aims to transform the economy from investment-driven and export-oriented toward technology-driven and domestic consumption oriented. More importantly, since 2013, the government has also formulated accommodating policies to support the transformation. These include a strong emphasis on innovative development, as well as policies to further enhance economic opening, including setting up Pilot Free Trade Zones (FTZ) and promoting the Belt and Road Initiative.

These will have important implications for Southeast Asia. China's economic interaction with Southeast Asia has grown rapidly and significantly, even during the rather turbulent post-2008 period. Indeed, China and countries in Southeast Asia have become significant economic partners as the regional production network in Asia has strengthened and have grown both in size and in scope. Although bilateral trade is still unbalanced, structural changes in China's economy and trade are expected to narrow the gaps by generating more opportunities for ASEAN countries.

Understandably, given the differences among ASEAN countries regarding their level of development, the impact of China's changing dynamics will differ considerably. For example, China's efforts to upgrade its industry and trade will benefit the relatively less developed ASEAN members, while intensifying competitive pressure on those at a similar development level.

2. Economic Growth is No Longer Driven by Trade Expansion

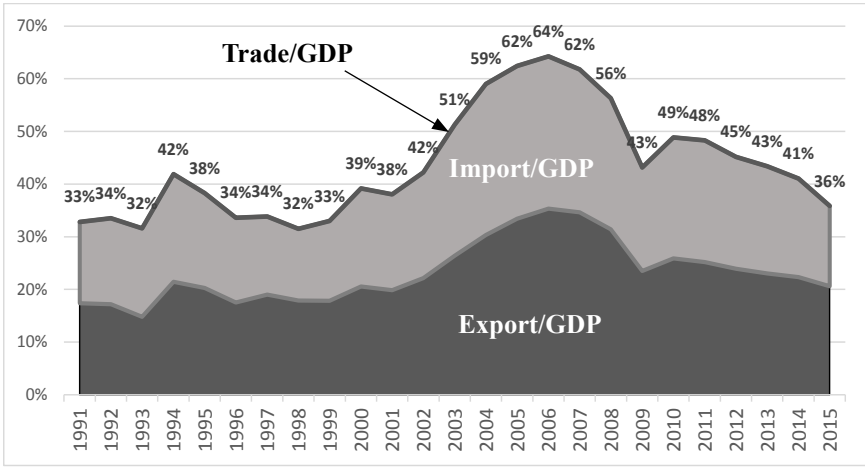
Economic opening and the resulting trade expansion had contributed significantly to China's phenomenal growth of the past three decades, both directly and indirectly. China has become one of the most open among the world's large economies, measured by trade dependency. The economy grew at nearly 10% a year on average between 1978 and 2015, thanks to the rapid growth in the secondary sector that also facilitated trade expansion, especially the processing trade (Table 1). From 1978 to 2015, total trade expanded by 15.3% a year in nominal terms, with the highest percentage from 1998

Table 1 Growth and Economic Opening are Closely Linked

	Economic Growth (%, in real terms)		*Trade Expansion (%, in nominal terms)*
	GDP	*Secondary Sector*	
1978-1988	10.1	11.0	17.4
1988-1998	9.6	12.4	12.2
1998-2008	10.1	11.0	23.0
2008-2015	8.5	9.0	6.4
1978-2015	9.7	11.0	15.3

Source: CEIC Data Manager.

Figure 1 Trade to GDP Ratio 1991-2015

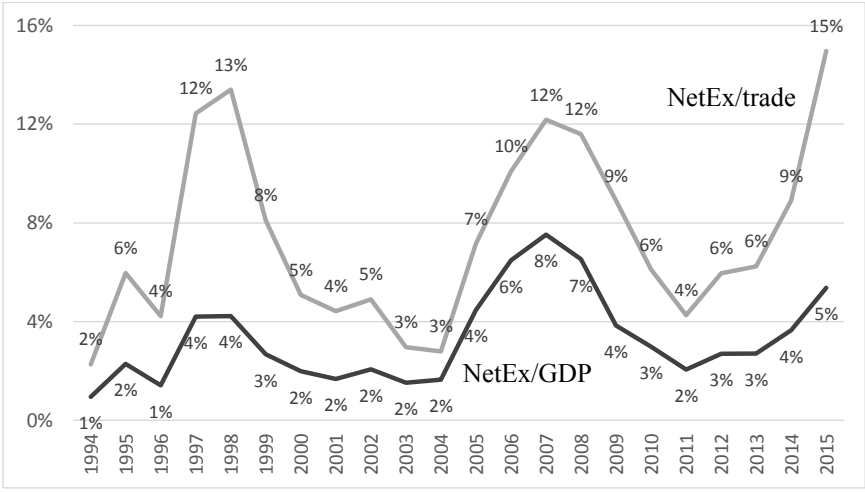


Source: CEIC Data Manager.

to 2008. It dropped to 6.4% in the post 2008 period while growth in gross domestic product (GDP) also decreased to single digits.

Meanwhile, China's trade to GDP ratio rose from below 10% in the late 1970s to 30% in the 1990s and over 60% in the mid-2000s. This is considerably higher than those of the other two large economies of the United States and Japan. China's trade to GDP ratio has since declined considerably, to less than 40% in 2015. This primarily reflects two trends: first, growth is less dependent on trade expansion; and second, China's trade is facing difficulties and challenges.

Figure 2 Trade Imbalance, 1991-2015



Source: CEIC Data Manager.

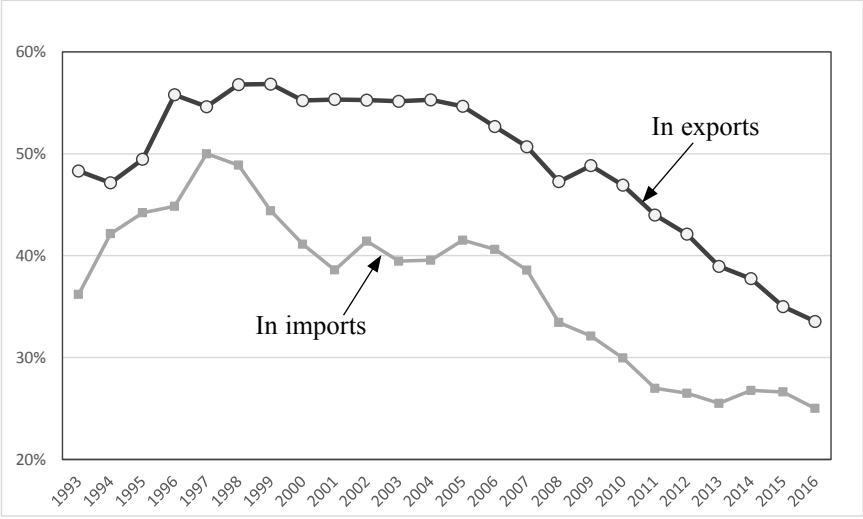
3. Structural Changes in China's Trade

Obviously, China has experienced various structural changes in trade after 2008. First of all, trade imbalances fluctuated. Trade surplus in goods declined significantly between 2008 and 2011, its ratio to total trade falling from 12% to 4% (Figure 2). This is mainly due to the weakness in world economy and the demand for Chinese products. However, its trade surplus rose to reach 15% of total trade in 2015, probably the outcome of two developments. The first is the depressed commodity price in recent years. The second is a shift by Chinese exporters from offshore to onshore in input sourcing.

Second, China's export sectors depend substantially on process trade, which requires large and efficient flows of parts and components to sustain production and growth, but the share of process trade in total trade has been continuously declining since 1997 (Figure 3). Between 1996 and 2007, process trade in exports accounted for more than half of China's total export but declined to about one-third in 2016. Similarly, the share of process trade in imports also fell considerably since the mid-2000s, from over 40% in 2005 and 2006 to about one quarter in recent years.

Third, the importance of state-owned enterprises (SOEs) and foreign investment enterprises (FIEs) in trade have both declined (Table 2). The share of SOEs in exports fell sharply from two thirds in the mid-1990s to about one fifth in the mid-2000s, and further to around one tenth in recent years. That in imports also dropped, though to a lesser extent, from 50% in 1995 to 23% in 2016. Meanwhile, the contribution of FIEs to China's trade varied over time.

Figure 3 Shares of Process Trade in Total Trade



Source: CEIC Data Manager.

Table 2 SOEs and FIEs in China's Trade, 1995-2016

% of total

	Export			*Import*			*Trade Surplus*		
	SOEs	*FIEs*	*Other*	*SOEs*	*FIEs*	*Other*	*SOEs*	*FIEs*	*Other*
1995	67	32	2	50	48	3	203	-96	-7
2000	47	48	5	44	52	4	73	9	18
2005	22	58	20	30	59	11	-28	56	72
2008	18	55	27	31	55	14	-32	57	75
2010	15	55	30	28	53	19	-84	68	116
2015	11	44	45	24	49	26	-28	29	98
2016	10	44	46	23	49	29	-28	29	100

Source: CEIC Data Manager.

Its share in exports rose from the 1990s to the mid-2000s but then declined to about 44%. That in imports followed a similar pattern, is now about 50%, as a result, FIEs' significance in generating trade surplus decreased, contributing less than 30% of the total, down from 60% in the mid- to late 2000s.

It meant that the dominance of SOEs and FIEs in China's trade had been diminishing and enterprises of other ownership types, such as domestic private firms, were playing an increasingly important role. Their shares in

Table 3 Trade in Goods and Services, 1998-2014 (billion US$ and %)

	Exports + Imports					*Balances*		
	Total	*Goods*	*Services*	*Goods (%)*	*Services (%)*	*Goods (A)*	*Services (B)*	*A + B*
1998	375	324	51	86	14	47	-3	44
1999	418	361	57	86	14	36	-5	31
2000	540	474	66	88	12	34	-6	28
2001	582	510	72	88	12	34	-6	28
2002	707	621	86	88	12	44	-7	37
2003	952	851	101	89	11	44	-9	35
2004	1,288	1,154	134	90	10	59	-10	49
2005	1,579	1,422	157	90	10	134	-9	125
2006	1,952	1,760	192	90	10	218	-9	209
2007	2,428	2,177	251	90	10	316	-8	308
2008	2,868	2,563	305	89	11	361	-12	349
2009	2,495	2,208	287	88	12	250	-30	220
2010	3,336	2,974	362	89	11	254	-22	232
2011	4,061	3,642	419	90	10	244	-55	189
2012	4,263	3,792	471	89	11	322	-90	232
2013	4,618	4,078	540	88	12	360	-119	241
2014	3,713	3,109	604	84	16	303	-160	143

Source: CEIC Data Manager.

exports and imports rose from 20% and 11% in 2005 to 46% and 29% in 2016, respectively. These firms are also key in generating trade surplus. The ratio of trade surplus by non-SOEs, non-FIEs firms to overall rose from 72% in 2005 to 100% in 2016.

Fourth, while trade in goods experienced a sharp growth slowdown, that in services expanded consistently, particularly in imports. From 2003 to 2008, service imports accounted for less than 12% of China's total imports, but the share rose to 16% in 2014 (Table 3). More significantly, the deficit in China's service trade went up rapidly. Before 2008, China's trade deficit in services was mostly less than US$10 billion. The trade deficit in services expanded by more than 10 times between 2008 and 2014, while that in goods trade remained roughly the same. The trade deceleration seemed broadly based and affected China's major trade sectors. As prices for China's imports declined more than its exports, China incurred its largest trade surplus in goods. The rise in service trade and its rising deficit were important to offset China's large trade surplus in goods.

Fifth, the mechanical and electrical (ME) products and hi-tech products have become more and more important in China's trade composition (Table

4). The net export ratio to total trade for ME products was only 10% in 2000 but quickly shot up to 95% in 2008 and 151% in 2010. That for hi-tech products was still negative in 2000 but increased to 25% in 2008 and 44% in 2010.

Table 4 Rising Importance of Mechanical & Electrical (ME) Products and Hi-Tech Products, 1993-2015

% of Total

	Exports		*Imports*		*Net Exports*	
	ME	*Hi-Tech*	*ME*	*Hi-Tech*	*ME*	*Hi-Tech*
1993	25		48			
1995	30		45		-92	
2000	42	15	46	23	10	-64
2005	56	29	53	30	75	20
2008	58	29	48	30	95	25
2010	59	31	47	30	151	44
2015	58	29	48	33	85	18

Source: CEIC Data Manager.

Table 5 China's Trade: Total and Share of Coastal Regions, 2001-2015

	National (US$ bil)			*% of coastal regions*		
	Export	*Import*	*EX + IM*	*Export*	*Import*	*EX + IM*
2001	267	244	510	88.1	83.3	85.8
2002	326	295	621	89.1	86.0	87.6
2003	438	413	852	89.4	86.7	88.1
2004	594	561	1,154	89.7	87.0	88.4
2005	762	660	1,423	89.8	86.9	88.5
2006	969	792	1,761	89.5	86.4	88.1
2007	1,218	956	2,174	89.1	86.0	87.7
2008	1,429	1,132	2,561	88.0	85.3	86.8
2009	1,202	1,004	2,206	89.6	85.0	87.5
2010	1,578	1,394	2,972	89.8	84.7	87.4
2011	1,899	1,741	3,641	88.7	84.0	86.4
2012	2,050	1,817	3,867	87.1	83.8	85.6
2013	2,211	1,949	4,160	86.4	83.8	85.2
2014	2,343	1,963	4,306	85.2	81.9	83.7
2015	2,282	1,681	3,963	85.7	81.8	84.0

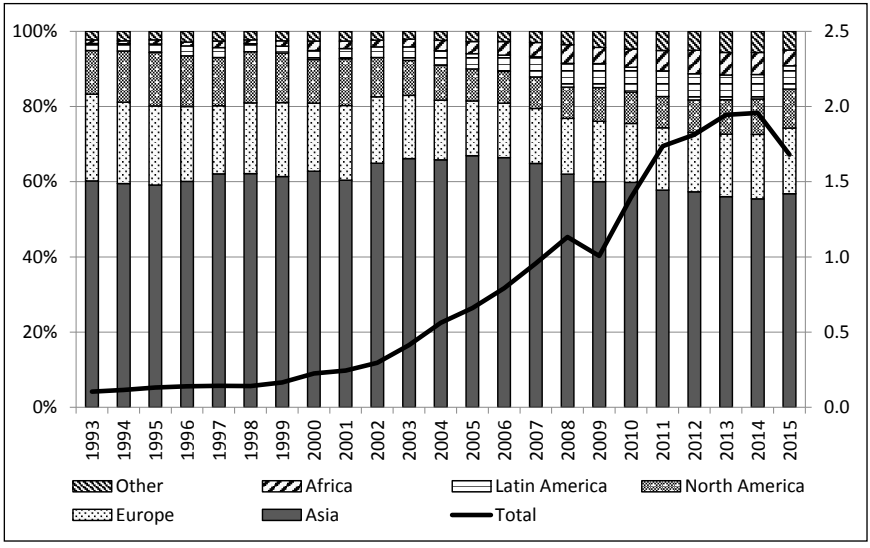
Source: CEIC Data Manager.

Sixth, China's trade in the coastal regions has declined, albeit only modestly. In 2015, exports from and imports to China's coastal regions accounted for 86% and 82% of the country's total, only a slight drop each from 88% and 85% in 2008, respectively (Table 5).

Seventh, there have been visible changes in the distribution of China's trade with its trading partners. Overall, Asia remains China's primary trading partner, accounting around half of China's total exports and close to 60% of its imports (Figures 4 and 5). This is followed by Europe and North America. It should be noted that, in recent years, countries in the developing areas of Latin America and Africa have gained in relative importance for China's trade.

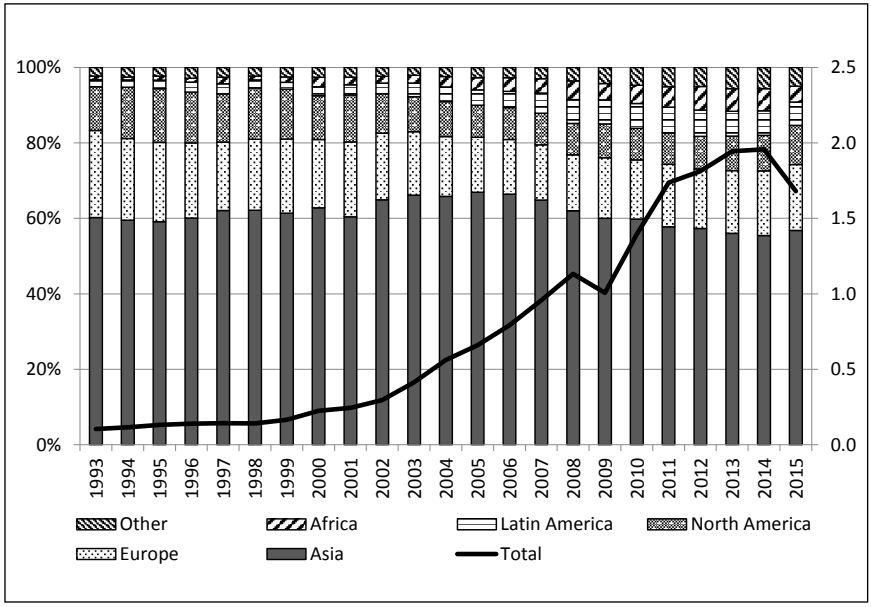
Within Asia, East Asian countries are the main trading partners of China, but the percentage has gradually decreased. In exports, Hong Kong, Japan, Taiwan and South Korea accounted for about 80% in 1993 but decreased to about 60% in 2015 (Figure 6). Imports from them also showed a drop of more than 20 percentage points (Figure 7). On the other hand, ASEAN countries, especially Malaysia and Thailand, have gradually increased their percentages in China's total trade. It is worth noting that the percentage of other Asian countries in China's trade, mostly the Central Asian countries, has increased from below 10% in 1993 to over 30% in 2015. It means that China's trade has become more diversified among the Asian countries in recent years.

Figure 4 China's Export with Major Countries, 1993-2015



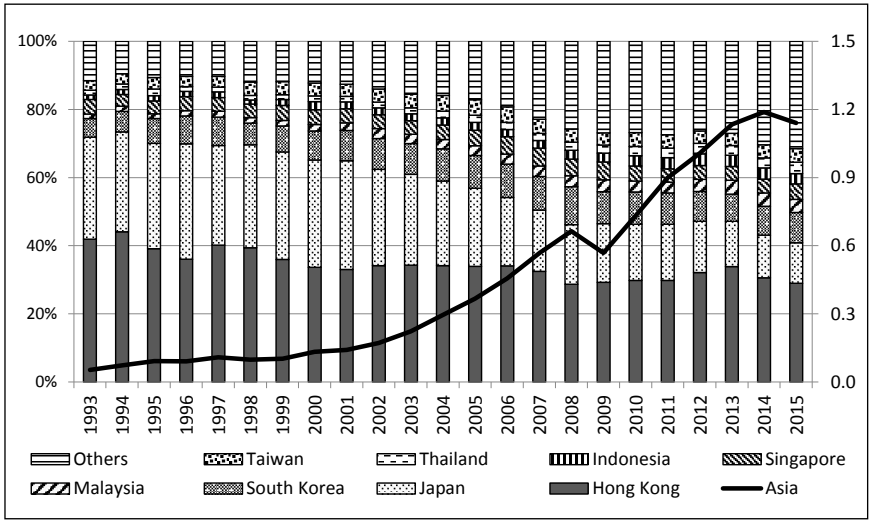
Source: CEIC Data Manager.

Figure 5 China's Import with Major Countries, 1993-2015



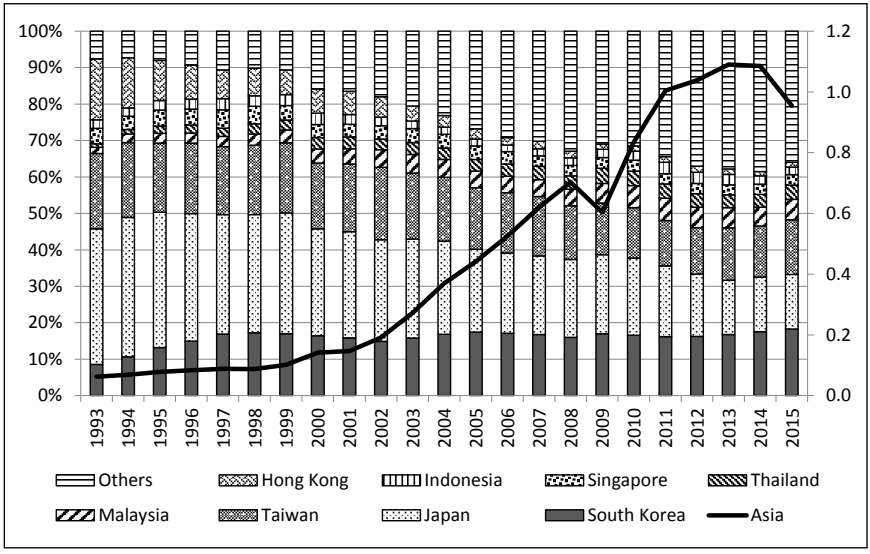
Source: CEIC Data Manager.

Figure 6 China's Export to ASEAN Countries, 1993-2015



Source: CEIC Data Manager.

Figure 7 China's Import from Asian Countries, 1993-2015



Source: CEIC Data Manager.

4. Trade and Economic Opening Remains Essential

Yet, trade and trade-related economic activities, exports in particular, remain essential to sustain China's growth. Although net export constitutes a small portion of the overall final demand, the absolute amount is huge given the size of the economy. Between 2011 and 2015, the amount of net exports, ranging from RMB1.2 trillion to RMB3.7 trillion, showed an increasing trend, especially in the last two years that were even better than in the period from 2006 to 2008. Even in relative terms, measured as shares to gross domestic product (GDP), it is generally higher than those of the early 2000s (Table 6).

Moreover, expansion in the trade sector and the associated investment are significant to support growth. Indeed, export-oriented industries have achieved faster growth in not only sales, revenues and employment, but also value-added. This is particularly true between the early 2000s and 2008 prior to a serious financial and economic crisis that hit the world economy.

Industries that focus more on export thus attracted higher investment and achieved stronger growth. Indeed, trade expansion and surging inward direct foreign investment facilitate the emergence and rapid expansion of industries such as the manufacturing of "computer, communication and other electronic equipment" and "electrical machinery and equipment". Meanwhile, employment in export production and in other trade-related activities is important to provide jobs, especially for the millions of relatively low-skilled

Table 6 China's GDP and Balance of Trade, 2001-2015

	GDP (RMB trillion)	*Balance of Trade*	
		Amount (RMB trillion)	*Share (%) in GDP*
2001	11.1	0.2	2.1
2002	12.2	0.3	2.5
2003	13.7	0.3	2.2
2004	16.2	0.4	2.6
2005	18.8	1.0	5.4
2006	21.9	1.7	7.6
2007	26.9	2.3	8.7
2008	31.7	2.4	7.6
2009	34.6	1.5	4.3
2010	40.7	1.5	3.7
2011	48.1	1.2	2.4
2012	53.5	1.5	2.7
2013	59.0	1.5	2.5
2014	64.0	1.7	2.7
2015	68.8	2.4	3.4

Source: *China Statistical Yearbook 2016*.

migrant workers. Employment growth of an industry is found to be positively correlated with its export propensity, particularly in the years between 2001 and 2007.[1] Hence, as export-oriented industries grow stronger and are likely more labour intensive, they contributed significantly more to employment.

Conversely, the importance of trade is also reflected in the negative drag of poor trade performance on growth. For example, the large negative shock in external demand in late 2008 led directly to China's economic deceleration. The regions most exposed to trade, such as Guangdong province, experienced the sharpest drop in growth. Similarly, in recent years, China's growth dropped to around 7.5% as net exports contributed negatively to growth.

5. Trade Development Key to China's Overall Policy Agenda

Trade policies formed an important part of China's overall economic policies, in particular its industrial policies. Since 2008, when China experienced a sharp decline in external demand and growth, the government had devised numerous policies to support trade. Policy objectives have shifted over time, from a relatively narrow approach of supporting the exporters and exporting industries in the early years to a broader approach of liberalization and trade facilitation. To support exports, the government may implement policies to

enhance price competitiveness of Chinese products. These could include efforts to maintain a relatively low and stable exchange rate for China's currency. The government also uses export tax rebates to alleviate exporters' tax burdens and enhance their competitiveness.

More broadly, various economic liberalization policies such as measures to improve trade financing and streamline administration, as well as currency swap arrangements between trading partners, can help to reduce cost and facilitate trade. Trade-related direct investment may also facilitate trade. The Chinese government is also promoting trade by pursuing bilateral and multilateral free trade arrangements. This has become especially important in recent years when free trade and the associated global trade regime have been threatened by growing protectionist tendencies.

Since 2013, China's trade policies have seemingly shifted to become more market accommodating. The most obvious example is the establishment of Shanghai Free Trade Zone (FTZ) in September 2013. Championed by China's Premier Li Keqiang, the Shanghai FTZ is expected to become "a model of China's upgraded economy" and "a vehicle to further integrate China with the rest of world". In addition to experimenting with pre-entry national treatment and negative-list approach towards foreign investors, the Shanghai FTZ also includes measures to streamline investment administration and trade facilitation.

In May 2014, as it became evident that China's trade was experiencing many difficulties in achieving the government's goal for annual growth of around 7.5%, the State Council announced *Opinions*. These *Opinions* were later substantiated by policies and measures formulated by other relevant government agencies. On 23 May 2014, China's General Administration of Customs issued "20 Measures to support the steady growth of foreign trade" (General Administration of Customs of PRC, 2014). On 11 June 2014, the People's Bank of China announced its "Guidance on implementing the *Opinions*" (People's Bank of China, 2014). In early June, the State Tax Authority announced measures to support trade growth (State Tax Authority, 2014).

While the overriding objective of these government publications is to support trade growth, the government emphasized the importance of the restructuring in trade, including enhancing imports, upgrading traded commodities, advancing trade in services, and facilitating trade-promoting outbound direct investment. The government aims to improve the business environment through trade facilitation and supporting Chinese firms' efforts to respond to trade restrictions imposed by importing countries.

The government has further instituted measures to improve trade financing, through exchange rate liberalization, expanding currency swap arrangements, improving financial services, enhancing export credit insurance support, improving export tax rebates, and supporting the development of

various trading firms including small and micro-sized firms. China has also enhanced its efforts to form closer economic ties with its trading partners. In addition to negotiating bilateral investment treaties, China had set up two Free Trade Areas (FTAs) in 2014, one with Australia and the other with Korea. China has also become more active in driving the agenda for regional and multilateral economic grouping, such as the Free Trade Area of Asia and the Pacific (FTAAP).

China's overall trade development was well below the target set by the government. Yet, the policies and measures of the year to support trade had remained largely neutral and market-oriented. Of note is whether such policy orientation can become the norm for the new leadership, if trade growth and restructuring remain slow. The progress in the Shanghai FTZ has been slow. The government had announced in September 2013 a long and complex negative list for the zone, which included 190 investment restrictions that closely resemble the catalogue of China's restrictions on foreign investment. In June 2014, Shanghai FTZ authorities issued a revised list that reduced the number of items to 139. Although part of the reduction was the rearranging and combining of items, the revision did open further sectors to foreign investors such as financial services, medical services and entertainment fields. The government has also extended nationally some of the successful reforms.

As such, more market-oriented reforms in both trade facilitating and extending FTZs could be expected. In December 2014, the State Council announced initiatives to further economic opening, including deepening reforms in the Shanghai FTZ, extending some reforms nationally, and establishing three more FTZs in Guangdong, Tianjin and Fujian. On 3 February 2015, the State Council released a circular, "Implement the 'three interoperability'[2] and advance the reform in building a grand custom clearance system" (State Council, 2014), that aimed to promote the implementation of China's custom clearance reform plan.

6. Economic Ties with Southeast Asia Central to China

Trade between China and Southeast Asian countries is fundamental for a strong bilateral economic relation. From a relatively small starting point, bilateral trade has begun to grow substantially since the 1980s, along with the establishment or resumption of diplomatic relations with ASEAN members. This coincided with China's efforts to expand its economic relations with the rest of the world after the country adopted a grand reform agenda in 1978. Bilateral trade has expanded further since the early 1990s when China opened its economy further, following Deng Xiaoping's *Nanxun* (Southern Tour) in 1992. China's accession to the World Trade Organisation in 2001 marked a

Table 7 China-ASEAN Bilateral Trade Growth, 1981-2014

	Exports	*Imports*	*Total*	*Balance*
ASEAN's trade with China (annual growth %)				
1981-1991	19.4	11.7	13.9	6.0
1991-2001	17.7	13.4	15.2	2.9
2001-2008	27.0	28.3	27.7	33.9
2008-2014	10.8	13.9	12.6	22.7
1981-2014	18.8	16.0	16.8	13.4
China's trade with ASEAN (annual growth %)				
1997-2001	11.5	17.4	14.6	
2001-2008	29.6	26.0	27.7	
2008-2014	15.6	10.1	13.0	
1997-2014	20.1	18.2	19.2	

Source: Calculated by the authors based on IMF's *Direction of Trade* of ASEAN countries, and CEIC Data Manager.

new beginning of China's expansion of trade with the world and ASEAN. China has been ASEAN's largest trading partner since 2009 and ASEAN China's third largest since 2010 (*China Daily*, 2014).

Table 7 summarizes the increase in China-ASEAN bilateral trade ties. Information based on ASEAN sources are listed in the upper panel, and those using China's official sources are in the lower panel. According to ASEAN sources, bilateral trade rose by 17% a year on average between 1981 and 2014. There are a few characteristics in this bilateral trade. First, growth in ASEAN's exports to China outpaced that in ASEAN's imports from China for the entire period of 1981 to 2014, at 19% and 16% a year, respectively. Second, the relative speed of expansion between export and import varies over time. ASEAN's export to China grew faster than its imports from China between 1991 and 2001, but the trend reversed since then. Third, growth in bilateral trade decelerated sharply since 2008, reflecting a worldwide trend. Meanwhile, export deceleration, from 27% to 11% is more significant than that in import, from 28% to 14%.

China reports trade with ASEAN since 1997. Between 1997 and 2014, total trade with ASEAN grew by 19% a year on average, compared to an annual growth of 16% for China's total trade. Annual growth in bilateral trade increased from 15% between 1997 and 2001 to 28% in the years between 2001 and 2008, followed by a deceleration to about 13% a year in recent years. Since 2001, China's exports to ASEAN grew faster than its imports from ASEAN, while the reverse is true for the years of 1997 to 2001.

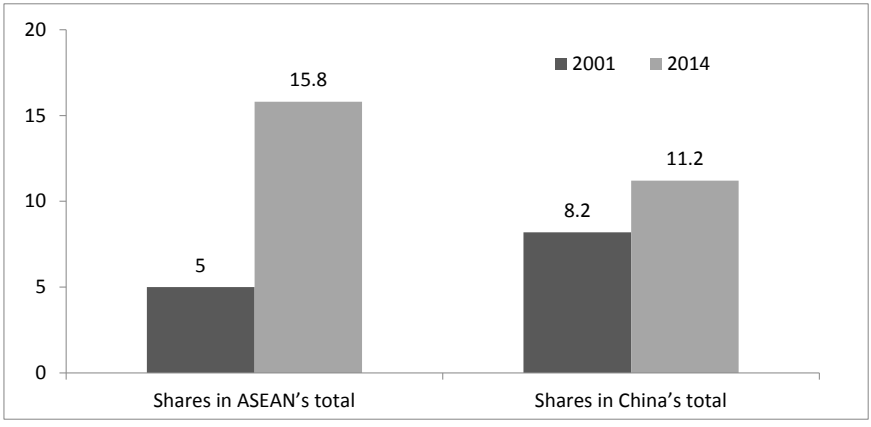
Although there are gaps between the values reported by the trading partners, the two sets of trade data have shown similar trends over time.

While total bilateral trade between China and ASEAN has expanded strongly over the past decades, there are several different tendencies in the trade relations. First, China's relative importance as a trading partner for ASEAN rose faster than ASEAN's for China. In the period of 2001-2014, the shares of ASEAN's trade with China in ASEAN's total increased from 5% to 15.8%, while the shares of China's trade with ASEAN in its total rose by only three percentage points, from 8.2% to 11.2% (Figure 8).

The trend shows that before 2000, ASEAN was a more important trading partner to China compared to China's relative importance to ASEAN. This has been reversed since then and now trade with China constitutes a larger share in ASEAN's total trade compared to ASEAN's share in China's total trade. According to China's Ministry of Commerce, China-ASEAN trade rose to US$472.16 billion in 2015 from US$7.96 billion in 1991, growing 18.5 percent annually. In 2015, as in the previous 6 years, China has been ASEAN's biggest trading partner, while ASEAN is China's third biggest (*Xinhua*, 2016).

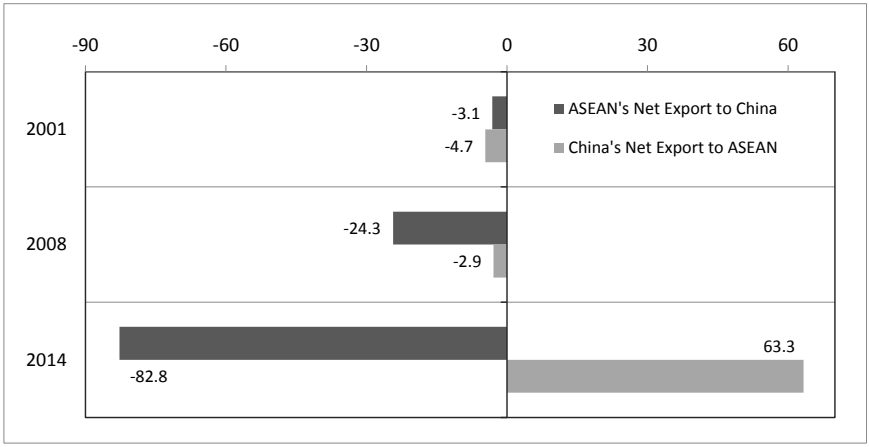
Second, bilateral trade has become increasingly unbalanced. According to data reported by ASEAN countries, the region had a relatively small trade deficit with China in 2001. The trade deficit rose sharply since then, by 26% annually between 2001 and 2014. ASEAN's trade deficit with China amounted to US$83 billion in 2014 (Figure 9). Data from China shows that the country mostly had a small trade deficit with ASEAN for the years from 2001 to 2008.

Figure 8 Shares of Bilateral Trade in Total Trade, 2001 and 2014 (%)



Source: Calculated by the authors based on IMF's *Direction of Trade* of ASEAN countries, and CEIC Data Manager.

Figure 9 Trade Balances between China and ASEAN, 2001-2014



Source: Calculated by the authors based on data from IMF's *Direction of Trade* of ASEAN countries, and CEIC Data Manager.

However, it reported trade surpluses of US$63.3 billion in 2014, roughly 13% of total bilateral trade. The emergence of this pattern of trade suggests that as trade relations between China and ASEAN intensify, ASEAN countries have become more closely tied to a China-centred regional production network and global supply chain. Meanwhile, ASEAN has also become an important market for Chinese products. Although China's economy has grown significantly and its products become globally competitive, together with its Asian neighbours, it has yet to become a major market for imports, including those from its neighbours.

Third, within ASEAN, China has increased its trade with newer ASEAN members while the combined share of ASEAN's six initial members, Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand in China's trade had declined from 94% in 1997 to 76% in 2014. Within this group, Singapore saw the sharpest drop, from 36% to 17%. In 2008, Malaysia surpassed Singapore to become China's largest trading partner within ASEAN. Further in 2014, Vietnam overtook Singapore to become China's second largest trading partner in ASEAN (Table 8). Between 1997 and 2014, the share of Indonesia in total China-ASEAN trade decreased from 19% to 13%. Meanwhile, the shares of Malaysia, Philippines and Thailand increased between 1997 and 2008, but declined thereafter. Among ASEAN's four newer members, Cambodia, Laos, Myanmar and Vietnam, China's trade with Vietnam has grown the fastest. The share of China-Vietnam trade in total China-ASEAN trade rose from 6% in 1997 to 17% in 2014.

Table 8 Shares of ASEAN Members in China's Total Trade with ASEAN, 1997-2014 (%)

	1997	*2001*	*2008*	*2014*
Brunei	0.1	0.4	0.1	0.4
Indonesia	18.6	16.1	13.7	13.3
Malaysia	18.2	22.6	23.2	21.2
Philippines	6.8	8.5	12.4	9.3
Singapore	35.9	26.2	22.7	16.6
Thailand	14.5	17.3	17.8	15.1
Sub-total: ASEAN6	94.1	91.0	89.8	75.9
Cambodia	–	0.6	0.5	0.8
Laos	–	0.1	0.2	0.8
Myanmar	–	1.5	1.1	5.2
Vietnam	5.9	6.7	8.4	17.4

Source: CEIC Data Manager.

In summary, Malaysia has been China's largest trading partner within ASEAN since 2008. Bilateral trade hit US$102 billion in 2014, a fivefold increase from that in 2003. Exports to and imports from China accounted for 12% and 17% of Malaysia's total, respectively (Table 9). Malaysia has long maintained a trade surplus with China. Machinery, electronics, plastic and fuels accounted for more than 50% of Malaysia's export to China. Bilateral economic ties are expected to be further strengthened.

Singapore has the most sophisticated and dynamic economy, and one of the wealthiest in the region. It is also one of the world's most open economies and the traditional trading hub in Southeast Asia, with a trade-to-GDP ratio of around 300% (Lim, 2013). Singapore was China's most important trading partner in ASEAN until 2008 when it was nudged down by Malaysia and taken another notched down by Vietnam when it became China's top trading partner in 2014. In 2014, exports to and imports from China accounted for 13% and 12% of Singapore's total, respectively. China's trade with Singapore recorded US$80 billion in 2014, more than half of which consisted of machinery and electrical products (Salidjanova et al. 2015). Nonetheless, Singapore remains significant to China as its second largest market for exports and the third largest source of imports within ASEAN.

Indonesia is ASEAN's most populous country, constituting more than 40% of its population. China is Indonesia's top trading partner and total bilateral trade hit US$63.58 billion in 2014. In that year, exports to and

Table 9 ASEAN's Trade with China: Shares in Total Trade (%)

	Brunei		*Cambodia*		*Indonesia*		*Laos*		*Malaysia*		*Myanmar*		*Philippines*		*Singapore*		*Thailand*		*Vietnam*		*ASEAN*	
	EX	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*	*EX*	*IM*
1985		2.0		2.0	0.5	2.4			1.0	2.0	1.2	3.2	1.8	5.4	1.4	8.6	3.8	2.4			1.3	5.0
1990		2.7	0.4	5.9	3.2	3.0		10.7	2.1	1.9	8.1	20.6	0.8	1.4	1.5	3.4	1.2	3.3	0.3	0.2	1.8	2.9
1995		3.0	1.5	3.6	3.8	3.7	2.8	3.7	2.6	2.2	11.4	29.0	1.2	2.3	2.3	3.2	2.8	2.7	6.4	3.9	2.7	3.1
2001	4.0	1.4	1.1	6.0	3.9	6.0	1.8	8.3	4.3	5.2	4.4	20.5	2.5	2.9	4.4	6.2	4.4	6.0	9.4	9.9	4.3	5.9
2007	3.1	5.6	0.3	17.7	8.5	11.5	5.8	9.3	8.8	12.9	7.0	33.3	11.4	7.2	9.7	12.1	9.6	11.6	7.5	20.3	9.2	12.6
2010	7.0	12.9	1.2	24.2	9.9	15.1	23.3	14.7	12.5	12.6	13.5	38.5	11.1	8.4	10.4	10.8	11.1	13.2	10.5	24.0	10.9	13.6
2012	2.7	21.3	2.3	30.6	11.4	15.3	21.5	16.2	12.6	15.1	14.3	36.6	11.8	10.8	10.8	10.3	11.7	14.9	11.2	25.8	11.4	14.8
2014	1.8	27.0	4.3	23.2	10.0	17.2	34.9	25.6	12.0	16.9	63.0	42.6	13.0	15.0	12.6	12.1	11.0	16.9	12.4	35.3	12.7	18.9

Source: Calculated by the authors based on data obtained from IMF's *Direction of Trade*.

imports from China made up respectively 10% and 17% of Indonesia's total with the world. China-Indonesia trade currently resembles a pattern of resources-for-manufactures. More than half of Indonesia's imports from China are machinery and electronics. Meanwhile, energy, coal, raw materials and agricultural products make up three-quarters of Indonesia's exports to China, compared to 45% of its exports to the world (Salidjanova et al., 2015). Leaders of the two countries agreed to further develop their bilateral trade to reach US$80 billion by 2015 (Fu Peng, 2013). They also committed to develop a more balanced, sustainable and strong two-way trade.

Thailand is the second largest economy in ASEAN. It is also highly export-oriented, with an export to GDP ratio of 65% in 2014. Thailand not only is an automobile-manufacturing hub in the region, but also has significant comparative advantage in agricultural products. In 2013, Thailand's top export market was China (12% of the total), followed by Japan (10%) and the United States (10%) (*Trading Economics*, 2016). In 2014, exports to and imports from China made up 11% and 17% of the country's total exports and imports, respectively. Thailand's trade with China is quite distinctive. In 2013, machinery and electrical products, plastic or rubber, and chemicals accounted for two-thirds of Thai exports to China. A unique feature of Thai trade is the export of services, particularly tourism, which allows the country to have a positive trade surplus in term of goods and services with China.

Bilateral trade between China and Vietnam has developed strongly in recent years despite their territorial disputes in the South China Sea. Since 2003, Vietnam's trade with China has an average increase of 30% annually from US$4.64 billion in 2003 to US$84 billion in 2014. China is Vietnam's largest trade partner, and Vietnam has a trade deficit with China amounting to nearly US$44 billion in 2014, up from US$31.7 billion in 2013. In 2014, Vietnam's exports to and imports from China constituted respectively 12% and 35% of the country's total. Vietnam mostly exports raw materials to China and imports manufactured products, such as garment, equipment and machinery. Vietnam also imports large quantity of electricity to power its northern provinces.[3]

7. Summing Up

Responding to both external dynamics and domestic structural changes, China's trade will continue to evolve. China will likely be more proactive in outward economic ventures, including trade and investment, as well as in global economic cooperation and governance. These will have significantly implications for ASEAN, China's close neighbor and key trading partner. Bilateral economic ties will continue to be strengthened, but benefits will not

be equally distributed across the region. Relatively less developed and more resource abundant members may gain more while those with a similar level of development will likely face more intense competition. Political mistrust could also drag on economic cooperation. It is hopeful that China-ASEAN could in another decade develop into a larger, more integrated, and more affluent economic area which will provide a strong foundation for the region's common development and prosperity.

Notes

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1. Correlation coefficient between export propensity and employment growth was above 75% between 2001 and 2012, and over 85% between 2001 and 2007 (Source: calculated by the authors using data from CEIC Data Manager).
2. The so-called "three interoperability" refers to information exchange, mutual recognition of regulatory regimes and mutual aid in law enforcement among relevant border agencies.
3. The Electricity of Vietnam, the country's power utility, imports several billions of kWh of electricity from China to ensure supply for 13 provinces in the north according to the Vietnam News Agency (*Tuoitrenews*, 2015).

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The Impact of China's Economic Restructuring on Southeast Asia: An Investment Perspective

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Abstract

China's economic growth in 2015 has fallen to 6.9% from an unrivalled average of 10% between 2002 and 2014. While the global economy is feeling the impact of China's economic restructuring, a change of such a magnitude in China has created a great impact on Southeast Asia, which is intensively involved in trade and investment with China. By analyzing macroeconomic data, we find no indication that China's outward investment in Southeast Asia was immediately shocked by China's New Normal. Instead, in an economically challenging era after 2007, Chinese OFDI in ASEAN has increased significantly. Though Chinese OFDI in Southeast Asia is distributed unevenly in geographical and industrial terms, the analysis of regional and sectorial distribution has reflected a paradigm shift of China's economy from an export oriented to an investment driven growth. The rising wave of Chinese investment in ASEAN can be understood by China's dilemma of over-capacity in some manufacturing sectors. Given the increasing production cost which has significantly reduced cost advantages of Chinese manufacturing, the rapid growth of Chinese outward investment is not only a result of a single firm's strategic shift to relocate to seek higher returns. It is rather a collective reaction of Chinese firms to the challenging business environment in China's domestic market.

Keywords: *Outward investment, China, Southeast Asia*

1. Introduction

China's economic growth in 2015 has fallen to 6.9% from an unrivalled average of 10% between 2002 and 2014. The global economy is feeling the impact of China's re-imbalance. It has spawned competing theories of what is happening to China's economy previously featured by miraculous growth since its economic reforms in 1978 (Rasiah et al., 2013). The heated debates can be divided into two schools, one of which believes the slowdown to be a

result of a deliberate attempt by the government to restructure its economy, whereas the other predicts the economy has slid into a hard landing which sees China entering a lost decade of stagnation or recession *à la* Japan (Powell, 2009; Lai, 2015). Whatever the explanation, a change of such magnitude in China will undoubtedly impact the rest of the world, including Southeast Asia, which is intensively involved in trade and investment with China in the past decades.

Understanding this impact requires knowledge of the nature and structure of China's investment in the region. Although a number of studies have examined a series of issues regarding China's outward FDI in general, including the trend and driving forces of China's outward FDI (Morck et al., 2008; Rui and Yip, 2008), the major focus of the previous research was the determinants and motivations of Chinese companies' in investing overseas (e.g. Buckley et al., 2007), FDI location choice of Chinese firms (Kang and Jiang, 2012) and FDI entry mode decisions of Chinese multinational enterprises (Cui and Jiang, 2009). Nevertheless, the growth in China's outward FDI in Southeast Asia has so far attracted little attention from scholars in mainstream research publications. There is still a dearth of regional studies on what attracts Chinese capital, especially to Southeast Asia which has received a great deal of investment from Chinese investors in recent years. Further, the impact of China's economic slowdown on its overseas investing activities in the region has not received sufficient attention.

Therefore, this paper aims to examine the impact of China's economic rebalancing on its outward investment to Southeast Asia. More specifically, this paper considers two sets of issues. Firstly, what impact has China's economic slowdown created on its outward investment in Southeast Asia? China has witnessed an unprecedented leap forward in investing in Southeast Asia since the 2008 global financial crisis despite its real GDP growth having undergone a significant slowdown. Whether this inverse relation between GDP growth and outward investment in Southeast Asia signifies China' transition from an export-oriented economy to an investment-led model remains as a core topic that we aim to address in the first part of this paper. Secondly, what is the nature and feature of Chinese investment in Southeast Asia as a whole as well as in specific individual sectors and countries in the region? To answer this question, we aim to capture the changes of regional and sectoral distribution of the investment in the face of the Chinese government's call for supply-side restructure reforms. We explored further on whether such an investment pattern shift is reflective of overall economic rebalancing, especially when the comparative advantages used to leverage rapid growth in the past (e.g. by relying on vast amounts of relatively low-wage labour and massive inflow of foreign direct investment) are viewed as lacking the power to sustain future growth.

The paper is organized as follows. After the introduction, section two presents methodology and analytical framework underpinning the analysis of this paper. Section three analyses the impact of China's economic slowdown on the pattern of its outward investment in Southeast Asia. Section four examines the nature and features of Chinese investment in Southeast Asia. Emphasis would be given to the changes of investment pattern in the face of China's recent economic restructuring. The paper ends with conclusions in section five.

2. Methodology

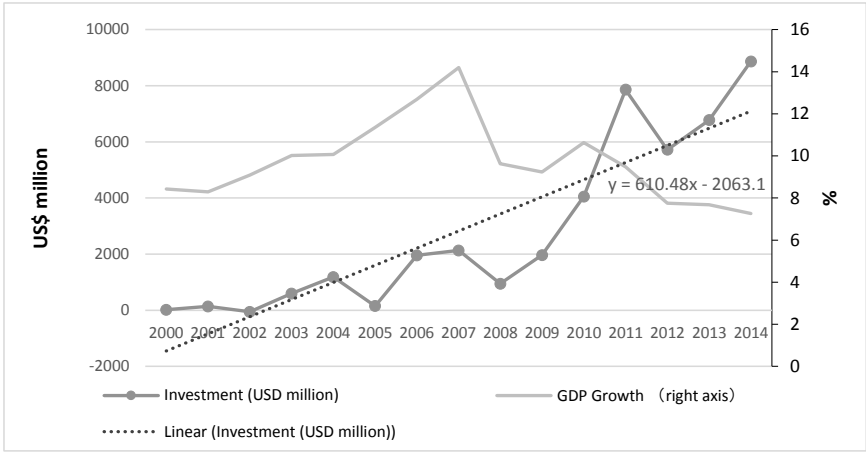
This research adopts a mix mode methodology. Complemented by descriptive quantitative analysis, qualitative evidences are collected from interviews and secondary sources such as government documentaries (Patton, 1990; Johnson et al., 2007). The combined use of qualitative and quantitative techniques enables the benefits of both approaches in research which offers greater validity to the results and analysis. By leveraging on the strengths of both approaches, corroborative results from mixed methodologies strengthen the robustness of research. By using contextual analysis of typical events in certain policy environments, the case study is used when necessary to interpret how firms' choice is influenced by government policy direction. An analysis of institutional players' behaviour is also necessary to reflect the role of specific institutional frameworks.

The quantitative data is extracted from various secondary sources, including the ASEAN Secretariat, China Global Investment Tracker and Global Investment Report by UNIDO. Specifically, investment data from the ASEAN Secretariat provides a sufficiently long time period which enables analysis of the investment from 2000 to 2014. While the China Global Investment Tracker covers a shorter period from 2005 to 2015, its strength lies in its featuring project-based data which allow sector-specific and region-specific analysis of China's investment in ASEAN. Out of 1,761 Chinese mega investment projects across the world from 2005 to 2015, we identified 238 projects in ASEAN. Despite the presence of established local partners, all projects have Chinese multinational corporations (MNCs) as major shareholders (over 50% ownership), and hence serve as a good indicator of MNC's investment in the region.

3. Chinese investment in Southeast Asia in an Economic Slowdown

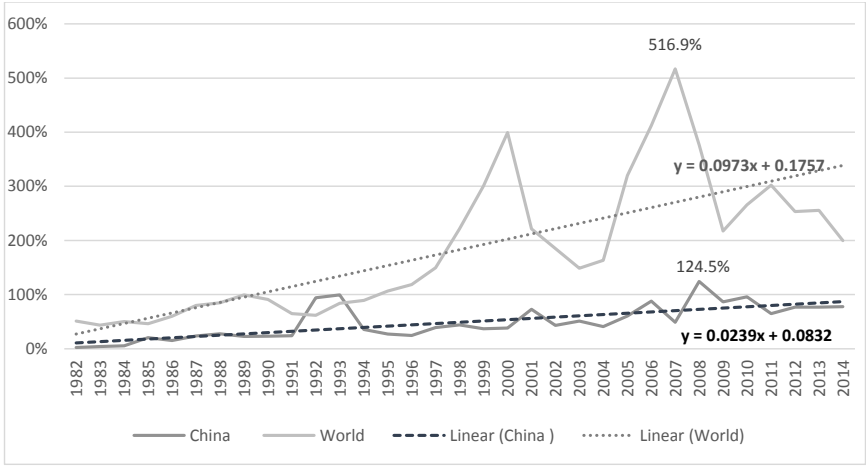
Although the share of outward investment in GDP of China has grown dramatically from 2.2% in 1982 to 77.7% in 2014, China's outward investment by and large remains much lower than the average share of the world (Figure 2). The exceptions in 1992 and 1993 whereby the share of

Figure 1 China's Investment Flow to ASEAN, 2000-2014



Source: ASEAN Secretariat (2015).

Figure 2 Outward Investment over GDP, China & World, 1982-2014 (%)



Source: World Bank (2015).

China's outward investment exceeded the world average is largely due to a jump in absolute value (from US$913 million in 1991 to US$4 billion in 1992, and US$4.4 billion in 1993 before returning to US$2 billion in 1994 and afterwards). The world share peaked at 516% in 2007 when investors' confidence gained from strong economic growth drove capital flow worldwide before the Global Financial Crisis struck in 2008. In 2007, China's share of outward investment in total GDP remains at a low 48%. Ironically, when crisis

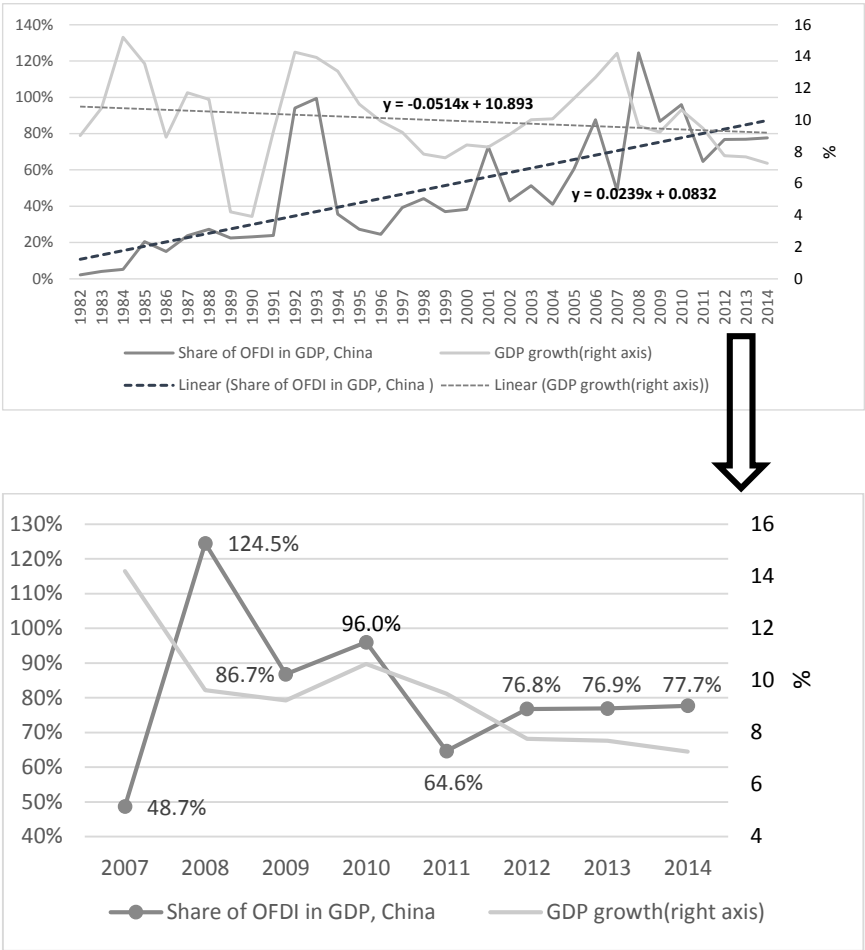
hit the world economy in 2008, China saw a surge of outward investment level to 124% whereas the world level drops significantly to 376% in 2008 from 516% in previous year. In general, while the world share of OFDI in GDP grows at an annual average of 9.7% from 1982 to 2014, China grew at a slower pace of 2.3% every year. Therefore, China's early outward foreign direct investment fell behind world average in terms of growth and level (Morck et al., 2008).

Though the scale of China's OFDI is quite small, a continuous growth trajectory from 1982 to 2014 indicates a promising outlook. Unlike international trade which is rather sensitive to economic turbulence in nature, the growth of China's outward investment demonstrates an inverse relation with its economic growth rate over the period of 1982 to 2014 (Figure 3). Over the last three decades, the share of outward investment in GDP saw a rather steady rise at 23% annually on average, whereas the country's GDP growth shows a general decline from 1982 to 2014. Nevertheless, when China's miraculous two-digit GDP growth slows down from 14% in 2007 to 7% in 2014, the investment share in GDP ranged between 64% in 2011 and 215% in 2008. Admittedly, the contraction could be partly understood as a consequence of the decelerating economic growth since 2007. It is, however, problematic to conclude that there existed a linear relation between the two, as the limited data of only seven years does not allow a decent period for proper statistical calculations.

In fact, China's outward foreign direct investment, despite occurring in an economically challenging era after 2007, is biased towards Southeast Asian countries. China's investment flow to ASEAN rose from US$948 million in 2008 to US$8.9 billion in 2014, while the same period saw China experienced a continuous growth deceleration from 9.6% to 7.2%. In contrast with general investment to the world, China's investment to ASEAN records a robust growth at 45% annually on average during 2008 to 2014 when its economy enters a "New Normal" period.

China's investment in Southeast Asia growing rapidly during this economically challenging period could be explained by the long-lasting close trade relations between the two. China-ASEAN bilateral trade volume recorded an average annual growth rate of 19.8% from 1994 to 2013. China has been ASEAN's largest trading partner since 2009, while ASEAN has been the third-largest trading partner of China since 2011, largely thanks to the complementary role of each in product structure and resource composition which enables an interdependence relationship between the two. Hence, Zhang and Daly's (2011) argument that China's outward FDI is largely attracted to countries with high volumes of exports from China is confirmed in Southeast Asia. In addition, the natural endowment and large market size enjoyed by ASEAN member states collectively attracts China's investment

Figure 3 China: GDP Growth and Share of OFDI in GDP, 1982-2014



Source: World Bank (2015).

which is both market-seeking and resource-seeking in nature (Kolstad and Wiig, 2012; Ramasamy et al., 2012).

In addition, the growing OFDI is echoed by China's transition from an FDI absorbing country to a global capital giver actively promoting its investment activities across the borders. Apart from the "Going-out" policy in 2001, the newly launched "Belt and Road Initiative" with a series of favourable measures has significantly boosted Chinese investment overseas. Previous studies have shown that institutional factors play a significant, complex and diversified role in determining FDI location choice in com-

parison with economic factors, while both types of factors influence the FDI location choice of Chinese multinational firms (Kang and Jiang, 2012).

Indeed, China has seen a boost in outward FDI in the region in the past decade, making use of its large foreign exchange reserves and seeking to solve its domestic problem of overcapacity. The fact that most MNCs have state ownership or control has given Chinese SOE access to cheap credit from state-controlled banks for overseas expansion. Adding to it is the highest enterprise savings rate that Chinese SOE having achieved which further propelled it overseas expansion (Morck et al., 2009). Though this surge is also due, in part, to increasingly favourable measures introduced by the host governments in emerging economies, such as Malaysia, it is by a larger extent of the push factor from China that act as a main driver shaping international expansion behaviour of most Chinese firms in Southeast Asia (Cheung and Qian, 2009).

4. Chinese FDI in ASEAN

4.1 Regional Distribution

Although Chinese investment in ASEAN remains still relatively low with projects of limited economic scale[1], the past few years have seen a robust growth in Chinese FDI in the region. FDI flow to ASEAN has recorded a 61% average annual growth from US$157 million in 2005 to US$7.27 billion in 2013 (Table 1). Growing capital inflow raised the Chinese FDI stock from US$1.2 billion in 2005 to US$35 billion in 2013, achieving a promising average growth of 51% annually.

Among the ten ASEAN member states, Singapore remains the hottest destination for Chinese outward FDI in 2013. Its share in total Chinese investment in ASEAN grew from 25% in 2005 to its highest 51% in 2008. Despite a slight decline to 41% in 2013, the city-state is still far ahead of the other ASEAN member states as the No. 1 recipient of Chinese investment from 2005 to 2013 (Figure 4). Indonesia maintains a relatively stable position in receiving Chinese investment, as indicated by its share stabilizing around 11% throughout the entire period. While Malaysia has become less attractive to Chinese investors as its share dropped from 15% in 2005 to 4% in 2013, Myanmar headed in the opposite direction, receiving 13% of Chinese FDI in the region in 2013 from a very low level of 2% in 2005, recording an impressive average annual growth of 10% during the period.

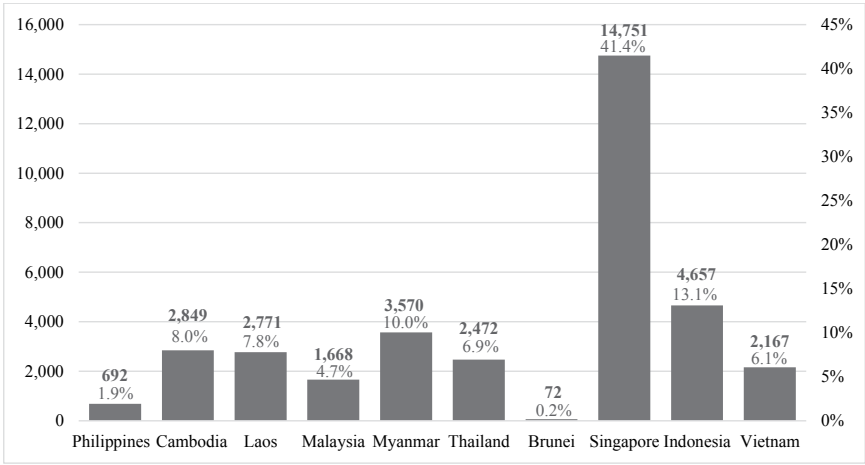
Coupled with encouraging investment stock growth, net investment flow to ASEAN witnessed a promising increase from US$157 million in 2005 to US$7.27 billion in 2013 with a 61% annual growth on average (Table 1). Singapore and Indonesia are still the major destinations for Chinese investment, accounting for about half (49%) of the total investment flow in

Table 1 China's Outward FDI Flows to ASEAN Countries, 2005-2013 (US$ million)

Country/Region	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*Average Annual Growth Rate (%)*
Brunei	0.02	–	1.18	1.82	5.81	16.53	20.11	0.99	8.52	113.15
Cambodia	5.15	9.81	64.45	204.64	215.83	466.51	566.02	559.66	499.33	77.14
Indonesia	11.84	56.94	99.09	173.98	226.09	201.31	592.19	1,361.29	1,563.38	84.11
Lao PDR	20.58	48.04	154.35	87	203.24	313.55	458.52	808.82	781.48	57.56
Malaysia	56.72	7.51	-32.82	34.43	53.78	163.54	95.13	199.04	616.38	34.75
Myanmar	11.54	12.64	92.31	232.53	376.7	875.61	217.82	748.96	475.33	59.17
Philippines	4.51	9.3	4.5	33.69	40.24	244.09	267.19	74.9	54.4	36.51
Singapore	20.33	132.15	397.73	1,550.95	1,414.25	1,118.50	3,268.96	1,518.75	2,032.67	77.82
Thailand	4.77	15.84	76.41	45.47	49.77	699.87	230.11	478.6	755.19	88.34
Vietnam	20.77	43.52	110.88	119.84	112.39	305.13	189.19	349.43	480.5	48.09
ASEAN	157.71	335.75	968.08	2,484.35	2,698.10	4,404.64	5,905.24	6,100.44	7,267.18	61.41

Source: Statistical Bulletin of China's Outward Foreign Direct Investment (2013).

Figure 4 China's Outward FDI Stock in ASEAN by Countries, 2005-2013 (US$ million)



Source: Statistical Bulletin of China's Outward Foreign Direct Investment (2013).

2013. With a small economies of scale, Brunei recorded a high growth rate of 113% over the period despite the fact the investment amount still remained very low at US$8.5 million in 2013. Overall, Chinese outward FDI net flow into ASEAN grew rapidly with all member states recording a two-digit average annual growth from 2005 to 2013.

Compared to inward FDI, outward investment has just started its engine. Those less developed provinces in China have also benefited from some capital that might have gone abroad. The national campaign such as "West's Great Development" and "The Rise of the Central" have made policy towards central and western China more attractive than ASEAN in attracting the capital. Although Chinese MNCs have taken first steps to invest in the ASEAN market, China's transition from an FDI recipient to investor requires a while before it can become an important international capital exporter such as the US and Japan. Meanwhile, an uneven distribution of outward investment exists among provinces of China. Richer coastal urban provinces and municipalities in the Eastern region report much larger investment stocks aboard than those in the Central and the West. This internal heterogeneity has made economic cooperation between China and ASEAN challenging but complementary. While divergent local policies towards FDI are different from one another, the variation in economic structure and socio-economic development level among eastern, central and western China and among different ASEAN countries requires greater attention for policy formulation to meet different stakeholder demands.

Table 2 China's Investment* in ASEAN by Sectors until 2015 (US$ million)

Sector	*Value*	*Share of total (%)*
Energy	17490	33.87
Basic metals manufacturing	12910	25.00
Real Estate	9730	18.84
Transport Sector^	3870	7.49
Technology product and services	2750	5.33
Finance	2030	3.93
Others	2860	5.54
Total	51640	100.00

Notes: * Only those projects valued above US$100 million.
^ Including aircraft lending and shipping.
Source: The China Global Investment Tracker (2015).

4.2 Sectorial Distribution

The analysis in this section is based on the data of 83 mega projects[2] with Chinese investment in the ASEAN region. The total investment for the 83 projects is valued at US$51.64 billion, taking up 95% of the total Chinese FDI stock in ASEAN by 2015 (US$54.32 billion). The fact that these 83 Chinese investors are MNCs reinforces the view that MNCs have taken the lead in investing in ASEAN.

By disaggregating the investment by sector, we found that Chinese investment is largely concentrated in the energy- and metal-related sectors which together absorbed two-thirds of total Chinese investment from 2005 to 2015 (Table 2). The pattern in ASEAN has not been very much different from that in other economies (Kolstad and Wiig, 2012). As ASEAN is rich in natural resource such as iron ore and petroleum, investing in natural and energy resources helps China hedge against future increases in commodity prices. Following the energy sector (33.87%) and metal-related industry (25%), lucrative real estate business becomes increasingly appealing to Chinese investors, attracting the third largest investment amounting US$9,730 million in ASEAN by 2015. Ranking as the fourth largest, transport equipment manufacturing has received US$3.87 billion in investment, accounting for 7.49% of total investment by 2015. In general, except for the real estate sector, Chinese MNCs' FDI in ASEAN has shown a strong tendency towards heavy industry.

In the manufacturing sector, Chinese investment has totalled US$15.2 billion by 2015, taking up 29.4% of total investment in ASEAN (Table

Table 3 Accumulated Investment in Manufacturing Sector from China to ASEAN, 2005-2015 (US$ million)

Sector	*Value*	*Share of total investment (%)*
Metals	12910	84.93
Transport Equipment*	1560	10.26
Textiles	420	2.76
Paper and Paper Product	200	1.32
Chemicals and chemical products	110	0.72
Total	15200	100.00

Note: * Excluding shipping and aircraft lending.
Source: The China Global Investment Tracker (2015).

3). The bulk of the investment in manufacturing went to sectors where China has comparative advantages, such as metal and transport equipment manufacturing. Among all the manufacturing activities, metal manufacturing accounts for 89.3% of total investment in ASEAN's manufacturing. Following metal fabrication, the transport equipment manufacturing sector attracted 10.2% of the total investment in manufacturing. In a nutshell, Chinese enterprises are investing heavily in producing heavy industrial products, such as steel and copper making, whereas the manufacture of light industrial products takes up only approximately 5% of the total by 2015.

The low investment level of textile and paper product manufacturing is possibly caused by the absence of data on small-scale investment which the current database is unable to capture. Due to the fact that light industry is not capital-intensive in nature (e.g. metal fabrication and energy industry), the sample has limited capability to capture the investment in light industry. Despite this shortcoming, the analysis using 83 mega investment projects provides considerable insights into Chinese MNC investment in ASEAN, as the strong capital capacity of most MNCs have made their investment large-scaled in nature.

Notably, over half (53%) of Chinese MNCs in ASEAN reported incorporating local partnerships. With an eye on developing markets where Chinese investors have to face challenges in understanding different policies, consumption behaviour and socio-cultural background, Chinese MNCs were inclined to collaborate with local partners to overcome difficulties and hurdles in local culture and market conditions. While they continued to forge joint ventures (some to establish wholly-owned overseas entities), Chinese MNC managers tend to launch local businesses through mergers and acquisitions (M&A), which offer the investors a quicker access to dealership

and local business networks. The strategy of having a local partner helps MNCs to adapt to the local environment quickly by not only managing good relationships with government and media, but also to quickly integrate with the local business community. Among these, collaboration with host country businessmen provides a feasible solution to engage local buyers and suppliers.

Both greenfield (establishment of new factory or plant) and brownfield (cross-border merger and acquisition) investments can be found as forms of China's OFDI in ASEAN. According to the report of China Global Investment Tracker from January 2005 to December 2015, 37% of the number of total investments (40 out of the 83 China-funded mega projects) was recorded as Greenfield. In general, China's greenfield investment in ASEAN is found mostly in the energy-related sector and infrastructure projects, in both of which China has a competitive advantage and which also helps to reduce its over-capacity in steel and concrete production. Singapore is perhaps the only exception where out of the 18 China-funded projects, only 1 project (taking up 0.8% of total value) was considered as greenfield investment while the remaining are all brown-field in nature. China's strategic intent of going global to acquire technology and know-how has driven China's capital into sectors which China does not have advantages in. Also, the expensive labour and land costs in Singapore has turned out to be a deterrent for Chinese SOEs who are also conscious of profit-maximizing.

5. Conclusion

China's economic growth in 2015 has fallen to 6.9% from an unrivalled average of 10% between 2002 and 2014. While the global economy is feeling the impact of China's economic restructuring, a change of such a magnitude in China has created a great impact on Southeast Asia, which is intensively involved in trade and investment with China.

By analyzing data from the China Global Investment Tracker, we find that China's investment in ASEAN has witnessed a significant growth in defiance of China's economic slowdown. Unlike international trade which is rather sensitive to economic turbulence, China's outward investment shows no immediate shock from the country's economic slowdown. Instead, in an economically challenging era after 2007, Chinese OFDI in Southeast Asian countries has increased significantly.

An analysis of regional and sectoral distribution of China's investment has captured a changing pattern of Chinese OFDI in Southeast Asia which reflects the paradigm shift of China's economy from an export-oriented to an investment driven growth. Chinese OFDI in Southeast Asia is distributed

unevenly in geographical and industrial terms. While Singapore, Indonesia and Malaysia remain hot destinations for Chinese OFDI, CLMV countries have caught up quickly in attracting Chinese capital especially in those sectors where Chinese companies have comparative advantage such as infrastructure, energy- and metal-related sectors. Though Chinese FDI in the region has shown a strong tendency to be in heavy industry by 2015, the lucrative real estate business has become increasingly attractive to Chinese investors buying overseas houses in the region.

The rising wave of Chinese investment in Southeast Asia can also be understood through the dilemma facing China's manufacturing which is heavily crippled by its redundant capacity. The strong currency in addition to increasing production costs, such as land and labour, has significantly reduced cost advantages of Chinese manufacturing in the international market. Therefore, the decelerating return rate in domestic China has driven a growing number of enterprises to move their domestic production overseas in search of higher returns. Southeast Asia, especially the CLMV countries with the advantages of having cheap labour with favourable policies towards foreign investment, has thus attracted large Chinese investment. The overall increase of Chinese OFDI is not only the result of a firm's strategic shift to relocate to seek higher returns, but also a necessary choice of Chinese firms to be adaptive to the worsening business environment in China's domestic market. Policy makers have to be cautious about the latter development, if not addressed, the Chinese economy may lose its glamour to not only domestic but also international investors. Necessary capital controls should be considered as an option, as uncontrolled capital outflow may eventually generate a disastrous impact on the domestic economy given the massive scale of capital which has been in place in the global market.

As with most studies, this study is not bereft of limitations. As argued by evolutionary economists, location, timing and sectors matter in institutional change (Nelson, 2008). Given the existence of huge diversity in socio-economic conditions among different ASEAN countries, in-depth country studies on a specific sector should be undertaken to better understand the intricacies faced by Chinese OFDI much better than the broad review undertaken in this paper. While a concrete regional study by using quantitative data should shed light on the overall development of Chinese OFDI in the region, qualitative in-depth studies should be conducted in future to garner deeper understanding on the impact of China's economic slowdown on firms' decision to relocate in Southeast Asia. Finally, the very nature of Chinese OFDI and ASEAN host country conditions are evolving. Down the road, the story of China-ASEAN investment links may well look different from what has been described in this paper.

Notes

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1. Compared to other major investors, China still remains a latecomer in investing in ASEAN. With a total investment of US$8,869 million flowing to ASEAN in 2014, China apparently has a long way ahead to compete with other leading investors in the region, such as the European Union ($29,268 million), Japan ($13,381 million) and the US ($13,042 million).
2. Mega projects refers to projects with investment above USD100 million.

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China's Growth Deceleration – A New Normal for Malaysia Too?

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Abstract

While the consequences of China's growth deceleration for China are hotly debated, its impact on Southeast Asia has received more balanced treatment, it being recognized that each country would be impacted differently. Malaysia's substantial trade with China, however, was said to be more likely affected than other countries trading less intensively with China. Statistics, however, show otherwise. Malaysia's exports and imports have both risen, thanks to process trade that was to see final assembly in China but destined to countries all over the world and to primary exports to China being only a small part of total exports. China's imports from Malaysia also show an upward trend. Driven by geo-strategic as well as economic considerations, China's investment in Malaysia also did not fall but instead experienced a significant increase. The former imperative is reflected in China's Maritime Silk Road while the latter is reflected by Chinese multinationals seeking overseas markets as domestic growth slows. Thus, Malaysia's post-Asian Crisis cannot be blamed on China. Instead a host of domestic (e.g., political scandal) and external (e.g. fall in crude oil prices) have conspired to undermine Malaysia's growth.

Keywords: *Growth deceleration, new normal, China, Malaysia*

1. Introduction

Just over three decades after its opening up, China's economy has grown to be the second largest (in current US$ terms) in the world. The recent phenomenon of its growth deceleration and stock market rout has therefore sent shockwaves worldwide, worrying investors everywhere but delighting its naysayers who see every reversal as a sign of China's impending collapse. Hutton's (2015) remark is typical of this latter group:

> China's banks are, in effect, bust: few of the vast loans they have made can ever be repaid, so they cannot now lend at the rate needed to sustain China's once super-high but illusory growth rates. China's growth is now below that of the Mao years: the economic crisis will spawn a crisis of legitimacy for the deeply corrupt communist party.

But he is hardly alone (see among others, Spence, 2015; Tobey, 2015). This view is contested by China scholars (for example Hu, 2015; Kaletsky, 2015; Quah, 2016) who lean towards what Chinese President Xi Jinping termed "China's New Normal".

We concur with the latter view, for the reason succinctly argued in a McKinsey opinion piece:

> The reality is that China's economy is today made up of multiple sub-economies, each more than a trillion dollars in size. Some are booming, some declining. Some are globally competitive, others fit for the scrap heap. How you feel about China depends more than ever on the parts of the economy where you compete. (Orr, 2016)

The decline, even collapse, of parts of the economy, like stock markets, does not signal total collapse of the Chinese economy. To believe otherwise is to ignore the complexity of the Chinese economy that scholars like Lardy (2015) have also noted.

With this premise, the next issue that is of importance is the implications of China's slowdown for Southeast Asia. Commentaries on these tend to be cautionary, while also recognizing some countries being more vulnerable (DW, 2015; Schonhardt, 2015). But all countries in Southeast Asia are not the same. Even before China's economic slowdown, but after the Asian Financial Crisis of 1997, the early movers and shakers of ASEAN – Malaysia and Thailand – had lost steam while early laggards – Indonesia and the Philippines – and latecomers – Cambodia, Laos, Myanmar and Vietnam, collectively referred to as the CLMV countries – were gathering momentum. And as China's growth decelerated, this trend has continued. As Table 1 shows, even as China's growth decelerated from about 2012, growth rates of Cambodia, Lao PDR and Vietnam remained robust. Indonesia's and the Philippines' also held up well up to 2015. As for Malaysia and Thailand, growth rates had gone south well before China's growth deceleration. Still, there are studies that show the relatively greater impact of China's slowdown on Malaysia (Zhai and Morgan, 2016).

Just as it is inappropriate to think of Southeast Asia as an entity, so it is misleading to think of Malaysia, the focus of this paper, succumbing to China in the way that has been reported for Southeast Asia, i.e. that like the rest of ASEAN, Malaysia's loss of growth momentum can be blamed, at least partly, on China. Hence, in attempting to assess the overall impact of a

Table 1 Annual Growth Rates – China and Selected ASEAN Countries, 2008-2015

Country	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
China	9.6	9.2	10.6	9.5	7.8	7.7	7.3	6.9
Malaysia	4.8	-1.5	7.4	5.3	5.5	4.7	6.5	5.0
Cambodia	6.7	0.1	6.0	7.1	7.3	7.5	7.1	7.0
Indonesia	6.0	4.6	6.2	6.2	6.0	5.6	5.0	4.8
Lao PDR	7.8	7.5	8.5	8.0	8.0	8.5	7.5	7.4
Philippines	4.2	1.1	7.6	3.7	6.7	7.1	6.1	5.9
Thailand	1.7	-0.7	7.5	0.8	7.3	2.8	0.9	2.8
Vietnam	5.7	5.4	6.4	6.2	5.2	5.4	6.0	6.7

Source: World Bank database for 2008-2015.

China slowdown on Malaysia, this paper will examine the efficacy of each channel through which this impact is transmitted, and then look at prospects for Malaysia as China settles into its "New Normal".

2. Malaysia's Trade with China

China's economic relations with Malaysia are manifested through primarily trade, and, more recently direct investment. The growing importance of bilateral trade between the countries has naturally made this the focus in assessing the impact of China's slowdown on Malaysia. But what is the reality of China-Malaysia bilateral trade?

As Table 2 shows, China's share of trade has been growing, so that by 2009, it had become Malaysia's largest trading partner. In 2016, exports to China represented 12.5% of Malaysia's total exports, slightly lower than the 13.1% in 2015, while imports from China reached 20.3% of total imports in 2016, the highest share since trade between the countries began. Taken together, Malaysia's bilateral trade with China accounted for 13% of the country's total merchandise trade.

With trade accounting for about 150% of GDP[1], any reduction in Malaysia's trade with China may be expected to impact total trade and hence Malaysia's GDP. This is a common theme of commentators of the Malaysian and ASEAN economies (e.g. SBR, 2013; Zurairi, 2013). Yet there is no indication of this from aggregate trade data (Table 2). Apart from the dip in trade as a result of the Global Financial Crisis in 2009, Malaysia's total exports have risen each year from 2000 to 2015, while total imports have risen monotonically. More telling has been Malaysia-China bilateral trade,

Table 2 Malaysia's Trade with China as a Share of Total Trade, 2000-2015

Year	*Exports to China (% of Total)*	*Imports from China (% of Total)*	*Net Exports (billion MYR)*	*Total Trade with China (% of Total)*
2000	3.2	3.9	0	3.5
2004	6.7	9.8	-7	8.0
2008	9.5	12.9	-4	11.0
2009	12.1	14.0	6	13.0
2010	12.5	12.2	14	12.4
2011	13.2	13.2	16	13.2
2012	12.7	15.2	-3	13.8
2013	13.5	16.3	-9	15.3
2014	12.2	17.0	-24	14.4
2015	13.1	18.8	-27	15.8
2016	12.5	20.3	-46	13.0

Source: Department of Statistics Malaysia: *METS Online*.

which, while moderating, continued to grow through 2015, although dipping in 2016. In addition, Malaysia exports about as much as it imports so that there is minimal net trade in either direction. This too had not changed much after China's growth began to slow in 2012. There is therefore as yet no basis for the argument, however nuanced, that China's deceleration would hit Malaysia's growth through a fall in the latter's exports. Malaysia's economic growth during this period might falter, or it might have held up, but no one should look to trade performance as an important factor to date.

What then might explain this lack of connection between China's slowdown and Malaysia's trade? Might the answer be found through a review of the details of bilateral trade between the countries? Table 3 shows the top five items of Malaysia's exports to and imports from China. With respect to exports, by far the largest item is SITC 77 – electrical machines, appliances and parts, the bulk of which is the output of the electronics and electrical industries and account for over 60% of the total value of Malaysia's top 5 exports to China.[2] And far from falling when China's growth slowed, these exports continued their rise until 2015, falling back a little in 2016. This rise mirrored and also contributed to the rise of Malaysia's total exports to China during the period 2015.

How could this have occurred in the face of China's slowdown? SITC77 exports come from Malaysia's participation in global supply chains that end in China which undertakes final assembly. Neither Malaysia nor China controls

these chains; control is vested in transnational corporations from the US, Europe and Japan. The volume of these exports depends on the demand for the final products which are not only for China's domestic consumption but also for the global market, and hence are not solely dependent on the health of China's economy.

Besides SITC77, exports of office machines (SITC75), petroleum and petroleum products (SITC33) and vegetable oils and fats (SITC42), each accounting for less than half, and often just a third of the value of SITC77, make up the second, third and fourth largest exports by value. Of these, export revenue from petroleum and petroleum products (SITC33) is expectedly the most volatile. Exports of vegetable oils and fats (SITC42) fell sharply in 2015 and was no longer in the top 5 in 2016 while exports of office machines (SITC75) have fallen considerably from the levels it attained in 2010 and 2011.

As for Malaysia's palm oil exports, these fall under SITC42. Since 2011, when these exports were ranked second, their proceeds had indeed been falling, from accounting for 10 % of the top 5 exports in 2012 to just below 5% in 2015. Thus, from the perspective of exports, the fall in exports of vegetable oils and fats (mainly palm oil) has been compensated by increases in the exports of other products, especially those related to process trade, discussed above. Rubber, once the mainstay of Malaysian exports, did not make even the top five with 2011 being the singular exception. Second, those primary commodities impacted form just a small share of total exports to China. As an illustration, using the broader SITC 1-digit classification, exports of animal and vegetable oils and fats (SITC4) are valued at no more than a third of the exports of mineral fuels and lubricants (SITC3) during the period covered in Table 2.

Unlike exports, Malaysia's imports from China have little to do with China's economic performance; instead, it is closely related to Malaysia's growth and development needs. Like exports to China, imports from China have more than doubled between 2009 and 2016. But compared to exports, imports from China are less concentrated. The top 5 imports are all industrial products – equipment, parts and iron and steel. While the top import in value terms is also SITC 77, its share of the top 5 imports stood at 35% in 2009, and despite a more than doubling in value, at only 45% in 2015. These imports have been increasing monotonically during the entire period.

With the exception of SITC75 – office machines and equipment – all top 4 import categories have seen significant increases between 2009 and 2016. Imports of iron and steel (SITC67) more than quadrupled over the period, industrial machinery and equipment (SITC74) doubled, and telecommunications equipment (SITC76) by 67%. These increases reflect Malaysia's growing use of Chinese equipment and iron and steel for its

Table 3 Malaysia's Trade with China, Top 5 Items, 2010-2016

A. Exports to China (RM million)

Item by 2-Digit SITC	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
23 Crude rubber		5,981					
33 Petroleum & petroleum products	3,918		4,515	6,775	6,538	10,558	7,695
42 Vegetable oils & fats	7,656	11,632	8,870	7,610	6,054	4,688	
51 Organic chemicals					4,374	4,374	5,354
57 Plastics in primary forms							4,262
62 Rubber manufactures	3,908	4,553	5,804				
68 Non-ferrous metals				6,714			
75 Office machines	15,839	11,261	9,681	7,273	6,753	6,871	7,415
77 Electrical machines, appliances & parts	23,243	28,252	29,100	31,698	34,660	35,059	34.192
Total Top 5 exports	54,240	61,679	56,589	54,703	53,036	51,504	58,918
Total exports to China	80,105	91,551	88,792	97,043	92,286	101,531	98,559
SITC77 as % of Top 5 Exports	42.8	45.8	51.4	57.9	65.4	68.1	58.0
Top 5 as % of Total Exports	67.7	67.4	63.7	56.3	57.5	50.7	59.8

B. Imports from China (RM million)

67 Iron & steel	2,821	3,451	4,375	5,107	6,665	7,319	7,400
74 Industrial machinery & equipment	3,237	4,324	5,853	6,099	6,699	8,263	8,690
75 Office machines & equipment	9,821	9,086	9,425	8,766	7,953	9,395	9,083
76 Telecommunications equipment	8,106	8,416	8,570	9,813	10,181	10,644	12,671
77 Electrical machinery, equipment & parts	12,905	15,255	23,985	27,809	29,902	28,704	29,153
Total Top 5 imports	36,890	40,532	52,208	57,594	61,400	64,325	66.997
Total imports from China	66,430	75,706	91,864	106,265	115,513	129,360	142,346
SITC77 as % of Top 5 Imports	35.0	37.6	45.9	48.3	48.7	44.6	43.5
Top 5 as % of Total Imports	55.5	53.5	56.8	54.2	48.7	49.7	47.1

Source: Malaysian External Trade Database http://trade.stats.gov.my/tradeV2/

projects. For example, imports of telecommunications equipment emanate from contracts signed between Malaysian telecommunications companies with China's Huawei and ZTE (Li and Cheong, 2017).

The significance of imports with respect to Malaysia's trade with China lies in data for the category SITC77, the largest with respect to both exports and imports. The difference between this group's exports and imports for this category is the value added Malaysia gains from participating in electronics supply chains.[3] As the table shows, this value addition after the Global Crisis in 2009 was a respectable 50% of this group's export value in 2009, but fell to only 18% in 2015. At barely RM5.04 billion (exports of RM34.19 billion against imports of RM29.15 billion) in 2015, this category's ability to offset the decline in commodity exports to China is no longer as impressive as viewed from the perspective of gross exports alone. Nevertheless, the value added for electronics appliances, etc. (SITC77) in 2016 (RM5.04 billion) still more than offsets the fall in value of vegetable oils (SITC42) between 2015 and 2016 (RM567 million).

What are the takeaways from this review of bilateral trade? First, the trade impact of China's economic slowdown is not as important as many believe. Second, this is because primary commodity exports to China represent just a small fraction of Malaysia's total exports of primary commodities.[4] And third, Malaysia's most important exports to China in the form of electronics parts and components are not all destined for the China market.

3. China's Investment in Malaysia

Chinese outward foreign direct investment is of relatively recent extraction, with impetus coming from the state's "Going Out" policy announced in 1999 (China State Council, 2006). Since then, a number of Chinese firms, led by state enterprises and followed by non-state enterprises, had invested overseas. These enterprises have initially concentrated their investments in resources (in developing countries and Australia) and technology (in advanced countries). With neither in plentiful supply, Malaysia was not on the radar of resource- or technology-seeking Chinese investment in the early years of this century.

Over the first decade of the "Going Out" Policy, Chinese enterprises' outward investment began also to include other motives like seeking markets. This motive is partly driven by intense competition in the home market in China. The expertise Chinese enterprises have developed in construction and transport infrastructure has also spurred these firms to seek opportunities abroad.

China did not figure prominently in Malaysia's FDI even as recently as 2008, when its first FDI project of over US$100 million was made. As Table 4 shows, China's FDI, measured in terms of actual flows, was a paltry US$372

Table 4 Foreign Direct Investment Flow into Malaysia by Selected Country of Origin, 2008-2013 (US$ mil.)

Year	*Total*	*Singapore*	*Japan*	*US*	*Netherlands*	*Hong Kong*	*China*
2008	13,323	4,723	2,637	3,823	2,375	1,867	372
2009	6,475	4,093	2,519	1,277	2.134	2,357	264
2010	9,434	3,814	3,311	5,382	4,066	1,278	343
2011	10,772	5,748	5,584	3,966	2,784	2,377	313
2012	6,933	5,659	4,520	3,819	2,673	3,197	773
2013	10,166	5,239	4,984	2,886	4,153	3,722	779

Source: US Department of State: Investment Climate Statement, 2014, citing Bank Negara and Department of Statistics.

million, just 3% of a total inflow of US$13,323 million. This level of inflow was maintained until 2011, after which it doubled in value, but more than doubled its share of the total, since total investment never reached the level achieved in 2008. Significantly, total investment was halved with the impact of the Global Financial Crisis, declining a little less with respect to investment from China.

That China's FDI in Malaysia has moved beyond the search for resources is revealed by the statistics on Chinese FDI in Malaysia's manufacturing sector (Table 5). China became a significant player only in 2012, well after the onset of the Global Financial Crisis in 2008, but coinciding with the start of China's economic slowdown. Between 2012 and 2015, China accounted for around 10% of total FDI in manufacturing. That share surged to 17% in 2016, reflecting not only the fall in total FDI to Malaysia but also increased Chinese investment, a part of which is related to developments emanating from China's One Belt One Road (OBOR) initiatives. This investment surge in 2016, during which there is much debate about growth dipping below the 7% target, is also confirmation that Chinese FDI bears little if any relationship with its economic growth. Indeed, if a link between Chinese outward FDI and economic growth is to be hypothesized, it should be that slower growth would lead to more outward FDI – Chinese enterprises, facing poorer market prospects at home, might be pressured to look for markets overseas.

Table 6, from the *China Global Investment Tracker*,[5] shows the sectoral composition of Chinese direct investment. Because these figures refer to commitments rather than disbursements they cannot be compared to the figures in Tables 4 and 5. China's first major investments in Malaysia were in the energy sector, with Sinomach committing US$120 million in July 2008 and Three Gorges Construction investing US$880 million in a hydroelectric

Table 5 Approved Foreign Direct Investment in Manufacturing in Malaysia by Selected Country of Origin, 2006-2016 (US$ mil.)

Year	*Total*	*Singapore*	*Japan*	*US*	*Netherlands*	*Germany*	*Hong Kong*	*China*
2006	5,512	514	1,202	675	895	63	n.a.	n.a.
2007	9,717	858	1,896	878	491	1,092	n.a.	n.a.
2008	13,323	565	1,637	2,544	526	1,287	24	10
2009	6,475	585	2,047	672	140	124	1550	47
2010	9,434	700	1,308	3,811	303	629	898	n.a.
2011	11,382	825	3,367	836	336	650	131	398
2012	6,948	738	930	985	276	231	30	659
2013	10,178	1,507	1,197	2,106	794	572	151	1,005
2014	11,312	2,235	3,106	386	233	1,262	n.a.	1,358
2015	5,103	324	932	965	204	270	740	435
2016	6,161	481	418	318	723	594	60	1,073

Source: For 2006-2013, US Department of State: Investment Climate Statement, 2014, citing Bank Negara and Department of Statistics. For 2014-2016, Malaysian Industrial Development Authority: Malaysian Investment Performance Reports, with US$1 to MYR3.50 in 2014, MYR4.30 in 2015 and MYR4.45 in 2016.

Table 6 China's Investments in Malaysia of US$100 million and above, 2008-2015

Year	*Real Estate*	*Non-energy Resources*	*Energy*	*Transport*	*Other*	*Total*
2008			1,000	680		1,680
2010	140		570		1,250	1,960
2011			830		1,040	1,870
2012	1,750	1,480	200			3,430
2013	1,770		2,970	580	950	6,270
2014	180		1,570	1,300	200	3,250
2015	1,890		3,340	830	600	6,660
2016	410	n.a.	n.a.	2,010	n.a.	n.a.

Source: *China Global Investment Tracker*.

project (see Annex 1). There was also an investment of US$680 million by the China Communications Construction Company in automobiles that year, signifying the rise of market-seeking Chinese FDI. Chinese FDI in Malaysia remained at about the 2008 level until 2012, when large investments of well over a billion were made in real estate and in timber boosted total Chinese

FDI by nearly 80% compared to 2011. Chinese FDI nearly doubled again in 2013, dominated by energy and real estate, fell by half in 2014, and again doubled to a record US$6.6 billion in 2015. Thanks to purchase of assets of Malaysia's heavily indebted 1Malaysia Development Berhad (1MDB), China was reported to have vaulted to the top of Malaysia's FDI league (Chew, 2016a).

Regardless of whether FDI to Malaysia revives, China is set to remain among the top of the FDI league. It is likely that its timely assistance to 1MDB would have put it in the good books of the Malaysian government when it comes to upcoming major infrastructure projects, of which the Kuala Lumpur – Singapore high-speed rail project, estimated to cost above US$10 billion, is the largest (Hafiz, 2016).[6] Despite the official stance that the project will be openly bid, China's presence in a string of infrastructure projects[7] will certainly help its cause. The Chinese government has also been adept at demonstrating in concrete terms its intention of being a benefactor of Malaysia. In November 2015, Chinese premier Li Keqiang pledged to buy Malaysian bonds in support of the sliding Ringgit, while the China Construction Bank announced the listing of the world's first 21st Century Maritime Silk Road bond worth RMB1 billion (RM667.1 million) on Bursa Malaysia (Khoo, 2016). It is therefore not surprising that Malaysia itself is gearing up for Chinese FDI (ASEAN Economist, 2016). The most concrete evidence of this increased China dependence is the November 2016 visit of Malaysian Prime Minister Najib to Beijing that produced pledges of US$33 billion in FDI from China (Chew, 2016b).

Although energy remains a major area for Chinese FDI, real estate and transport equipment have also been important areas, the latter clearly representing a degree of market-seeking by Chinese enterprises. As the Chinese economy slows, Chinese enterprises are likely to look increasing to overseas markets to expand. This may prove a boon to Malaysia, where FDI has stalled for a variety of reasons to be discussed later.

China's FDI is driven not just by commercial considerations but also by strategic imperatives, as the Guangxi Beibu Gulf International Port Group's investment in Kuantan port and the Malaysia-China Kuantan Industrial Park suggests. Malaysia appears also to be aware of the potential to capture more Chinese FDI through the latter's One Belt One Road (OBOR) grand strategy, into which the establishment of financial institutions like the Asian Infrastructure Investment Bank fit (Tan, 2015). This ambitious strategy, although primarily serving China's geopolitical imperatives (reduced dependence on traditional sea lanes for the resources it needs and greater voice in international affairs) also fits well with substantial infrastructure needs in the countries along the OBOR, Malaysia among them (Cheung and Lee, 2015).

Thus, not only is Chinese FDI in Malaysia delinked from its economic growth, the former is likely to increase even as China's economy slows. Driven by the need to meet debt obligations and also standing to benefit from China's OBOR, Malaysia is becoming increasingly dependent on Chinese FDI. At the same time, the outward expansion plans of its growing number of Chinese transnational corporations should accelerate with their domestic market not growing at the same pace as before.

4. Malaysia's Investment in China

Outward FDI (OFDI) from Malaysia had increased significantly. Table 7 shows that despite some fluctuation, OFDI from Malaysia has been in excess of US$15 billion since 2008, the exception in 2009 reflecting the impact of the Global Financial Crisis. Contrary to expectations, developed countries have not been the centre of attention – in 2011 and 2012 they account for less than half of Malaysia' OFDI, and in 2008-2010 for a third or less. Most Malaysian OFDI has gone to Asia, with Singapore a major destination. Direct flows to China have been unimportant; even including investments routed through Hong Kong. Information on the major activities in which Malaysian OFDI are involved in China is not readily available, but an analysis of Malaysian Chinese investment in China shows this to be largely

Table 7 Host Region and Country FDI Flows from Malaysia, 2001-2012 (US$ million)

Region/Country	*2008*	*2009*	*2010*	*2011*	*2012*
World*	15,120	6,505	15,263	18,080	16,806
Developed countries	3,593	899	3,233	6,300	7,093
Europe	1,327	142	1,370	3,171	-1,574
North America	-549	429	-3	676	7,168
Other (Australia)	2,815	329	1,865	2,452	1,499
Developing countries	9,845	4,645	9,815	10,299	9,146
Asia	7,385	2,909	7,916	4,326	7,954
China	198	281	87	296	73
Hong Kong SAR	340	-616	493	161	1,260
Singapore	1,772	632	4,384	2,574	2,952

Note: * The numbers do not add up because some categories have been omitted from this table.

Source: UNCTAD FDI/TNC database, based on data from Bank Negara Malaysia and the Department of Statistics Malaysia.

engaged in manufacturing for the China market (Cheong et al., 2017). China's "new normal" is likely to affect Malaysian businesses in China both positively and negatively. On the one hand, economic slowdown will impact these businesses negatively. On the other, the switch to consumption-driven growth should have salutary effects. Overall, however, given their modest scale in relation to total investments, the impact on Malaysia is not likely to be material.

5. Malaysia–China Exchange Rates

A third area in which Malaysia–China economic relations can be impacted is the Ringgit–Yuan exchange rate. After a protracted period of appreciation to reach a point where the US could no longer argue that China is a currency manipulator (Crutsinger, 2015) and the IMF said its currency was no longer undervalued (IMF, 2015), China devalued the Yuan by 1.87% on August 11, 2015, followed by a series of further downward adjustments (Inman et al., 2015). This triggered almost immediate commentary about its adverse impact on Southeast Asian exports (Jennings, 2015), on their currencies (Deng, 2015) and on financial markets (El-Erian, 2016).

What is to be made of all these narratives? First, it should be remembered that the Chinese Yuan has undergone a period of appreciation that should theoretically have made ASEAN's exports much more competitive. The devaluation has not caused a complete reversal of this, so why should the loss of competitiveness cause such an alarm for ASEAN's exports? Second, the effect of quantitative easing, which the US, Europe and Japan have undertaken repeatedly since the Global Financial Crisis of 2008, has been similar to direct devaluation – money supply in the economy is increased, thus lowering the exchange rate of the national currency. It seems odd that these have not received the same attention as China's devaluation when it comes to exchange rate impact. Also, apart from the need to distinguish between short-term and longer-run impact, the above general diagnoses are less than helpful given that ASEAN countries are not all alike.

When it comes to Malaysia, the same questions discussed above may be asked. First, how has it affected the competitiveness of Malaysian exports? Table 8 shows the exchange rate between the Malaysian Ringgit (MYR) and the Chinese Yuan as well as several ASEAN currencies. The figures show how much MYR is needed to exchange for one Chinese Yuan (CNY), one Singapore dollar (SGD), 100 Thai Baht (RHB) and 100 Philippine Peso (PHP), with a rising number signifying a depreciation of the MYR. As Table 8 shows, the MYR remained stable against the CNY until mid-2015, and depreciated thereafter. The depreciation of the Malaysian Ringgit was precipitated by numerous factors affecting the economy, of which China's

Table 8 Exchange Rates between the Malaysian Ringgit (MYR) and Selected Foreign Currencies, 2012-2016

Year/Month	*Chinese Yuan (MYR:CNY1)*	*Singapore $ (MYR:SGD1)*	*Thai Baht (MYR:THB100)*	*Philippine Peso (MYR:PHP100)*
2012 Jan	0.50	2.44	10.00	7.20
Jun	0.50	2.47	10.01	7.32
2013 Jan	0.49	2.49	9.95	7.43
Jun	0.50	2.45	10.14	7.31
2014 Jan	0.54	2.59	9.96	7.40
Jun	0.57	2.57	9.81	7.35
2015 Jan	0.57	2.64	10.67	7.84
Jun	0.59	2.72	10.92	8.24
2016 Jan	0.66	3.03	11.95	9.18
Jun	0.63	2.99	11.58	8.86
Dec	0.64	3.10	12.52	9.05

Source: Bank Negara Malaysia. Available online at <http://www.bnm.gov.my/ index.php?ch=statistic&pg=stats_exchangerates&lang=en&StartMth=1&StartYr=2016&EndMth=12&EndYr=2016&sess_time=1200&pricetype=Mid&unit=rm>

slowdown was arguably not the most important (Saleem, 2015).[8] It was not just against the CNY that the MYR depreciated; it depreciated as much against the Singapore dollar (SGD) (by about 20% between January 2012 and December 2016) and also against the THB and PHP. Thanks to this substantial depreciation, the worst in Asia, Malaysian exports should remain highly competitive from an exchange rate perspective despite China's devaluation.

Beyond the above generalization about competitiveness, the extent to which two countries' exports compete depends on whether the same products are exported by both. This can be measured by the export similarity index.[9] Loke (2009: 11) found similarity between Malaysia's and China's exports to be rising to a moderate level (40%) before it was reversed (to 30%) in 2008. A more recent study by Nasrudin et al (2014: 28) found moderate similarity of around 40% between Malaysia and the China-ASEAN Free Trade Area as a region while China's is somewhat higher at above 50%. The greater the similarity, the larger the competitive edge afforded by currency depreciation.

Thus, reviewing the Ringgit–Yuan exchange rate trajectory in combination with the degree of export similarity suggests that the devaluation of the Yuan should be less of a worry than the need to arrest the slide in the Ringgit.

It should also be remembered that because of both countries' participation in production networks in which parties are tied to fixed term contracts, free market exchange rates are not as material as it appears.

6. Conclusion – Malaysia's Woes and China's New Normal

There is no doubt that Malaysia has been experiencing bad times of late. With growing economic ties with China, it is also easy for commentators to point a finger at China's slowdown as a major contributor to the country's woes. Policy-makers would likewise find it convenient to blame external forces rather than domestic issues for which they are to an extent accountable. The horde of commentary in the international media has made it easy for both groups to ride the bandwagon of "public opinion".

But what does more careful examination of data reveal? First, the impact on trade with China is not as important as it is often believed. While Malaysia's exports of palm oil are adversely impacted by virtue of lower prices and reduced volume, the value of palm oil exports represent only a small proportion of exports destined for China and an even smaller proportion of total exports. This is also the case with petroleum exports to China, the share of which in total exports to China (7.6% in 2016) is smaller than petroleum's share in total exports (9.6%). Second, Chinese FDI did not follow the deceleration of Chinese economic growth; instead it has moved in the opposite direction. And as total FDI in Malaysia has stagnated, China's share has grown even more. Chinese FDI has been driven by both strategic and commercial imperatives. While China's OBOR strategy has the potential for Malaysia to increase FDI from China, China's slowdown may spur Chinese enterprises to invest overseas, including in Malaysia. Thirdly, Malaysia's currency has depreciated substantially well before China's Yuan devaluation, so that any loss of export competitiveness would have been more than offset.

Overall, then Malaysia's "new normal" of uneven growth cannot be blamed on China's growth deceleration. Malaysia's growth post-1997-99 Asian Financial Crisis that never recovered to the level of the 1980s and early 1990s clearly preceded China's growth slowdown from about 2012. The explanation for this slowdown has to be found elsewhere. However, "elsewhere" does not mean that external factors are not to blame. Indeed, the collapse of oil prices in 2015 struck a particularly harsh blow to an economy that has come to depend on oil export revenues and was already beset by challenges.

This dependence, as well as the still significant contribution of oil palm in net exports to China, raises questions as to why a country that has been

touted by the government as being well on the way to becoming a developed country was so dependent on primary commodity exports. That, as has been noted, so little value-added has accrued to Malaysia's electronics exports only strengthens arguments of structural problems in the domestic economy. Of direct relevance is Malaysia's failure to develop its human capital to its full potential (Cheong et al, 2016). Amid the current economic gloom, Malaysia is also rocked by political scandals that have been addressed by measures that undermined rather than restore confidence (Chander and Welsh, 2015). The upshot of this and other adverse developments has been stagnation in private investment, while a net outflow of FDI to the tune of US$6 billion was reported for 2014, amounting to 6.5% of Malaysia's GDP (UNCTAD, 2015).[10]

Although this paper is not the place to address these domestic issues, making them explicit is important to show that China's New Normal is the least of the many challenges Malaysia faces. Malaysia must deal with its own demons first.

Finally, what does China's New Normal really portend for Malaysia? On the positive side, as has been concluded, China's growth deceleration, coupled with its implementation of OBOR can actually yield benefits for its economic relations with Malaysia. Malaysia may also benefit from China's shift towards consumption, for instance, in the form of tourist arrivals. However, China's rapidly advancing technological prowess, also part of its "new normal" only now garnering attention, should see more Malaysian imports of Chinese high-tech equipment such as telecommunications equipment that will tilt the China-Malaysia trade balance in the former's favour. Adding to this imbalance will be Malaysia's implementation of mega-projects with Chinese participation seeing more imports of Chinese steel. Over the longer term, Malaysia is also likely to lose out in process trade as China progressively takes over upstream segments of the supply chains in which Malaysia currently participates. Finally, a potential benefit of a China slowdown for Malaysia may be to force the latter to rethink the many vulnerabilities of its own making – reliance on primary commodity exports and on a cheap labour model that adds little value to production in supply chains, born of the failure to develop and retain the quantity and quality of human capital needed to move the country up to advanced economy status, and to capture the opportunities arising from China's rebalancing. Will this occur? The ball is entirely in Malaysia's court.

Annex 1: China's Investment to Malaysia since 2008

Year	*Chinese Entity*	*US$ Million*	*% Share*	*Transaction Party*	*Sector*	*Subsector*
2008	Sinomach	120			Energy	
2008	Three Gorges led consortium	880			Energy	Hydro
2008	China Communications Construction	680			Transport	Autos
2010	Chinalco*	350	35	GIIG	Metals	Aluminum
2010	Sinomach	310			Energy	Coal
2010	Sinoma	140		Hume Cement	Real estate	Construction
2010	Sinohydro	260		Tenaga	Energy	Hydro
2010	Sinomach	900		Lion Group	Metals	Steel
2011	Chinalco*	800		Smelter Asia	Metals	Aluminum
2011	Genertec	830	50	Alstom	Energy	Coal
2011	Shougang Group*	240	40	Hiap Teck Venture Berhad	Metals	Steel
2012	Power Construction Corp	1,420			Real estate	Construction
2012	Three Gorges	200			Energy	Hydro
2012	Country Garden Holdings*	330			Real estate	Property
2012	MCC	1,480			Other	Timber
2013	Guangxi Beibu*	400	49	Malaysia-China Kuantan Industrial Park	Real estate	Property
2013	Guangxi Beibu	480	40	IJM Corporation	Transport	Shipping
2013	Guangxi Beibu"	650			Metals	
2013	Power Construction Corp	300		OM Holdings	Metals	
2013	Power Construction Corp	2,400		Tenaga	Energy	Gas
2013	Comtec Solar*	380			Energy	Alternative

Annex 1: (continued)

Year	*Chinese Entity*	*US$ Million*	*% Share*	*Transaction Party*	*Sector*	*Subsector*
2013	China Communications Construction	100			Transport	Shipping
2013	Power Construction Corp	190		Sarawak Cable	Energy	
2013	Guangzhou R&F	1,370			Real estate	Property
2014	Beijing Urban Construction	1,300	50	Zenith Sdn.	Transport	Autos
2014	Shanghai Greenland	$180			Real estate	Property
2014	Shandong Daiyin*	$200			Other	Textiles
2014	Sinopec	1,330		Petronas	Energy	Oil
2014	Shanghai Electric	240		Sarawak Energy	Energy	Coal
2015	State Construction Engineering	430			Real estate	Construction
2015	Shanghai Greenland	660			Real estate	Property
2015	Jinkosolar*	100			Energy	Alternative
2015	SAIC	280	49	Weststar Maxus	Transport	Autos
2015	State Construction Engineering	600			Other	Industry
2015	China Energy Engineering*	940	50	JAKS Resources	Energy	Coal
2015	State Construction Engineering	100			Real estate	Construction
2015	China Communications Construction	550			Transport	Shipping
2015	China General Nuclear	2,300	100	Edra	Energy	
2015	China Railway Engineering	700	40	1MDB	Real estate	Property

Note: * Refers to greenfield investment.
Source: China Global Investment Tracker.

Notes

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1. According to the World Bank database (data.worldbank.org), trade (the sum of exports and imports of goods and services) accounted for 140% of Malaysia's GDP in 2014.
2. In SITC group 77 for 2015, out of a total export value of RM35 billion, nearly RM31 billion were from SITC776 – "thermionic valves and tubes, photocells, etc. and parts thereof NEC".
3. As proof that imports and exports of SITC77 relate to electronics industry supply chains, about RM17 billion (60% of SITC77) consists of items under SITC776, which dominates the items exported, in 2015. An additional RM4.5 billion (16% of SITC77) are imports of SITC772 – "Electrical apparatus, resistors other than heating resistors, printed circuits, switchboards and control panels".
4. In 2016, Malaysian exports of petroleum and petroleum products (SITC33) to China amounted to 10.2% of its total exports of this item. For vegetable oils and fats, the share was 9.5%.
5. The China Global Investment Tracker, launched in 2005, is co-published by the American Enterprise Institute and the Heritage Foundation. It tracks all Chinese investments overseas that are valued at US$100 million and above.
6. In March 2016, the China Global Investment Tracker showed the China Railway Engineering Corp. investing US$2,010 million in Malaysia's transport sector and US$410 million in the real estate sector, the vendor of the real estate being 1MDB.
7. The second Penang Bridge, with the China Engineering Harbor Company as main contractor, was completed in 2014. The 944 MW Murun Dam, constructed

by China's Three Gorges Development Company, was completed in 2015. The Gemas – Johor Bahru electric double-track rail project, with China Railway Construction Corporation as main contractor, is scheduled for completion in 2019 (Hafiz, 2016).

8. From MYR3.16 to US$1 on 31 August 2014, the rate went to MYR4.19 exactly a year later, peaking at MYR4.41 on 27 September 2015.
9. This index is defined is the sum over all products of the smaller of the share of a particular export to total exports in two countries, expressed as a percentage (Finger and Kreinin, 1979). Sometimes, net rather than gross exports is used for estimation.
10. Malaysia also ranks fifth globally in terms of illicit financial outflows in 2013, with an accumulated outflow of US$419 billion since 2004, US$48 billion leaving in 2013 alone (Kar and Spanjers, 2015).

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The Impact of China's New Normal on the Philippine Economy

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Abstract

Despite being an economically challenging time for China and the global economy, the period since 2012 has been one of high economic growth for the ASEAN countries as the Philippines and other East Asian economies are using their fiscal and monetary ammunition to stimulate their economies' domestic demand. The economic slowdown of China from 2012 to the present coincides with the period when the Philippines has been going into strong domestic demand generation and rebalancing to offset a weak external sector. However, given the fact that the bilateral trade of Philippines and China takes up not more than 5% of Philippine GDP, China's economic restructuring alone will most likely have a small to moderate impact on the Philippines' trade sector. Meanwhile, the weak global trade and the falling Chinese imports from East Asia have reduced the vertical trade integration of ASEAN+3 in the period after the global financial crisis. The obstacle to vertical trade integration in East Asia may not bode well for regional dynamism in the world of globalization. While the pivot of the Duterte administration towards China (away from the US) has resulted in a negotiated but still-to-be-realized package of US$9 billion loans and US$15 billion worth of investments over the next five years, the role of the PRC as a lender and investor in the Philippines will very potentially be more vital and crucial in the future. Any fall in China's capability to fulfill these loans and investments have the potential to change the course of growth and infrastructure in the Philippines.

Keywords: *Economic slowdown, bilateral trade, Philippines, China*

1. Introduction: China's Slowdown

There have been serious concerns in the global markets, particularly the Asian regional markets, about the possible disorderly and damaging effects of a serious slowdown or hard landing of the economy of the People's Republic

of China (PRC). The slowdown in the Chinese economy was felt first in 2012 when the PRC's GDP growth rate fell from almost 10% in 2011 to 7.7% in 2012. The growth rates in succeeding years did not improve and even fell further to 7.4% in 2013 and to 6.9% in 2015. The Chinese GDP growth rate fell further to 6.7% in 2016, but the authorities announced in mid-April 2017 a 6.9% growth rebound for the first and second quarters of 2017. The concern with China's slowdown has concentrated much on the slowdown in the growth of the manufacturing sector, which has led to a significant fall in the growth of China's imports. This affects exports of Asian countries, and more generally global exports. Throughout much of 2015 and 2016, global commodity prices, led by oil and gasoline, had fallen due partly to the slowdown in the large imports from China.

Figure 1 shows the rapid increase in the export and import growth rates of the PRC from 2000 to 2011, with the exception of 2001 (the global dot-com recession) and 2009 (the Global Financial Crisis, GFC). But both export and import growth increasingly declined during the period 2012 to 2016, with the growth rates going into negative territory in 2015-16. It must also be pointed out that Figure 1 shows that import growth declined faster than export growth in the 2012 to 2015 period. Imports fell by a whopping 14% between 2014

Figure 1 Growth of Merchandise Exports and Merchandise Imports of PRC

Source: Calculated from ADB Key Indicators 2016. Data for 2016 was derived from CNBC 2017, based on Reuters.

and 2015. In 2016, initial reports from official data, and quoted by Reuters (CNBC, 2017) shows exports fell heavily by 7.7% and imports fell further by 5.5%, much smaller though compared to 2015[1].

There are two opposing camps viewing the Chinese economic slowdown. The optimists see a soft landing as likely since China's problem is mainly an aggregate demand problem with export and investment demand cooling down and a need to switch to consumption spending. This also requires a shift from a more industrial economy to a service-based economy. The solution is made easier given that China still has a low GDP per capita compared to developed countries and has a lot of room to catch up in terms of stimulating domestic demand. This is true especially if they use more of fiscal stimulus than credit expansion (the latter has caused high debt problems in the past). Economists in this camp include former World Bank economist Justin Lin, Yale's Stephen Roach, Goldman Sachs' former chief economist Jim O'Neill and Nobel Laureates Joseph Stiglitz and Michael Spence.

On the other hand, the more pessimistic economists concentrate on the excess capacity of China's economy and the need for a supply-side solution. Excess capacity especially in favoured state-owned enterprises (SOEs) like steel and cement is a major problem and will lead to "zombie" firms with bad debts leading to possible major financial crisis. The PRC's pro-SOE stance, lack of privatization and lack of competitive market policies, coupled with the Chinese Communist Party's strong reliance on SOE revenues and lack of political will for major economic reforms, may lead to a hard landing or long-run stagnation with high financial defaults similar to the Japanese economy in the 1990s and 2000s. These economists include Keyu Jin, professor at the London School of Economics, Zhang Jun, Director of Fudan University's China Center for Economic Studies and Woo Wing Thye of the University of California, Davis[2].

GDP growth of the PRC slowed further to 6.7% in 2016. This was far better than market expectations, and reduced global concerns on China in the second half of 2016. Initial estimate of China had the growth in the first semester of 2017 to be 6.9%, which further buoyed the market sentiments on China. The victory of Donald Trump as President of the United States in late 2016, his stated promise to impose 45% tariffs on Chinese imports, his insistence that China is practising unfair trade and manipulating its currency, his de-facto two China policy, and possible retaliatory and more confrontational stance by China in the South China Sea – all brought back global concerns on harmful economic and political relations between China and the US. But the cordial meeting concerning controversial trade issues between President Trump and President Xi Jinping in the first week of August 2016 allayed, temporarily at least, the strong fears of a trade war between the two economic giants and strong protectionist policies from the US.

It is the aim of this paper to find out the vulnerability of the Philippine economy to a continuous Chinese slowdown and cutback in China's imports, as well as volatilities caused by the Chinese economy. It also explores the impact on the Philippine economy in case China falls into a hard landing.

2. The Macro-economy of the Philippines in the 2000s: Stimulating Domestic Demand and Relying Less on Exports

The traditional way to investigate the impact on the Philippines of China's slowdown is to assume that the most direct effect would be the effect on Philippine exports as China significantly reduces its imports. This section shows that this is not a major concern for the Philippines because the 2000s already saw Philippine exports and imports fall significantly as a percentage of GDP. The dwindling trade sector was due, first, to Philippine exports not doing as well as (or competing badly with) other East Asian exports. Second, the export share in the economy fell further due to the massive decline in global trade in the Global Financial Crisis (GFC) of 2008-2009, and very frail recoveries of the First World economies in 2011 to the present period. This is shown in Table 1.

The National Income Accounts show that Philippine exports of goods and services fell continuously (with only a few temporary upturn years) from 51.4% of GDP in 2000 to 27.5% of GDP in 2016. The sharp fall of exports during the GFC years of 2008 and 2009 is very obvious in Table 1. But the fall had been continuous since 2001. Imports behaved similarly, falling continuously from 53.4% of GDP in 2000 to 36.1% in 2016. The rise in imports from 33.5% in 2015 to 36.1% in 2016, in addition to the decline of exports from 28.2% in 2015 to 27.5% in 2016, has raised trade deficits to an almost alarming point of 8.6% of GDP. In this context, the continuing decline of Philippine exports to China and other countries is beginning to cause some worries. But overseas workers remittances are still relatively alright (though not as vibrant as before) and, as of now, still provide strong foreign exchange funds to support the trade deficit.

The slowing Chinese economy contributed to the falling global trade from 2012 to 2016, leading to the further decline in Philippine export share from 32.0% of GDP in 2011 to 27.5% in 2016. However, 2012 to 2016 is exactly the period when the Aquino government consciously and successfully stimulated the domestic demand of the economy through higher government investments and public expenditures, as well as sovereign credit upgrades awarded to the country for its improved macroeconomic fundamentals. These fundamentals consist mainly of a strong fiscal sector (with the imposition of excise [sin] taxes on cigarettes and alcohol), strong current account balances due to remittances of overseas Filipinos workers (OFWs),

Table 1 Share of Components of Gross Domestic Product (GDP) and Gross National Income (GNI) – as % of GDP

Item	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
I. Household Final Consumption Expenditures	72.2	73.6	73.9	74.4	74.5	75.0	74.6	73.5	74.3	74.7	71.6	73.5	74.2	73.4	72.5	73.8	73.7
II. General Government Consumption Expenditures	11.4	11.1	10.6	10.2	9.4	9.0	9.2	9.3	8.8	9.9	9.7	9.7	10.8	10.8	10.5	11.0	11.2
III. Gross Domestic Capital Formation	18.4	22.1	24.5	23.0	21.6	21.6	18.0	17.3	19.3	16.6	20.5	20.5	18.2	20.0	20.5	20.6	23.6
A. Fixed Capital Formation	22.1	20.8	20.6	20.7	20.3	19.9	20.1	19.9	19.7	19.0	20.5	18.7	19.6	20.6	20.6	21.4	23.8
B. Changes in Inventories	-3.7	1.3	3.9	2.3	1.3	1.6	-2.1	-2.6	-0.4	-2.4	0.0	1.7	-1.4	-0.6	-0.1	-0.9	-0.2
IV. Net Exports	-2.0	-6.9	-8.9	-7.5	-5.5	-5.6	-1.8	-0.1	-2.5	-1.1	-1.8	-3.6	-3.3	-4.2	-3.6	-5.3	-8.5
A. Exports of Goods and Services	51.4	46.0	46.7	47.2	48.6	46.1	46.6	43.3	36.9	32.2	34.8	32.0	30.8	28.0	28.8	28.2	27.5
B. Less: Imports of Goods and Non-Factor Services	53.4	52.9	55.7	54.7	54.1	51.7	48.4	43.4	39.4	33.4	36.6	35.7	34.1	32.2	32.4	33.5	36.1
Expenditures on Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Net Primary Income	17.2	18.1	18.6	22.5	23.1	25.9	25.7	25.3	26.6	32.7	20.5	19.8	20.5	21.5	21.0	21.0	20.4
Expenditures on Gross National Income	117.2	118.1	118.6	122.5	123.1	125.9	125.7	125.3	126.6	132.7	120.5	119.8	120.5	121.5	121.0	121.0	120.4
Growth Rate of GDP	4.41	2.89	3.65	4.97	6.70	4.78	5.24	6.62	4.15	1.15	7.63	3.66	6.68	7.06	6.13	5.81	6.84

Source: Calculations by author based on original data from Bangko Sentral ng Pilipinas, <www.bsp.gov.ph/>.

and an accommodative monetary policy with sound prudential measures. Table 1 shows further that despite trade deficits (with imports being larger than exports), the Philippine economy has been earning foreign exchange instead of depleting its foreign exchange despite significant trade deficits due to a large net primary income in the external current account. This is due to remittances of overseas Filipino workers who bring home overseas remittances of more than 20% of GDP[3]. Thus, the Philippines had been building up foreign exchange reserves in the 2000s despite trade deficits and a weak export performance. This mitigates the impact of export cutbacks due to a slowdown or decline in the imports of PRC.

It could be observed in Table 1 that fixed capital formation (including government investments) returned to more than 20% of GDP in 2010-2016 (reaching 23.6% in 2016 – the highest since 2002), and government expenditures went beyond 10% of GDP. During this period, the Philippines won a series of upgrades from the international rating agencies of S&P, Moody's and Fitch, with the Philippines reaching the minimum investment grade rating of BBB. The period of 2012-2016 have been years of high economic growth for the Philippines, with GDP growth rate ranging from 5.8% to 7.0% despite an unfriendly global environment. This high growth continued in the first semester of 2017 when Philippine GDP growth was around 6.5%. It had been achieved in other Southeast Asian economies such as Vietnam, Indonesia, Cambodia and Laos as well. In summary, on a macro perspective, the decline in the share of the trade sector in the Philippines has been more than compensated by the promotion and stimulation of domestic demand. Foreign exchange reserves remain strong despite trade deficits because of overseas workers' remittances.

3. Philippine Exports to China[4]

3.1. Level and Composition of Philippine Exports to China

Table 2a shows Philippine exports of goods as percent of GDP, including exports to PRC, Hong Kong and other countries. It shows that, as a percent of GDP, total exports of Philippine products made up 47% of GDP in 2000, and continuously declined to 18.4% of GDP in 2016.[5] This is consistent with the trend shown in Table 1. The table shows that, as a percentage of GDP, exports to PRC and Hong Kong increased to around 3.9% of GDP (with PRC increasing much faster and catching up with Hong Kong) in 2007. The GFC brought this down to less than 2% for both countries in 2009. The recovery thereafter never brought the exports of both countries back to the heights of the 2007 level. Exports to Hong Kong hovered below 2% of GDP (with a slight blip above 2% in 2015 and 2016) while exports to PRC improved to

Table 2a Total Value of Exports, Exports to PRC and Hong Kong, as % of GDP

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Total exports	47.00	42.16	43.28	43.18	43.43	40.02	38.79	33.79	28.27	22.81	25.80	21.55	20.83	20.85	21.82	19.65	18.36
Exports to HK and PRC	3.17	3.11	4.57	6.24	6.35	7.20	6.82	7.74	6.02	3.65	5.04	4.43	4.38	4.25	4.91	4.20	4.15
Exports to HK	2.35	2.07	2.90	3.69	3.44	3.24	3.03	3.89	2.87	1.91	2.17	1.65	1.91	1.67	1.94	2.14	2.15
Exports to PRC	0.82	1.04	1.67	2.56	2.90	3.96	3.79	3.85	3.15	1.74	2.87	2.78	2.47	2.58	2.98	2.06	2.02

Table 2b Total Exports: FOB Value in Million USD and Percent Share of PRC and HK

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Total Exports	38078	32150	35208	36231	39681	41255	47410	50466	49078	38436	51498	48305	52100	56698	62102	58827	55981
PRC and Hong Kong	6.75	7.38	10.55	14.46	14.61	17.98	17.58	22.89	21.31	15.99	19.54	20.58	21.01	20.40	22.51	21.36	22.67
PRC	1.74	2.47	3.85	5.92	6.69	9.88	9.76	11.39	11.14	7.63	11.12	12.91	11.84	12.39	13.63	10.50	10.98
Hong Kong	5.01	4.91	6.70	8.54	7.93	8.10	7.82	11.50	10.16	8.36	8.42	7.66	9.17	8.01	8.88	10.86	11.70

Table 2c Merchandise Exports from Japan, USA, PRC, HK, Taiwan 2016 (in USD Million, fob, in % of GDP and % share)

	Million USD	*% of GDP*	*% Share*
Total	55981	18.36	100.00
Japan	9488	3.11	16.95
USA	8602	2.82	15.37
HK	6548	2.15	11.70
PRC	6144	2.02	10.98
PRC+HK	12692	4.16	22.67
Taiwan	1121	0.37	2.00
Others	24078	7.90	43.01

Source: Philippine Statistical Authority.

below 3% until 2014, but fell back to 2% of GDP in 2015 and 2016 affected most likely by the slowdown of China's manufacturing imports. The export share of PRC is thus not a very large number for the Philippines (2% of GDP). The combined exports to PRC and Hong Kong sums up to only 4.2% of GDP in 2015 and 2016.

Table 2b shows the total Philippine exports of goods in fob million US dollars, and the percent share of the PRC and Hong Kong markets in total exports. From just 6.75% of the country share of exports (with PRC having less than 2% share) in 2000, the two economies combined climbed to more than 20% in less than 10 years. By 2016, the total amount of the two economies still hold more than 22% share of Philippine exports – around 11% for PRC and 11.7% for Hong Kong.

Table 2c shows that the top destination country for Philippine exports in 2016 is Japan with almost 17% of the export share, followed by the US with around 15.4% of the share. Hong Kong and China are almost tied in third place with each having an export share hovering around 11% in 2016. If we combine Hong Kong and China, the two economies will become the top export destination for the Philippines, taking up 22.7% of the total in 2016[6].

Table 3 shows the composition of the exports of the Philippines to major countries in the first semester of 2016. It can be seen that the top export of the Philippines is electronic products. This cuts across exports to all countries, pointing to the lack of diversification in Philippine exports. The concentration on electronic exports is strongest in Singapore, Hong Kong and Germany, comprising more than 80% of the exports in the first semester of 2016.

Table 3 Philippine Exports to Major Trading Partners by Top Five Commodities, First Semester, 2016

Country/Commodity	*Value*	*% Share*
Japan	**5,747.52**	**100.0**
Woodcraft and Furniture	1,528.63	26.6
Electronic Products	1,513.05	26.3
Machinery and Transport	484.12	8.4
Other Manufactured Goods	419.05	7.3
United States of America	**4,269.78**	**100.0**
Electronic Products	1,836.62	43.0
Ignition Wiring Sets and Other Wiring Sets Used in Vehicles	326.16	7.6
Machinery and Transport Equipment	295.11	6.9
Other Manufactured Goods	281.51	6.6

Table 3 (continued)

Country/Commodity	*Value*	*% Share*
Hong Kong	**3,010.34**	**100.0**
Electronic Products	2,556.16	84.9
Gold	101.95	3.4
Other Manufactured Goods	59.99	2.0
Electronic Equipment and Parts	48.34	1.6
Fish, Fresh or Preserved	42.37	1.4
People's Republic of China	**2,701.61**	**100.0**
Electronic Products	1,629.06	60.3
Other Manufactured Goods	235.89	8.7
Other Mineral Products	170.12	6.3
Chemicals	112.59	4.2
Machinery and Transport Equipment	97.56	3.6
Singapore	**1,808.66**	**100.0**
Electronic Products	1,585.47	87.7
Petroleum Products	34.92	1.9
Electronic Equipment and Parts	29.84	1.6
Other Manufactured Goods	23.95	1.3
Woodcraft and Furniture	23.37	1.3
Germany	**1,129.21**	**100.0**
Electronic Products	925.04	81.9
Other Manufactured Goods	75.42	6.7
Articles of Apparel and Clothing	15.38	1.4
Machinery and Transport Equipment	13.12	1.2
Tuna	11.52	1.0
Thailand	**1,019.53**	**100.0**
Electronic Products	469.62	46.1
Other Manufactured Goods	145.31	14.3
Metal Components	124.42	12.2
Machinery and Transport Equip	83.50	8.2
Ignition Wiring Sets and Other Wiring Sets Used in Vehicles	47.73	4.7
Republic of Korea	**985.59**	**100.0**
Electronic Products	464.25	47.1
Other Manufactured Goods	97.98	9.9
Copper Concentrates	88.63	9.0
Bananas (Fresh)	47.70	4.8
Pineapple and Pineapple Products	42.27	4.3

Source: Philippine Statistical Authority

The concentration is less for China with electronics comprising 60% of the exports. The concentration is lower in the US, Thailand and South Korea with the share of electronics comprising from 40% to 50% of the exports. Exports to Japan is the least dependent on electronics as it comprised only 26% of the total in the first half of 2016.

Table 4 shows that the composition of the top exports to PRC changed significantly through the years. Semiconductor components and devices were the top exports and even grew in concentration from 2000 to 2008, comprising more than 70% of total exports to PRC. But this declined rapidly during the GFC to less than 30% by 2015 and 2016. What grew in terms of composition were electronic data processing products, other mineral products, chemicals, other manufactures, machinery and transport equipment, electronic equipment and parts and copper concentrates. All these changes seem to indicate shifts in the product patterns of trade integration between China and the Philippines. The rise of electronic data processing vis-à-vis semiconductor components may serve as a signal of China's upgrading into higher-tech products such as laptops, desktops and the like. The shift to other mineral products, chemicals, other manufactures, and machinery and transport equipment may point to shifts in trading from the global value chain system into more basic and consumer goods in the 2010s. This will be made clearer in the next section. But all in all, Table 4 still indicates that electronic exports – semi-conductors and electronic data processing combined – make up a much bigger share of exports to Hong Kong and China compared to other countries.

Table 5 shows that exports to Hong Kong are very concentrated to a few products. This is also true, but less so for PRC, compared to exports to other countries. The top 10 exports to Hong Kong make up 93% to 95% of total exports in 2014 and 2015, while the top 5 exports make up around 90% of total exports. For the Philippine exports to PRC, the top 10 make up close to 90% of total exports in recent years, and the top 5 make up around three-fourths of total exports. This compares with exports to other countries, where the top 10 exports make up three-fourths of the total, and the top 5 below 60%. The concentration of a few exports to Hong Kong and PRC seems to point to more exports in the global chain of electronic products where the Philippines provide intermediate inputs and capital goods, such as semiconductor components and electronic data processing devices. The concentration in the vertical trade integration of electronic products is much less with other export destination countries. Vertical trade integration and global value chains will be discussed in the next section.

Figure 2 shows the graph of the ratio of exports to PRC to GDP for key emerging markets in Asia (Deorukhar and Le, 2016). It can be seen that Taiwan, Korea, Malaysia, Vietnam and Thailand have large exports to PRC,

Table 4 Philippine Exports to Hong Kong, China and Other Countries by Commodity Groupings: 2010 to 2016 (Total in million US$, Components in % of Total)

Year	*2000*	*2005*	*2007*	*2008*	*2009*	*2010*	*2012*	*2013*	*2014*	*2015*	*2016*
Total Exports (in million US$)	**38078**	**41255**	**50466**	**49078**	**38436**	**51498**	**52100**	**56698**	**62102**	**58827**	**17363**
Hong Kong (in million US$)	**1907**	**3341**	**5804**	**4987**	**3213**	**4336**	**4776**	**4541**	**5512**	**6391**	**1907**
Components/Devices (Semiconductors)	66.41	71.95	80.42	74.61	73.05	70.41	57.51	58.73	64.53	73.16	72.48
Electronic Data Processing	7.78	11.02	3.65	6.68	5.94	12.94	6.93	16.43	15.72	10.86	9.20
Machinery & Transport Equipment	0.41	0.80	0.53	0.54	0.84	0.64	9.81	1.83	5.02	2.56	1.41
Other Manufactures	2.18	1.76	3.54	1.48	2.19	2.74	5.69	5.90	2.41	2.22	2.00
PRC (in million US$)	**663**	**4077**	**5750**	**5469**	**2934**	**5724**	**6169**	**7025**	**8467**	**6175**	**1672**
Components/Devices (Semiconductors)	39.77	59.90	67.04	72.17	52.87	44.94	40.66	25.40	21.71	29.45	26.60
Electronic Data Processing	9.45	25.02	10.18	10.73	14.10	25.45	18.91	20.61	22.31	21.41	32.13
Other Mineral Products	1.16	0.67	5.55	2.62	3.86	3.88	10.38	13.30	19.85	11.07	2.87
Chemicals	3.11	0.73	1.27	1.57	3.85	4.08	3.52	7.39	7.93	7.18	5.14
Other Manufactures	2.76	1.16	0.90	1.09	2.42	3.96	4.47	9.63	6.36	6.44	7.78
Machinery & Transport Equipment	0.82	0.73	0.85	0.83	1.49	1.03	2.46	1.89	2.39	2.68	3.78
Electronic Equipment & Parts	0.63	0.11	0.33	0.43	0.41	0.21	1.74	1.39	1.23	2.64	2.20
Copper Concentrates	0.70	0.00	0.14	0.12	2.39	2.02	0.84	0.88	0.05	2.62	2.83
Other Countries (in million US$)	**35508**	**33837**	**38912**	**38621**	**32289**	**41437**	**41154**	**45131**	**48122**	**46262**	**13785**
Components/Devices (Semiconductors)	52.79	45.41	38.81	34.64	36.19	43.94	29.68	28.68	27.41	31.20	32.02
Machinery & Transport Equipment	1.30	4.03	3.31	3.79	4.31	4.12	6.63	4.15	7.47	7.82	7.37
Other Manufactures	1.37	3.11	3.68	4.35	4.44	4.72	8.78	10.08	9.34	7.47	6.92
Electronic Data Processing	13.30	12.16	11.98	11.12	13.40	8.37	3.74	5.10	6.34	6.50	6.86
Woodcrafts Furniture, Furniture	0.59	0.41	1.98	2.38	2.54	2.48	5.24	6.83	6.15	6.06	7.35
Ignition Wiring Sets	1.61	2.11	2.28	2.22	2.31	2.62	3.49	3.82	4.36	4.58	4.96
Articles of Apparel	4.10	4.06	3.92	3.51	3.34	2.69	3.33	3.33	3.75	3.06	2.54
Chemicals	0.57	1.04	2.14	2.41	2.21	2.79	3.44	4.61	3.12	2.86	2.87
Coconut Oil	1.27	1.94	1.85	2.58	1.78	2.83	2.46	2.13	2.46	2.41	1.79

Note: FOB value in USD; 2016 data covers the reference months January to April only.
Source: Philippine Statistical Authority.

Table 5 Concentration of Philippine Exports (% Share of Top 5, Top 10, Top 20 Exports)

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Hong Kong																	
Top 20	91.9	92.0	93.2	94.4	92.7	93.3	94.7	96.3	95.3	93.6	94.7	93.1	93.9	96.4	97.7	98.7	99.1
Top 10	85.0	83.6	87.5	90.7	87.9	89.2	90.8	93.8	92.6	89.7	91.4	88.2	86.2	89.9	93.0	95.3	95.1
Top 5	77.3	77.9	82.9	86.5	85.9	85.9	84.0	89.5	84.7	83.1	88.0	84.2	80.8	84.4	89.0	90.2	86.2
PRC																	
Top 20	83.4	82.6	82.4	88.1	90.9	93.8	93.8	95.5	94.1	93.6	93.3	94.3	95.8	95.4	96.0	96.3	96.4
Top 10	65.7	68.2	74.4	75.8	81.3	89.5	88.3	87.3	90.6	83.0	86.8	85.8	88.4	85.4	86.9	88.2	88.9
Top 5	56.2	61.0	70.0	72.8	79.1	87.5	85.5	85.0	88.2	77.1	82.3	81.6	78.0	76.3	78.2	75.6	74.5
Other Countries																	
Top 20	81.9	79.4	80.8	79.8	81.6	81.8	80.0	78.5	77.1	80.9	83.3	78.1	85.1	83.9	86.5	87.0	87.4
Top 10	77.6	74.1	76.2	74.6	75.8	75.4	72.9	71.0	68.3	71.8	76.2	70.3	70.7	71.7	72.8	74.3	74.8
Top 5	69.4	65.2	67.6	65.4	66.4	65.1	62.7	59.8	56.3	60.9	63.6	54.6	54.1	54.8	56.7	59.0	60.5

Source: Philippine Statistical Authority.

Figure 2 Exports to China as Share of GDP

Source: BBVA Research, Haver Database.

from more than 6% of GDP for Thailand to a high 13% of GDP for Taiwan. The Philippines, Indonesia and India, on the other hand, have low exports to GDP ratios, at less than 3% of GDP in 2015. It can also be seen in Figure 2 that, compared to 2010, exports to China for most of the Asian countries have gone down. The main exceptions are Vietnam and Thailand, where exports to China (as shares of GDP) have gone up from 2010 to 2015.

In summary, PRC accounts for around 11% of Philippine exports in 2016, and Hong Kong for more than 11%. Thus, Philippine exports to PRC and Hong Kong comprise a significant share of Philippine exports (a combined sum of more than 20%). However, Philippine exports had not grown as large as the exports of other East Asian economies (measured as percent to GDP). Philippine exports to PRC and Hong Kong comprise only slightly more than 2% of GDP for each of the economies above. Therefore, the Philippines is not as vulnerable to a collapse in Chinese imports as other East Asian countries.

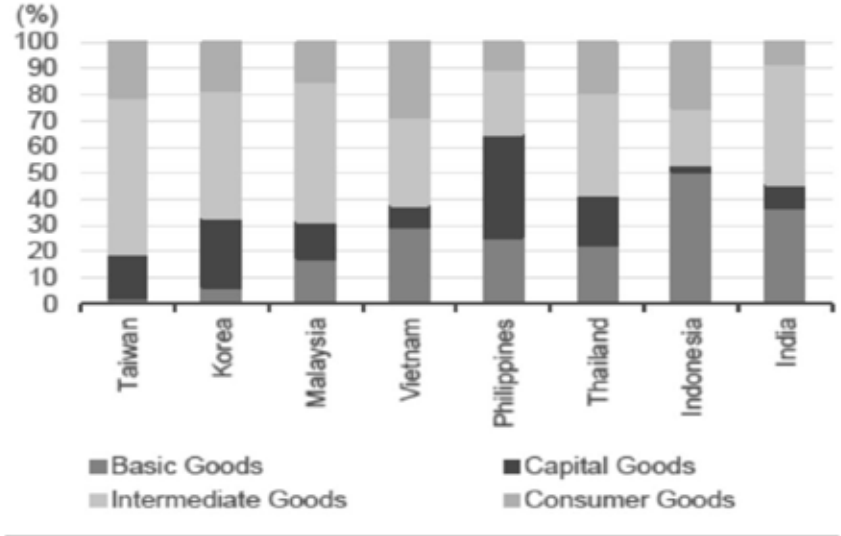
3.2. Philippine Exports to China in the Context of ASEAN+3 Integration

The 2000s saw a big rise in trade integration in ASEAN+3 (the 3 being China, Korea and Japan)[7]. The focal point of the integration was China, a major hub for the processing and assembly of East Asian intermediate products and

capital goods for export to developed economies. The dynamic exporting countries in East Asia also process and assemble intermediate inputs and capital goods derived from other East Asian countries as well. This global value chain has led to more integration within ASEAN+3 in the 2000s. Figure 3 shows the compositions of the exports of selected Asian countries to the PRC in 2014 (Deorukhar and Le, 2016). One can see that capital goods and intermediate products form a significant portion of the exports of the Asian economies to the PRC, comprising 50% or more of total exports (with the exception of Indonesia, whose exports were more on basic commodities and consumer goods).

Surprisingly, the Philippines (Figure 3) has the largest component of capital goods in the composition of its exports to PRC. We can explain this by pointing to Table 5 where we can see that some of the latest top exports of the Philippines to PRC are made up of electronic data processing, machinery and transport equipment and electronic and office equipment. Other major exports also include semiconductor components, other mineral products, chemicals and other manufactures, which make up much of the intermediate input components. It must be pointed out, however, that the capital goods component of Philippine exports is import-intensive, meaning the high-tech

Figure 3 Composition of Exports to China as Share of Total Exports, 2014



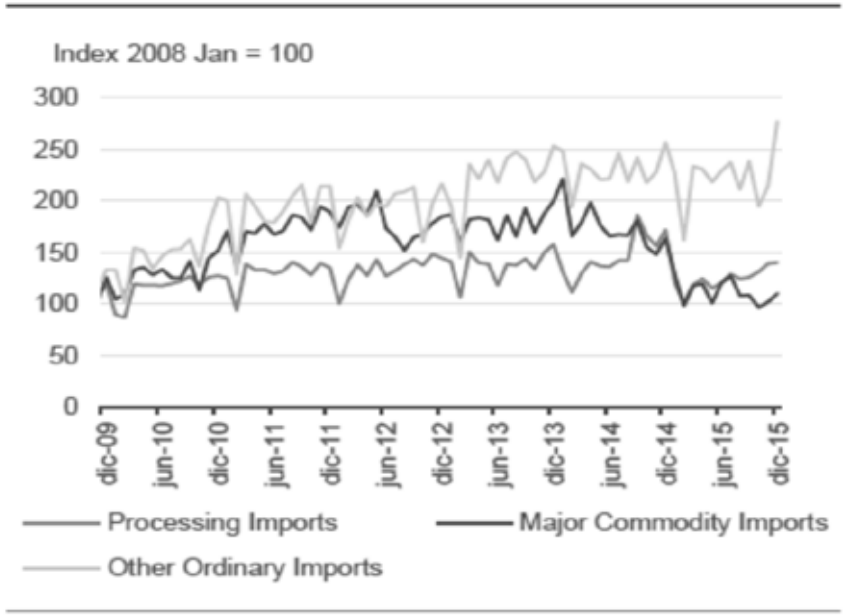
Source: BBVA Research, UNCTAD Database.

parts and intermediate inputs (such as microchips, integrated circuits) are mostly imported. This reduces the seemingly high-tech feature of Philippine exports to PRC, since the more high-tech components of the electronic products are not produced in the country.

The good days of vertical integration and global value chain in ASEAN+3 is being challenged in recent years due to weak global export demand from developed countries as well as China's structural transformation away from external demand towards domestic demand and from investments to consumption. Figure 4 shows the pattern of processing imports (imports of intermediate inputs and capital goods for further processing domestically), commodity imports and other imports (consumer goods and capital goods). It can be seen that 2014 saw the start of the sharp decline of commodity imports lasting all the way through 2015. Processing imports also started a significant decline especially in 2015. Thus falling commodity imports and processing imports from China translate into rather significant adverse impact on countries exporting commodity and intermediate inputs and capital goods to China, based on the global value chain system.

Inasmuch as the Philippines participated in the vertical integration and global value chain expansion of ASEAN+3 in the 2000s, the decline in

Figure 4 Indices of China's Processing, Commodity and Other Imports

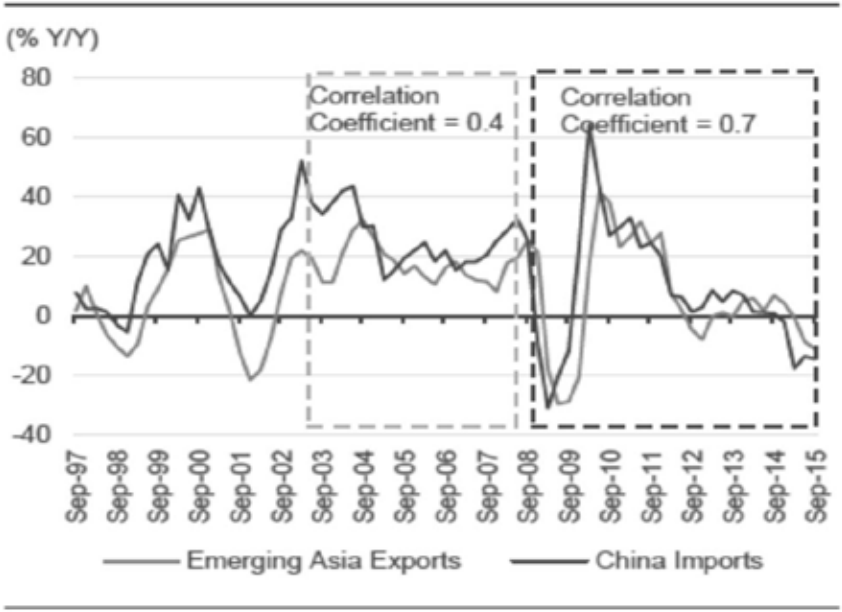


Source: BBVA Research, Haver Analytics.

the current trend of vertical integration might have a negative impact on Philippine exports. But inasmuch as the Philippines was not as successful as the other ASEAN countries in the vertical integration and global chain production process, the loss is not as big as in the other countries. Furthermore, we had seen in Tables 4 and 5 that Philippine exports to China and other countries had been overly dependent on electronic and semiconductor products which rely on cheap labour in the assembly process. These are the exports that are part of the vertical integration and global value chain. Would the loosening of vertical trade integration with China perhaps allow a more healthy diversification of Philippine exports in ASEAN+3 to include other products such as basic goods and other more value-added manufactures? This is an empirical research begging to be undertaken.

Figure 5 shows that the movement of China's imports and emerging Asia's exports had been more correlated since after the GFC – from the third quarter of 2009 to the present. The weaker conditions for global exports facing the Asian economies, including regional export demand (especially from PRC) had made movements of exports in the ASEAN+3 area more correlated (with less room for choices and alternatives in national exports and imports). This means that economies that strongly export to China with high domestic value-added content will be more adversely affected by a

Figure 5 Correlation of China's Imports and Emerging Asia Exports



Source: BBVA Research, Haver Analytics.

China slowdown or a China economic crash. The Philippines, as we explained earlier, is not so exposed to Chinese imports, and therefore will not be as affected as Taiwan, Korea, Malaysia, Vietnam and Thailand.

3.3. Who will Benefit if China Abandons Labor-Intensive and Low- and Middle-Skilled Technology-Intensive Exports

It is a known fact that China is losing some foreign investments due to its rising wages. At the same time, it is going up the technology ladder to higher-skilled and technology-intensive products. This will leave room for other Asian economies to take China's place in labour-intensive, resource-intensive manufactured exports and low-/middle-skilled and technology-intensive manufactured exports[8]. One simple way to look at this is to study the revealed comparative advantage (RCA) of exports which is the ratio of a particular product's share in a country's exports to the same product's world share in total world exports. If the ratio is more than 1, the country or economy is said to have a revealed comparative advantage in that product.

Table 6 shows the RCA for the different categories of products for China and selected East Asian economies. It can be seen that for labour-intensive, resource-intensive manufactures, the countries with RCA are Cambodia, Vietnam and Indonesia. And indeed these countries are already getting higher foreign investments in the last few years for the production of this type of product. The most notable among these countries is Vietnam. For low/medium-skilled technology-intensive manufactures, the country that is set on filling China's shoes is Thailand. Among the countries challenging China for the high-skilled technology-intensive manufactures, Malaysia, Singapore and the Philippines all have higher wages than China for high-skilled workers and so are less competitive than China. The Philippines in addition is burdened by having weak infrastructure and lagging technological development. Furthermore, Philippines production of high-skilled technology-intensive manufactures are highly import-intensive, where the high-tech and high-skilled components of the product are mostly imported rather than produced within the country (see section 4.) All in all, the countries most likely to benefit from China's "flying geese" departure from some export sectors will be mainly Vietnam – plus Cambodia and Indonesia – for the labour-intensive, resource-intensive manufactures. For the low/medium skilled technology-intensive manufactures, Thailand seems to be a front runner, but Vietnam, though it does not have an RCA in these products, is fast gaining ground in this territory because of foreign investments going into these sectors.

The Philippines with relatively high wages, inadequate and inefficient infrastructure, high import intensity and low technological development, unfortunately, as of now, seems unlikely to take over the products that

Table 6 RCA Index on Manufactured Goods Based on Degree of Manufacturing, 2013

	China	*Cambodia*	*Indonesia*	*Malaysia*	*Philippines*	*Singapore*	*Thailand*	*Viet Nam*
Labour-intensive and resource-intensive manufactures	1.76	6.67	2.82	0.77	0.98	0.14	0.70	3.53
Low-skill and technology-intensive manufactures	1.07	0.43	0.81	0.50	0.44	0.45	0.76	0.73
Medium-skill and technology-intensive manufactures	0.71	0.08	0.73	0.57	0.74	0.58	1.17	0.41
High-skill and technology-intensive manufactures	0.98	0.07	0.68	1.56	1.36	1.77	1.02	0.74

Source: Mendoza et al. (2015), p. 15. Based on UNCTAD 2013 data.

China is imparting to other economies. The Philippines has to significantly improve in infrastructure and technology/productivity to compete well in the ASEAN+3 region.

4. Philippine Imports from PRC and Hong Kong

Even less affected by China's slowdown would be the imports of the Philippines from the PRC and Hong Kong. This is because it is unlikely that China will reduce its own exports to markets that actually demand them, unless there is total political and economic chaos and disorder. Furthermore, there will always be more alternatives open for the Philippines to access imports from other economies if imports from PRC are closed.

Table 7a shows that imports from China to the Philippines have grown continuously through the 2000s, from 1% of GDP in 2000, to almost 5% of GDP in 2016. This translates (Table 7b) to a rise from 2.4% of total imports coming from the PRC in 2000 to 18.5% in 2016. Hong Kong, on the other hand, had a share of 3.7% of total imports in 2000 that rose to around 4% before the GFC (especially in 2005 to 2007), but fell to around 2.5-3.0% in 2014-2016. This translates into only 0.6-0.8% of GDP in 2015-16. Thus for imports, the PRC dominates Hong Kong, with the two economies adding up to 19-21% of total imports in 2015-16.

China is the top country source of Philippine imports. This is clearly shown in Table 7c, where 18.5% of the country's total merchandise imports in 2016 came from China. A far second is Japan, providing only 11.8% of Philippine imports, with the US third with 8.9% of Philippine imports in 2016. The combined imports from China and Hong Kong comprise 21.4% of total imports in 2016. This is more than one-fifth of total imports. Thus, even if there is no problem presented by China's slowdown on Philippine imports from China, the availability and prices of these imports from China will have impact on the Philippine economy.

Table 8 shows that the composition of imports coming from China has shifted strongly from semi-conductor components/devices and electronic data processing – imported inputs to Philippine electronic exports – in the period before and during the GFC (mid-2000s to 2009) to consumer and intermediate manufactures, such as iron and steel, industrial machinery and equipment, mineral fuels and lubricants, metal products and transport equipment in 2010 to 2016. This points to the weak global and regional export demand after the GFC, and the Philippine rebalancing towards a higher share of domestic demand.

The still significant imports of semiconductor products and electronic data processing show that intermediate inputs for electronic exports are largely imported. Thus the RCA rating of the Philippines in Table 6 is disputable

Table 7a Total Value of Imports, Imports to PRC and Hong Kong, as % of GDP

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Total imports	45.67	45.81	50.51	50.74	50.46	48.01	44.25	38.83	34.80	27.23	29.29	28.60	26.33	24.18	24.14	24.97	26.62
Hong Kong & PRC	2.75	3.28	3.73	4.37	5.08	5.00	4.96	4.39	3.84	3.33	3.27	3.63	3.48	3.67	4.29	4.70	5.70
Hong Kong	1.67	1.87	2.07	2.04	2.00	1.96	1.80	1.56	1.21	0.92	0.78	0.72	0.62	0.50	0.61	0.65	0.79
PRC	1.08	1.41	1.66	2.32	3.08	3.04	3.17	2.83	2.63	2.41	2.48	2.91	2.86	3.16	3.68	4.05	4.92

Table 7b Imports: CIF Value in Million USD and Percent Share by Countries

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Total	37002	34939	41092	42576	46102	49487	54078	57996	60420	45878	58468	64097	65839	65739	68704	74750	81154
PRC & Hong Kong	6.02	7.15	7.39	8.6	10.07	10.42	11.22	11.31	11.03	12.22	11.15	12.7	13.23	15.17	17.78	18.82	21.43
PRC	2.37	3.07	3.29	4.58	6.11	6.33	7.16	7.3	7.55	8.85	8.47	10.19	10.87	13.08	15.24	16.23	18.47
Hong Kong	3.65	4.07	4.1	4.02	3.96	4.08	4.06	4.01	3.48	3.37	2.68	2.51	2.36	2.09	2.53	2.59	2.96

Table 7c Merchandise Imports from Japan, USA, PRC, HK, Taiwan 2016 (in USD Million, CIF, in % of GDP and % Share)

	Million USD, CIF	*In % of GDP*	*% share*
Total	81154	26.62	100.00
PRC + Hong Kong	17391	5.70	21.43
PRC	14990	4.92	18.47
Hong Kong	2401	0.79	2.96
Taiwan	5151	1.69	6.35
Japan	9540	3.13	11.76
USA	7216	2.37	8.89

Source: Philippine Statistical Authority.

Table 8 Philippine Imports from Hong Kong, China and Other Countries by Commodity Groupings: 2000 to 2016 (Total in million US$, Components in % of Total)

Year	*2000*	*2005*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Total Imports (in million US$)	**37002**	**49487**	**57996**	**60420**	**45878**	**58468**	**64097**	**65839**	**65739**	**68704**	**74750**	**26884**
Hong Kong (in million US$)	**1351**	**2021**	**2326**	**2102**	**1548**	**1566**	**1608**	**1553**	**1373**	**1741**	**1934**	**776**
Components/Devices Semiconductors	21.42	22.14	21.71	19.42	20.86	29.13	30.26	28.93	27.07	26.45	25.13	23.62
Electronic Data Processing	5.30	31.52	31.65	33.76	30.46	24.99	17.29	7.77	7.03	8.82	12.62	9.77
Telecommunication	2.75	1.31	3.45	5.23	7.68	6.44	7.42	7.22	7.67	6.96	8.46	10.37
Transport Equipment	5.74	0.49	0.55	0.61	0.36	0.69	0.65	1.05	2.17	8.26	6.68	6.58
Industrial Machinery and Equipment	3.81	2.53	2.38	2.95	2.97	4.55	5.37	5.38	5.66	5.33	6.02	6.31
Communication Radar	2.69	1.22	1.08	1.27	0.92	1.71	5.33	5.63	9.48	7.47	5.17	6.22
Telecom Equipment and Elec. Machinery	2.80	3.28	2.94	3.29	2.50	3.06	2.81	3.66	4.26	3.83	4.64	5.75
PRC (in million US$)	**875**	**3134**	**4233**	**4561**	**4060**	**4954**	**6533**	**7155**	**8597**	**10472**	**12131**	**4753**
Iron and Steel	3.81	7.40	8.43	8.55	2.50	6.12	6.35	5.33	6.22	9.45	15.76	12.68
Components/Devices Semiconductors	7.64	24.23	20.58	21.16	22.82	13.82	8.96	7.89	6.31	8.18	10.17	10.26
Industrial Machinery and Equipment	3.69	3.04	4.50	5.03	4.67	5.97	6.41	7.06	7.15	7.18	7.23	7.21
Mineral Fuels, Lubricants and Related Mat.	4.63	4.38	3.28	4.59	7.44	4.45	8.25	7.36	10.15	9.67	5.07	7.59
Metal Products	3.37	2.03	2.81	2.53	2.32	2.76	3.59	3.70	3.63	3.86	4.20	4.22
Transport Equipment	1.04	1.55	2.92	2.32	1.79	2.44	2.54	3.61	3.72	3.78	3.87	3.34
Non-metallic Mineral Manufactures	3.22	2.31	2.25	2.58	2.89	3.21	2.86	3.81	4.02	3.92	3.45	3.46
Telecommunication	0.59	3.09	4.25	5.14	7.42	5.70	4.97	7.54	5.09	3.92	3.33	6.83
Miscellaneous Manufactures	3.50	1.70	1.82	1.85	2.11	2.89	3.78	3.48	3.67	4.15	3.29	3.18
Telecom Equipment and Elec. Machinery	2.88	3.82	3.12	2.59	2.64	3.37	3.24	3.28	3.26	3.46	3.01	2.59
Electronic Data Processing	2.79	9.59	6.72	6.50	7.75	9.19	5.30	4.98	3.49	3.48	3.00	3.36
Other Countries (in million US$)	**875**	**3134**	**4233**	**4561**	**4060**	**4954**	**6533**	**7155**	**8597**	**10472**	**12131**	**4753**
Components/Devices Semiconductors	34.06	38.89	36.93	28.00	26.41	27.27	24.46	20.85	20.56	19.00	24.11	20.93
Mineral Fuels, Lubricants and Related Mat.	11.58	14.41	18.94	23.42	18.26	18.63	22.08	23.77	22.70	22.18	14.93	10.41
Transport Equipment	2.83	3.15	4.66	5.11	5.74	6.83	5.95	8.38	10.98	10.52	9.73	11.67
Industrial Machinery and Equipment	5.73	3.91	3.88	4.07	4.08	4.50	4.77	4.98	4.87	4.61	5.60	7.04
Other Food and Live Animals	1.77	1.57	1.63	1.93	2.42	2.80	2.65	2.74	3.03	3.81	4.11	4.27

Note: CIF value in USD; 2016 data covers the reference months January to April only.
Source: Philippine Statistical Authority.

since its RCA in highly-skilled, technology-intensive electronic products is mainly assembly and processing of high-tech micro-chips and sophisticated integrated circuits. The product may be rated as high-skilled and technology-intensive. But if the technology and sophisticated inputs are all imported, and simple assembly and processing are the value-added of the Philippines, the economy does not really have an RCA for a high-tech product.

Table 9 shows that Philippine imports from China are less dependent on electronic products compared to other top source countries like the US, Thailand, Singapore, Korea and Taiwan. Imports from Japan are also no longer too reliant on electronic products.

We have discussed early on that the Philippine trade on goods is traditionally in deficit, meaning that net exports (exports less imports) are usually negative overall for most years. One question is: what is the trade balance with the PRC and with Hong Kong? Table 10 shows that the Philippines has a strong trade surplus with Hong Kong, with exports going to Hong Kong far higher than imports coming from Hong Kong. This trend has been growing in the recent years. However, it is China that is more interesting. From small trade deficits with China, the Philippines started to have significant trade surplus with PRC from 2005-2008, the height of vertical trade integration and global value chains in ASEAN+3. The post-GFC

Table 9 Philippine Imports to Major Trading Partners by Top Five Commodities: First Semester, 2016

(CIF: Value in Million US Dollars)

Country/Commodity	*Value*	*% Share*
People's Republic of China	**7,114.38**	**100.0**
Electronic Products	1,639.11	23.0
Iron and Steel	1,047.27	14.7
Mineral Fuels, Lubricants and Related Materials	537.25	7.6
Industrial Machinery and Equipment	521.36	7.3
Miscellaneous Manufactured Articles	410.92	5.8
Japan	**4,477.19**	**100.0**
Electronic Products	1,310.73	29.3
Industrial Machinery and Equipment	698.64	15.6
Transport Equipment	686.97	15.3
Telecommunication Equipment and Electrical Machinery	277.41	6.2
Iron and Steel	199.21	4.4

Table 9 (continued)

Country/Commodity	*Value*	*% Share*
United States of America	**3,356.69**	**100.0**
Electronic Products	1,381.10	41.1
Feeding Stuff for Animals (Not Including Unmilled Cereals)	354.09	10.5
Cereals and Cereal Preparations	202.37	6.0
Industrial Machinery and Equipment	176.22	5.2
Other Food and Live Animals	165.48	4.9
Thailand	**3,207.89**	**100.0**
Transport Equipment	1,279.05	39.9
Electronic Products	527.04	16.4
Other Food and Live Animals	181.28	5.7
Industrial Machinery and Equipment	179.15	5.6
Plastics in Primary and Non-Primary Forms	145.94	4.5
Singapore	**2,564.26**	**100.0**
Electronic Products	1,177.98	45.9
Mineral Fuels, Lubricants and Related Materials	294.56	11.5
Other Food and Live Animals	172.46	6.7
Industrial Machinery and Equipment	144.39	5.6
Plastics in Primary and Non-Primary Forms	125.80	4.9
Republic of Korea	**2,549.81**	**100.0**
Electronic Products	908.34	35.6
Mineral Fuels, Lubricants and Related Materials	418.95	16.4
Transport Equipment	237.91	9.3
Industrial Machinery and Equipment	176.10	6.9
Textile Yarn, Fabrics, Made-up Articles and Related Products	86.51	3.4
Taiwan	**2,538.05**	**100.0**
Electronic Products	1,472.70	58.0
Mineral Fuels, Lubricants and Related Materials	244.87	9.6
Industrial Machinery and Equipment	135.20	5.3
Iron and Steel	98.43	3.9
Plastics in Primary and Non-Primary Forms	63.07	2.5

Source: Philippine Statistical Authority.

Table 10 Philippine Net Exports as % of GDP: Total and PRC & Hong Kong, and Other Countries, 2000-2016

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Net Exports	1.33	-3.66	-7.23	-7.56	-7.03	-7.99	-5.46	-5.04	-6.53	-4.42	-3.49	-7.05	-5.49	-3.32	-2.32	-5.32	-8.26
HK and PRC	0.42	-0.16	0.83	1.88	1.26	2.19	1.86	3.34	2.19	0.32	1.77	0.80	0.89	0.59	0.62	-0.50	-1.54
Hong Kong	0.69	0.20	0.83	1.65	1.44	1.28	1.23	2.33	1.66	0.99	1.39	0.93	1.29	1.17	1.32	1.49	1.36
PRC	-0.26	-0.37	0.00	0.23	-0.18	0.91	0.62	1.02	0.52	-0.67	0.39	-0.13	-0.39	-0.58	-0.70	-1.99	-2.90
Other countries	0.90	-3.49	-8.06	-9.44	-8.29	-10.18	-7.31	-8.39	-8.72	-4.74	-5.27	-7.85	-6.39	-3.91	-2.94	-4.82	-6.71

Source: Calculated from Bangko Sentral ng Pilipinas and Philippine Statistical Authority.

period saw trade deficits with China returning in 2011 up to the present. As intermediate exports waned and Chinese domestic demand oriented imports (manufactured and consumer goods) increased, trade deficits rose, reaching its peak in the most recent period. In 2016, trade deficits with the PRC reached 2.9% of GDP. The trade deficit with China has drastically increased from 2014, when it was just 0.7% of GDP. Again this is a sign of the waning of vertical trade integration and global value chains in East Asia as developed markets' exports remain in the doldrums, while Asian economies rebalance towards domestic demand. It must be pointed out that the trade deficit with China of 2.9% of GDP is a significant portion of the huge trade deficit of the Philippines in 2016, which is 8.3% of GDP. As was discussed earlier, this large deficit is being cushioned by strong international reserves due to overseas workers' remittances.

6. Chinese Investments in the Philippines and Chinese Loans to the Philippines: Major Prospects in the Future

Table 11 gives us the list of approved foreign investments for the Philippines in 2015 and 2016. One can see that China is not a big foreign investor of the Philippines at present. For 2015 and 2016 combined, the approved foreign investment of China is less than US$3 billion, or a minute 0.6% of the total approved foreign investment for the two years. Hong Kong comprised slightly more, or around US$3.5 billion for the two years, making up 0.8% of the total approved foreign investments to the Philippines for 2015 and 2016. Hong Kong and China combined provided around US$6.5 billion, or only 1.4% of total approved foreign investment for 2015 and 2016. This compares very badly with the top foreign investors in the country such as the Netherlands, Japan and the US, which provided 28.5%, 17.6% and 11.5%, respectively, of total approved foreign investments in 2015 and 2016. It seems the Philippines is not a top area of investment for PRC. Especially under the Aquino Administration (2011-2015), territorial disputes in the South China Sea between the Philippines and China had reduced investment, loans and official development assistance from China.

Table 12 shows the breakdowns of external debt in the Philippines from 2005 to 2016. As can be seen from the table, in 2015, China lagged far behind top bilateral lenders to the country, led by Japan, which owns close to one-third of the total bilateral external debt of the Philippines. In 2015 and 2016, the other top lenders to the Philippines ahead of China are the United Kingdom, US, Germany and France. China's loans to the Philippines, as of end-June 2016, supported some infrastructure projects: power generation (US$403 million), ports development (US$124 million), water supply (US$108 million) and irrigation (US$76 billion).[9] The low performance of

Table 11 Total Approved Foreign Investments by Country of Investor, 2015 to 2016 (in million pesos)

Country	*Approved Foreign Investment*		*Total 2015 & 2016*	*% to Total*	*Growth 2015-2016*
	2015	*2016*			
Total	245,215.7	219,038.6	464,254.3	100.0	(10.7)
Netherlands	82,726.6	49,445.9	132,172.5	28.5	(40.2)
Japan	54,711.1	27,058.7	81,769.9	17.6	(50.5)
USA	21,740.6	31,427.8	53,168.3	11.5	44.6
Singapore	16,817.2	24,056.0	40,873.2	8.8	43.0
South Korea	23,165.6	16,134.5	39,300.1	8.5	(30.4)
Australia	538.3	32,439.8	32,978.1	7.1	5,926.7
Others	12,817.0	8,625.9	21,442.9	4.6	(32.7)
British Virgin Islands	5,625.7	4,520.6	10,146.2	2.2	(19.6)
UK	4,129.2	4,733.9	8,863.1	1.9	14.6
Cayman Islands	4,428.6	3,656.4	8,084.9	1.7	(17.4)
Germany	3,064.7	4,904.6	7,969.3	1.7	60.0
Taiwan	5,457.7	1,608.4	7,066.1	1.5	(70.5)
Malaysia	2,904.3	1,084.5	3,988.8	0.9	(62.7)
Hongkong	2,134.1	1,401.2	3,535.3	0.8	(34.3)
India	1,760.5	1,595.6	3,356.2	0.7	(9.4)
Thailand	448.9	2,567.2	3,016.1	0.6	471.9
China (PROC)	1,455.1	1,519.4	2,974.4	0.6	4.4
Canada	329.7	1,395.6	1,725.2	0.4	323.3
Switzerland	918.6	412.0	1,330.6	0.3	(55.2)
France	21.5	444.3	465.8	0.1	1,970.4
Denmark	20.8	6.4	27.1	0.0	(69.4)

Source: Philippine Statistical Authority.

Table 12 Philippines: Total External Debt by Country Profile (US$ million, end of period)

	2005	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
By Source	61,555	61,372	66,508	65,228	64,738	73,594	75,569	79,949	78,489	77,674	77,474	74,763
Country	35,399	33,567	38,109	37,145	32,605	38,735	39,905	43,062	43,454	42,003	42,702	40,862
of which:												
USA	4,478	3,376	3,149	3,977	2,220	2,865	3,884	5,116	4,719	4,569	3,631	3,499
Japan	12,787	11,978	16,348	17,969	16,002	17,016	16,472	15,421	13,401	11,686	12,296	12,134
UK	1,408	585	711	816	730	2,031	1,691	2,616	4,774	4,784	4,217	4,098
France	2,460	3,374	3,639	827	842	1,220	1,244	1,184	1,394	1,096	1,042	1,141
Germany	3,625	4,376	3,665	3,265	2,396	2,772	2,015	2,088	1,566	1,560	1,837	1,584
PRC	305	318	371	470	432	866	1,480	1,611	1,745	1,989	1,108	949*.
Multilateral Agencies	7,516	7,299	7,891	9,082	10,939	10,908	11,581	11,698	10,366	10,663	11,783	11,971
Bondholders/Noteholders	18,640	20,507	20,508	19,000	21,195	23,951	24,084	25,190	24,669	25,008	22,989	21,930

Note: * PRC data for 2016 is for Jan-June only.
Source: Bangko Sentral ng Pilipinas.

Chinese ODA and state banks loans to the Philippines no doubt is related to the Philippines' territorial disputes with China.

Furthermore, Chinese ODA and loans had become controversial because the money had gone into projects tainted with corruption. The most notorious is the ZTE-NBN (National Broadband Network) project where then Philippine President Gloria Arroyo and her husband were implicated in receiving bribe money from Chinese company ZTE to win a bid for setting up the national government broadband network in 2007-2008. The deal awarded to ZTE was cancelled after a political outcry against Arroyo shook the government (Landingin, 2010).

But the biggest victim is the North Luzon Railway (Northrail) project funded by the Export-Import Bank of China with a US$900 million loan. After releasing the first tranche of US$400 million, China Ex-Im Bank asked for the immediate payment of the disbursed portion of US$185 million and cancelled the first tranche loan. This was in the midst of a strong dispute between China and the Philippines over islands in a section of the South China Sea (the disputed area is called the West Philippine Sea) and charges of corruption on the Philippine side in terms of right-of-way and relocation of those affected by the railway project. The entire Northrail loan was abrogated[10] and the forthcoming Southrail loan also cancelled in 2010. Thus ODA projects with China have been jeopardized by the political tension between the two countries, and charges of corruption (Landingin, 2010).

As a result of the above, China did not become a significant ODA funder and lender to the Philippines. Thus, it was not just a Chinese slowdown that was affecting the access to Chinese funds and the Asian Infrastructure Investment Bank (AIIB) in 2015-16. The Philippines was one of the last to sign up as a partner member of AIIB in December 2015, because of its political problems with China.

The new President of the Philippines Rodrigo Duterte has announced a more accommodative stance on the Philippine-China territorial dispute and expressed the wish that China would fund his ambitious national railway program. This occurred despite the recent ruling on 11 July 2016 from the Hague in favour of the Philippines' claim of China's infringement on the sovereignty of the Philippines in the South China Sea.

In September 2016, President Duterte made a historic visit to China and announced the China pivot – the Philippine's turn towards China as a major economic partner and away from the US (due to the latter's criticism of human rights abuses and extrajudicial killings in the drug war program of Duterte). This resulted in a US$24 billion investment and loan package deal consisting of US$9 billion of soft loans – US$6 billion from the PRC government as ODA and US$3 billion as a credit line from the Bank of China. The US$15 billion investments from PRC will go partly to projects outlined

in the preliminary agreements, including projects involving railways, ports, energy, mining and agriculture. The US$24 billion package will cover a period of five years (Remo, 2016).

Following the China pivot by the Duterte administration, the Asian Infrastructure Investment Bank (AIIB) established by the PRC and of which the Philippines is a co-founder, has agreed to fund the P23.46 billion Metro Manila flood control program, and the P37.7 billion bus rapid transit (BRT) system along the major highway of Metro Manila (De la Paz, 2016). If all these come to fruition, China will be the biggest investor and lender to the Philippines in the next five years (i.e. for the whole term of President Duterte). A China slowdown and hard landing on China which reduces its capacity to fulfil these loans and investments may entail very major opportunity costs to the Philippines. If, on the other hand, the loans and investments will be implemented, strong mutually agreed-upon regulations against corruption and inadequate implementation which had plagued past Chinese-funded investments and loans will have to be instituted.

There are some Filipinos who expressed concern that the large loans will make the Philippines highly and dangerously indebted to China. This of course depends on the effects of these debts on the fiscal deficit and foreign debt to GDP ratio. Given that the debts are long-term, the danger is in the long-run – if the Philippines does not translate the projects into foreign exchange and fiscal earning achievements.

7. Hong Kong, Taiwan and China as Sources of Overseas Filipino Workers' (OFW) Remittances

The Philippines has an economy that is very dependent on its overseas workers' remittances. As discussed earlier, the remittances provide a very strong cushion and buffer offsetting the depletion of foreign exchange reserves due to high trade deficits. OFW remittances make up more than 20% of the country's Gross National Income, further comprising a major source of Philippine consumption expenditure. Thus a stop to the employment of overseas Filipinos will have a major impact on the economy. Table 13 shows the major countries on which Filipino overseas incomes depend. The biggest remittances come from the Americas (mainly the US and Canada, comprising 36.2% of total remittances in 2016), and the Middle East (comprising 28.1% of total remittances in 2016). Asia is providing the third largest source of remittances, increasing its share to 18.3% of the total remittances by 2016. Hong Kong and Taiwan are major employers of overseas Filipino workers. But the combined remittances from Hong Kong (2.8% of the total), Taiwan (1.2%) and the PRC make up only 4.6% of the total remittances for 2016, with China providing only 0.6% in 2016. Thus, a decline in the economies of

Table 13 Philippines: Overseas Filipinos' Cash Remittances by Country and Region (thousand US$)

	2012	*2013*	*2014*	*2015*	*2016*
Total	21,391,333	22,984,035	24,628,058	25,606,830	26,899,840
ASIA	13.8	14.5	17.9	17.9	18.3
China (Mainland)	0.4	0.4	0.1	0.2	0.6
Hong Kong	2.0	2.4	3.7	3.6	2.8
Korea	0.8	0.8	0.7	0.9	0.8
Japan	4.7	3.9	5.8	4.8	5.1
Malaysia	0.8	1.2	0.8	1.3	1.2
Singapore	4.0	4.6	5.7	5.9	6.2
Taiwan	0.8	0.9	0.9	0.9	1.2
Americas	52.3	47.4	35.5	36.6	36.2
Europe	16.0	17.2	16.9	16.2	14.1
Middle East	16.2	18.9	26.8	26.2	28.1

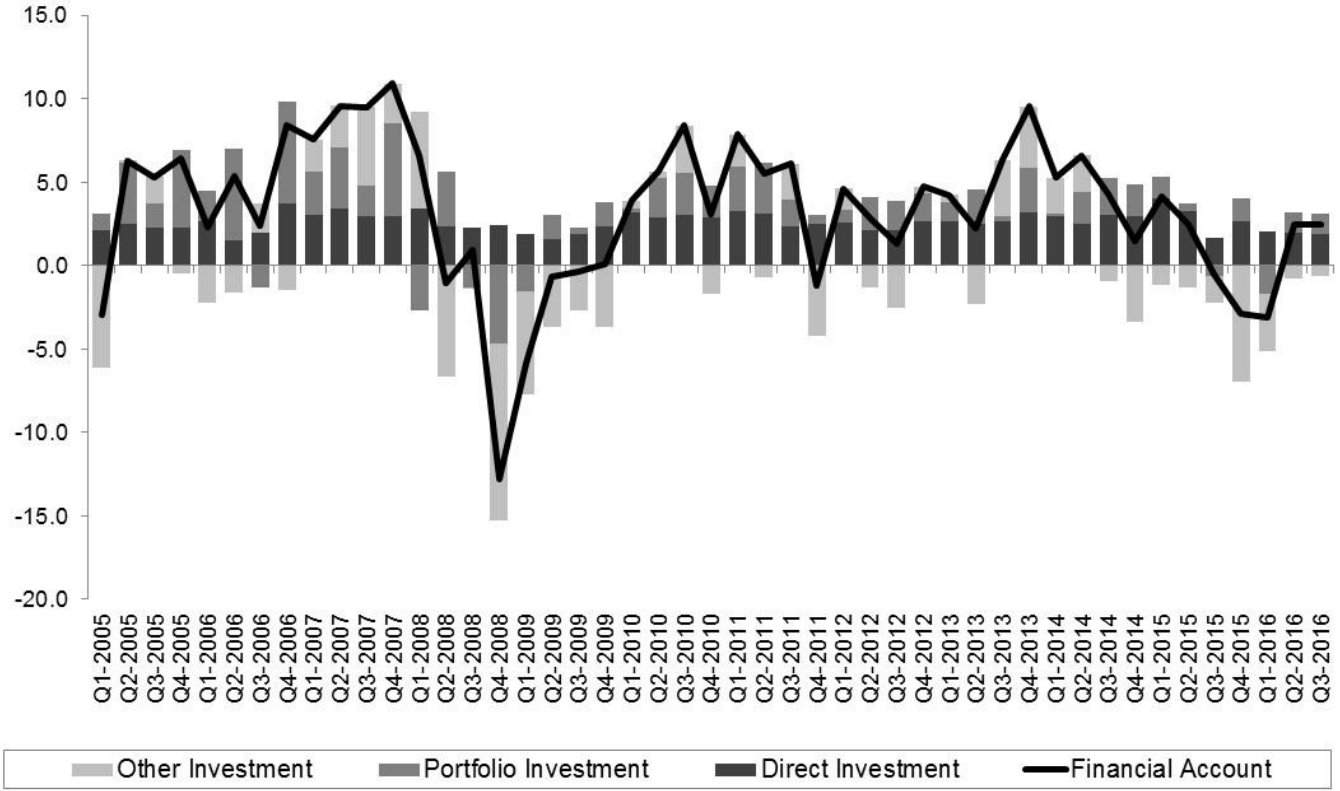
Source: Data are based on bank reports submitted to the Bangko Sentral ng Pilipinas.

Hong Kong, Taiwan and PRC will not cause a major decline in the Philippine economy, although many Filipino families will be affected. More than US$1.3 billion of overseas workers' remittances would have been jeopardized in 2016 if the entire Hong Kong-Taiwan-PRC set of economies had been shut to overseas Filipino workers.

8. Transmission of China Economic Woes to the Philippine Economy via Global Financial Markets

Based on the experience in 2015, a volatile and unpredictable impact of the slowdown of China is the strong volatilities and declines in the global financial markets. The world was rocked by the China slowdown throughout 2015, especially its attempt to widen its currency band in the third and fourth quarters of 2015. This brought massive foreign capital outflow from emerging markets, especially in East Asia. ASEAN+3 was hard-hit. Figure 6 shows that in ASEAN+3 as a whole net financial flows (as percentage of GDP) from foreigners went into negative territory in the third and fourth quarters of 2015 and first quarter of 2016, when China rattled the financial markets (simultaneous with global fears of prospective increases in the US Federal interest rate). Such significant negative flows of foreign capital for ASEAN+3 only happened during the GFC in 2008-9. The negative flows in late 2015 were not as deep as in the GFC, but can get worse if the China problem worsens. The experience in 2008-9 showed massive outflows of foreign funds from emerging markets causing sharp depreciations and losses in

Figure 6 Non-resident Flows – ASEAN+3 (% of GDP)



Notes: Break in comparability of data for PHI (2005), BRU (2010) and MAL (2010). For Malaysia, this effectively discounted "other investments" in its assests and liabilities breakdown.

1. For consistency of charts, net of "other investment" corresponds to resident inflow for Malaysia starting 2010.
2. In the case of Lao PDR, net of direct , portfolio and other investments corresponds to "non-resident inflows" direct, portfolio and other investments starting 2014.
3. ASEAN+3 excludes CAM starting Q12015; BRU and VIE for Q12016; LAO and MYA for Q32016; PRC and HKG for Q42016.

Source: *Balance of Payments Statistics*, International Monetary Fund.

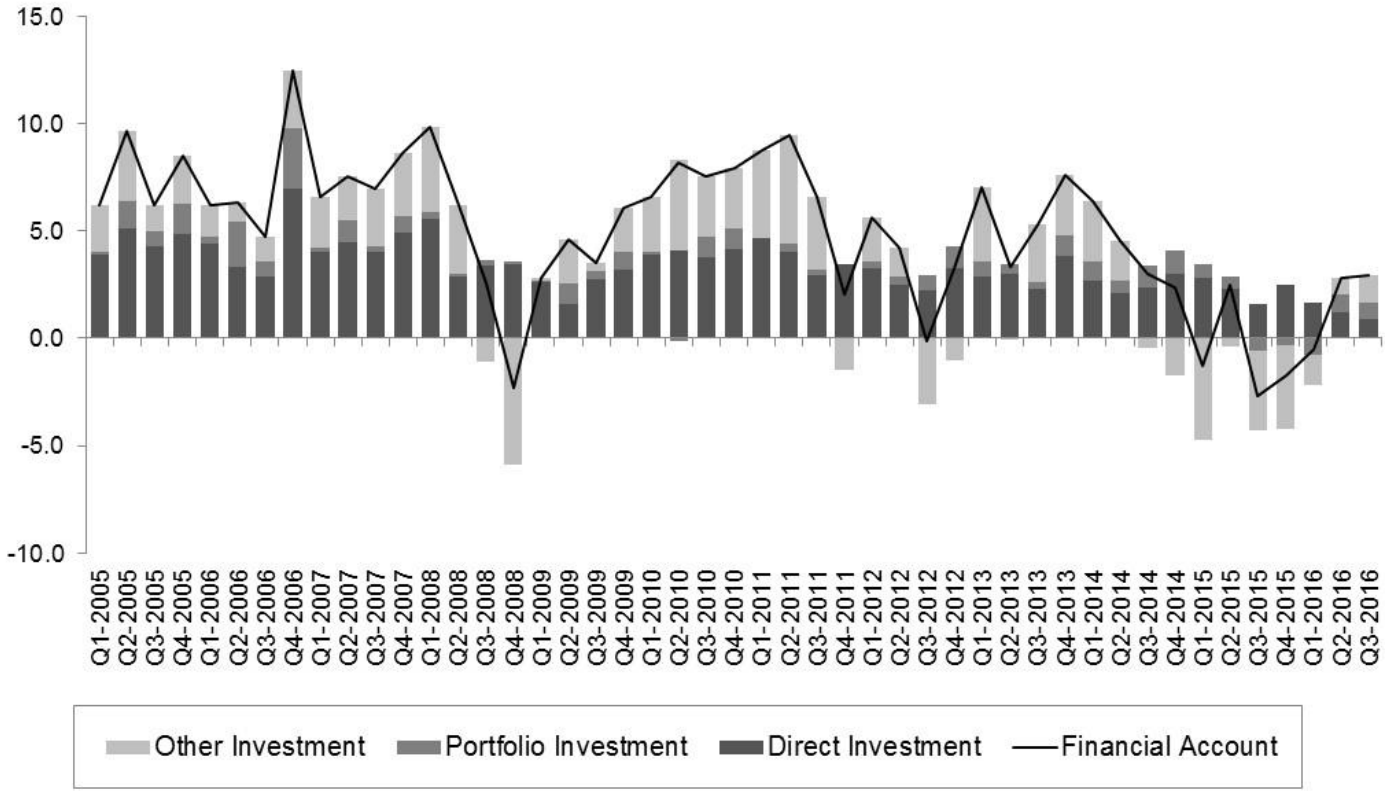
foreign reserves. Korea ran into trouble then and had to go to currency swaps with the US, Japan and PRC. The stock market collapse also triggered wide losses of confidence in the economies and hits investments and consumption hard, leading to recessionary tendencies. Foreign flows in the stock market is captured in Figure 6 mainly by portfolio investments, or foreign flows into stocks and bonds. Note that in Figure 6, the foreign inflows out of ASEAN+3 from the third quarter of 2015 to the first quarter of 2016 (the most volatile period caused by worries over China) were mainly in the form of other investments and portfolio investments. Volatilities in portfolio investments represent much of the gyrations in the stock (and bond) markets. Other investments represent the gyrations on foreign loans (especially short-term foreign debts) and foreign currency deposits that flow out during perceived "bad" times.

Thus the China problem can be a serious problem if it becomes a global and regional financial market problem, triggering losses of confidence and panics, as in 2008-9. This can only happen if China goes into a very hard landing such as a sharp recession and/or financial default/currency crises.

Figures 7a and Figure 7b show the international financial flows in and out of China itself. Figure 7a shows the net foreign (non-resident) inflows (foreign inflows less foreign outflows) into China. One can see from Figure 7a that the net foreign outflows out of China started much earlier in 2015, and in the third and fourth quarter of 2015, was bigger than the net outflows during the GFC. Of course these outflows were manageable because the capital account of China was still controlled and not liberalized. Figure 7b shows the net international financial flows in and out of China. It includes the foreign (non-resident) net flows plus the Chinese residents' net flows. One can see in Figure 7b that Chinese residents significantly brought capital out of the country starting 2014, peaking at the third and fourth quarter of 2015. This made net financial flows go into very highly negative territory. Aggravating this is the large gap between the recorded flows and "errors and omissions", bringing up the suspicion that much of the outflow may be "capital flight" by Chinese residents. The large net financial outflows (peaking at 8% of GDP in the third quarter of 2015) did not, however, cause any crisis in China given its trillions dollars worth of foreign exchange reserves.

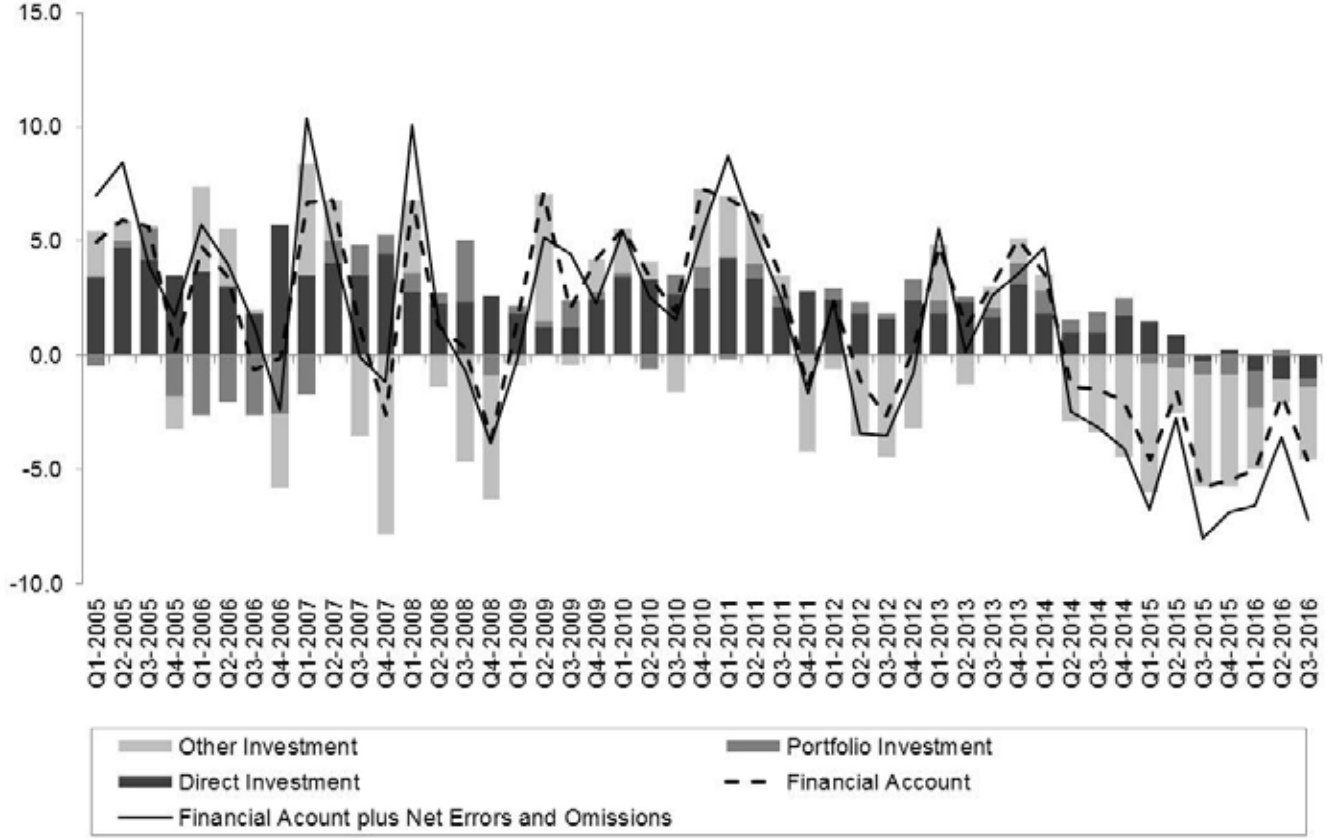
Figure 8 shows the foreign flows in and out of the Philippines. Note that net foreign flows during the turbulent periods of 2015 and early 2016 did not bring foreign financial flows into negative territory as it did during the GFC. But note that there were significant outflows of portfolio investment from the second quarter of 2015 to the first quarter of 2016. The volatilities in the stock market did bring losses of confidence and currency depreciation during this period, but was not serious enough to cause a financial panic or crisis.

Figure 7a Non-resident Flows – PRC (% of GDP)



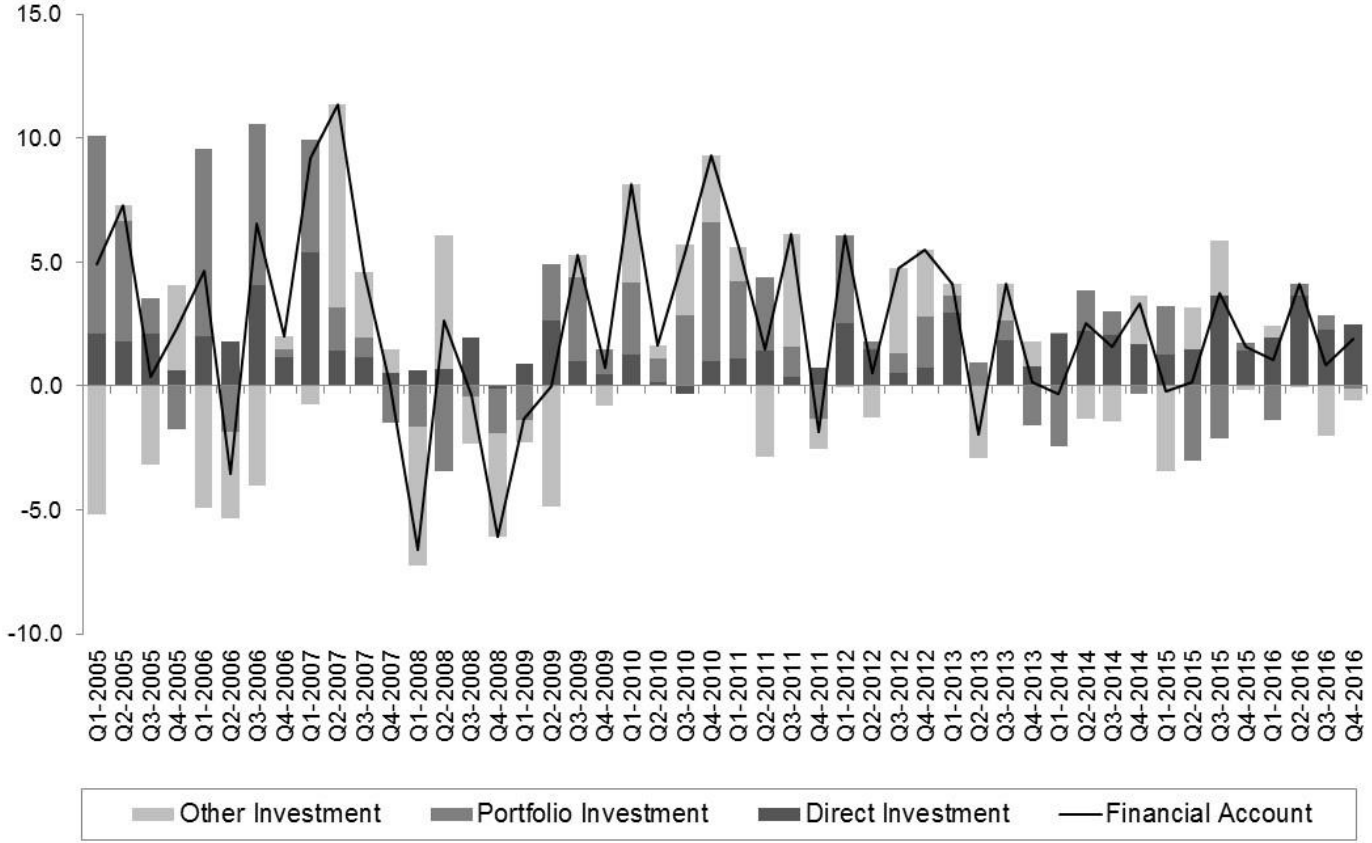
Source: *Balance of Payments Statistics*, International Monetary Fund

Figure 7b Net Financial (Non-resident and Resident) Flows – PRC (% of GDP)



Source: *Balance of Payments Statistics*, International Monetary Fund

Figure 8 Non-resident Flows – Philippines (% of GDP)



Source: *Balance of Payments Statistics*, International Monetary Fund

9. Summary and Conclusion

In summary, the Philippines is not as vulnerable as other East Asian economies to the slowdown of Chinese imports arising from a Chinese economic slowdown or hard landing. This is because it is not very dependent on exports going to China (or Hong Kong).

However, a Chinese slowdown and a weak global economy may bring about a reduction in the vertical trade integration in ASEAN+3 as export production for the developed world is shifted towards production of traded goods for domestic demand. The result of reduction in Asian vertical trade integration may have a negative or a positive effect to the Philippines. The Philippines had not benefited as much as other East Asian countries (such as China, Malaysia, Thailand and Vietnam) in the vertical trade integration of East Asia because of its limited participation in the regional value chain and integration processes. On the one hand, a reduction of Chinese imports and vertical trade integration may lead to some lost exports of electronic inputs, which with the right policies, could have delivered higher technology if the Philippines was able to go into backward integration. But on the other, it may improve the composition of Philippine exports towards more consumer and final products as its current export composition is overly dependent and concentrated on low-end semiconductor and electronic products. The economy would be healthy if these other exports have higher value-added content and are less import-intensive. The current shift of trade to cater to the domestic demand of the region – rather than to integrated production of exports to developed markets – may provide an opportunity to diversify Philippine exports to the East Asian markets. In light of this, more detailed analyses of the trade structure between the two countries, as well as serious trade meetings and agreements, are required to upgrade the volume and quality of Philippine exports and trade with China.

Although Chinese investments and loans are still rather subdued now, the China pivot of the Duterte government may entail much dependence on Chinese funds and capital for infrastructure expansion in the future. Any China slowdown may affect future Chinese funding and investment in the Philippines and may have potential negative impact on future trends in infrastructure development and technological growth. In addition, perception of some corruption on both sides has tainted Chinese official development assistance and investments between the two countries. Some strengthening of institutions should be effected in preparation for the China pivot.

Bad news on the Chinese economy and Asian trade will no doubt affect financial markets and may cause currency depreciation, depletion of international reserves and reduced economic confidence in investments and domestic demand. One must not forget that the regional and national financial markets as relatively open capital markets can lead to uncontrollable external

volatilities. We had seen sufficient turmoil during late 2015 to remind us that the Chinese economy and its prospects affect not only the real sectors of exports, regional/global trade and foreign investments, but also provide enough ripples in the financial markets to affect currencies, equity markets, international reserves and overall economic confidence.

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Notes

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1. It is not clear whether the 2016 data quoted by Reuters and CNBC are also merchandise trade data which was used by ADB for the other years.
2. Discussions of these issues and debates can be read in Stiglitz (2016), Woo (2016; 2017) .
3. Most experts think more than 20% of GDP is overestimating the Filipino overseas workers' remittances. The real figure may be around 10% of GDP, but this is still large compared to the trade deficits.
4. Including the Hong Kong Special Administrative Region. Hong Kong is included in this analysis because: 1) Hong Kong is part of China, and 2) many goods from the Philippines to China go through Hong Kong.
5. This differs from the percent of exports in Table 1 because: a) exports in Table 2 do not include exports of services while those in Table 1 do; and b) Table 1 is based on National Income Accounts while Table 2 is based on Balance of Payments and External Sector Accounts.

6. This is strengthened if we add Taiwan to this list of economies.
7. One should include Taiwan, of course, to complete the trade integration in East Asia.
8. It has been called the flying geese phenomenon.
9. This breakdown is based on statistics of Bangko Sentral ng Pilipinas, officialy obtained by the author from its staff.
10. The Northrail project will be taken over by ODA to be given by Japan.

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The Impact of Chinese FDI on Economy and Poverty of Lao PDR

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Abstract

Concentrated in the resources sector such as mining and hydropower, Chinese FDI in Laos has increased significantly. Using a computable general equilibrium (CGE) model, this paper aims to investigate the impact of Chinese FDI on the economy and poverty in Laos. From the simulation results, we conclude that Chinese FDI has a positive impact on macroeconomic variables such as GDP, welfare and exports. However, it also has side-effects through the appreciation of the real exchange rate and a negative impact on production factors of non-resources sectors – a phenomenon which is called the Dutch disease effect.

Keywords: *Chinese FDI, impacts, CGE model, Laos*

1. Introduction

Capital inflows from foreign direct investment (FDI) provide an important source of financing for low-income and developing countries by promoting economic growth and enhancing technology capability in the long term. However, FDI can also have negative impact on the local economy in the low-income country. This phenomenon is called the Dutch disease, which occurs when FDI leads to real exchange-rate appreciation that negatively impacts the production of tradable goods (Corden and Neary, 1982). The impact of FDI on an economy depends on various factors such as the type of FDI, macroeconomic management, FDI policies of host countries and characteristics of the host country economy. Therefore, the impact of FDI is still not clear in the case of Laos due to lack of studies.

One national development goal of Laos is to no longer be categorized as a least developed country (LDC) by 2020 (GoL, 2004). In order to overcome

poor infrastructure, limited human resources and low productivity, the government of Laos has enthusiastically promoted foreign direct investment (FDI). The foreign direct investment inflows in 2007 is estimated to be US$950 million, recording a 60% increase over the previous year. About 90% of the FDI was linked to the resource industry and accounted for most of the increase (Kyophilavong, 2012). From 1989 to 2008, there were 1,547 projects worth US$9 billion. FDI in the natural resources sector constituted more than 70% of total investment in Laos in the same period. Among all the foreign countries investing in Laos, China is ranked the highest in terms of total amount of investment and number of firms. Similarly, Chinese FDI is mainly concentrated in the resource-related sector, such as mining and hydropower (Kyophilavong, 2012).

The main impacts of Chinese FDI on the economic development of Laos occur through four channels. First, Chinese FDI has both positive demand and supply-side effects on national GDP because of increased investment and capital stocks. Second, Chinese FDI promotes exports and helps to reduce trade deficits. Third, Chinese FDI increases government revenues. The royalties and taxes collected from Chinese FDI projects could thus lower the government's budget deficit. Fourth, the investment generates employment because it requires a significant input of labour. In addition, Chinese FDI could promote technology development.

However, Chinese FDI could have negative impacts on the Lao economy in the long term given the fact that most Chinese FDI is concentrated in natural resource extraction sectors (mining and hydropower in particular). Chinese FDI in natural resource extraction sectors leads to decline in the other sectors, such as agriculture and industry, which must compete internationally under real exchange-rate appreciation. While a number of studies examine the impact of Chinese FDI on the host country economy, there is no study of the impact of Chinese FDI on the Lao economy using a quantitative approach such as the computable general equilibrium (CGE) model or macroeconomic model (Jenkins and Edwards, 2006; Gu, 2009). Therefore, the main objective of this study is to quantify the potential impact of Chinese FDI on the Lao economy and on poverty in Laos by using the CGE model.

2. Lao Economic Development and Poverty Reduction

Since introducing the New Economic Mechanism (NEM) in 1986, Laos transitioned from a centrally planned economy to a more market-oriented one. As a result, Laos was able to deliver high economic growth except during the Asian Financial Crisis of the late 1990s. Economic growth averaged about 8% from 1990-2013 (Table 1). In 2013, the GDP was distributed across the agricultural (25.2%), industrial (28.0%) and service (38.9%) sectors

Table 1 Lao PDR – Changes in Key Macroeconomic Indicators

Macroeconomic indicator	*2011-2013*	*2006-2010*	*2001-2005*	*1996-2000*	*1990-1995*
Population growth (%)	2.04	2.16	1.58	2.07	2.71
GDP growth (%)	7.98	7.98	6.24	6.17	6.28
GDP per capita (constant 2000 US$)	1329	841	371	302	243
GDP per capita growth (%)	6.10	5.90	4.58	4.00	3.44
Money supply growth (%)	31.90	38.34	20.18	66.04	30.92
Inflation, CPI (%)	5.92	4.98	10.31	57.00	15.27
Trade balance/GDP (%)	-0.30	-0.59	-10.43	-17.03	-13.02
External debt stock (% of GDP)	76.50	101.10	129.86	152.99	160.25
Budget deficit/GDP (%) – including grants	-2.85	-2.53	-4.13	-4.87	-7.95
Budget deficit/GDP (%) – excluding grants	-9.26	-6.05	-6.04	-8.88	-11.52
Exchange rate (kip per US$)	8018	9056	10164	4094	727

Sources: World Bank online database, *World Development Indicators*. Asian Development Bank (ADB).

and others (7.9%). In addition, the country's macroeconomic situation was relatively stable, evidenced by the stability of the average inflation rate and the exchange rate from 2011-2013. Meanwhile, GDP per capita increased significantly from US$310 in 1980 to US$984 in 2010 before reaching US$1,000 in 2012. These economic developments resulted in Laos moving from "Low Income" status to a "Low-Middle Income" country category by 2012, according to the World Bank.

There are three main important reasons why economic reform promotes economic growth. First, the liberalization of investment and trade provides more incentives for increased productivity and production in various sectors. Second, it can result in increasing domestic demand through foreign direct investment (FDI), official development assistance (ODA) and remittance. Third, economic reform can allow for increases in production and export activities, especially in hydropower and the mining sector. Lastly, human resources, infrastructure and government spending play important roles for economic development.

Before the economic reforms of 1986, Laos was extremely poor. Since 1986, poverty has decreased significantly. The poverty reduction program has been supported by multinational corporations, international organizations

and other parties. In order to eradicate poverty by 2020, the government has implemented the National Growth and Poverty Eradication Strategy (NGPES), an overall development and poverty alleviation framework (GoL, 2004). Analysis of four Laos Expenditure and Consumption Surveys (LECS) by the World Bank (WB) and Department of Statistics showed that the incidence of poverty has fallen since LECS 1, though it fell slowly from 1997-98. The incidence of poverty fell from 46% in LECS 1 to 39% in LECS 2, and from 33.5% in LECS 3 to 28% in LECS 4 (Table 2). While poverty has gone down, inequality has gone up, especially in Vientiane and other urban areas. The Gini coefficient increased from 30.5 in LECS1 (1992/93) to 35.4 in LECS 4 (2007/08). In Vientiane, the Gini coefficient increased from 29.7 in LECS1 (1992/93) to 38.00 in LECS 4 (2007/08) (Table 3). Reforms have reduced poverty significantly but have also led to increased inequality.

In the meanwhile, the economic reforms have strengthened property rights and land ownership providing more incentives for households and enterprises to increase production and productivity. In addition, improvement of infrastructure provides opportunities for farmers to access markets which increase their revenues. Moreover, the government also has a clear plan and strategy to reduce poverty in rural areas in particular.

Even though Laos has been maintaining high economic growth, low inflation and a stable exchange rate, serious macroeconomic challenges still remain. First, Laos has faced chronic twin deficits in government and trade

Table 2 Lao PDR: Relative Poverty, 1993-2013 (%)

	LECS1 1992/93	*LECS2 1997/98*	*LECS3 2002/03*	*LECS4 2007/08*	*LECS5 2012/13*
Laos	64	39.1	33.5	28	23.2
Urban	27	22	20	17	10
Rural					
With road	43	32	31	30	28.6
Without road	61	51	46	43	
Lowland			28	20.5	
Midland			36.5	29	
Upland			34	33	

Note: LECS – Lao Expenditure and Consumption Survey.
Source: World Bank and Department of Statistics (Laos); Lao Statistic Bureau (LSB) (2014).

Table 3 Lao PDR: Gini Coefficient, 1993-2013

	LECS1 1992/93	*LECS2 1997/98*	*LECS3 2002/03*	*LECS4 2007/08*	*LECS5 2012/13*
Laos	30.5	34.9	32.6	35.4	36.17
Urban	30.9	39.7	34.8	36.3	37.51
Rural					
With road	29.3	32.1	30.3	33.2	32.52
Without road	27.5	30.9	29.4	33.3	
Region					
Vientiane	29.3	36.9	36	38	
North	26.9	34.5	30.7	35.2	
Central	31.5	32.5	31	34	
South	32.3	32.4	31.4	32.2	

Note: LECS – Lao Expenditure and Consumption Survey.
Source: World Bank and Department of Statistics (Laos); Lao Statistic Bureau (LSB) (2014).

balances. From 2011-2013, the budget and trade deficit accounted for about 9.2% (excluding grants) and 0.62% of GDP respectively. The budget deficit is mainly financed by official development assistance (ODA), while the trade deficit is financed by foreign direct investment (FDI) and remittances. The fiscal situation is not strong in Laos, and continued increases in budget deficits could accelerate inflation and lower the value of the kip (Lao currency), potentially leading to the type of economic instability experienced during the Asian financial crisis. Second, there is a huge gap between savings and investment. The savings rate is low because average income is low due to the underdevelopment of the financial sector. The banking sector is inhibited by the state commercial banks, which are not fully performing important banking functions.[1] Third, Laos also faces a high external debt burden. Accumulated external debt accounted for more than 76% of GDP in 2011-2013. If Laos becomes over-dependent on foreign finance, potential difficulties meeting its debt obligations could cause an external debt crisis and subsequently lead to macroeconomic instability. Fourth, as the Lao economy is dependent on the resource sector[2], this could have a negative long-term impact in the form of Dutch disease which is characterized by the following four features: (1) real exchange rate appreciation; (2) declining input in non-booming sectors; (3) declining exports and output in non-booming sectors; and finally, (4) declining real GDP (Corden, 1984; Corden and Neary, 1982).

3. FDI Policy and Trends

3.1. FDI Policy

Laos began to move away from a centrally planned economy when it introduced the *New Economic Mechanism* (*NEM*) in 1986. This reform has opened an opportunity to private sector development. The key reform programs of this legislation included: 1) price liberalization, 2) tax reform (financial reform), 3) privatization of state owned enterprises (SOEs), including collective enterprises in the agriculture sector, 4) banking reform, and 5) an open door policy. These changes released the great potential of the private sector, especially in terms of participation in international trade. A more detailed discussion of key policy measures of the reform programs follows.

Promoting multi-sectoral ownership entailed encouraging private sector ownership and privatization of SOEs, particularly private land use rights and private businesses. Laos introduced the FDI Law 1988, which was revised three times in 1994, 2004 and 2009 respectively. The amended FDI laws featured: (1) consolidated regulations for both domestic and foreign investors to participate on a "level playing field"; (2) shortened procedures for opening new businesses; (3) no terms of investment for promoted activities; (4) extended investment incentives – education and health care sectors being top priorities; (5) foreign access to local financial sources; (6) foreign invested companies having the right to own a piece of land for building their offices/residences; (7) foreigners being allowed to invest in the real estate sector; and (8) development of Special Economic Zones (SEZs) and industrial parks (Vongsay, 2013).

3.2. FDI Trends

Investment has increased from 1989 to 2015 in terms of the number of projects and registered capital (Table 4). FDI flows into Laos rose significantly after the first revised FDI law in 1994 but declined during the Asian Financial Crisis (1998 to 2001). Starting from 1993, FDI in resource sectors (mining and hydropower) has been growing rapidly. However, registered capital registered a decline in 2010 due to the global financial crisis in 2008-2010.[3]

The top 10 foreign investors of Laos in 1989-2015 are shown in Table 5. Lao FDI is dominated by neighbouring countries. In terms of capital registration, the top three countries are China, Thailand and Vietnam, accounting for more than 60% of all FDI in Laos.

Moreover, FDI in Laos is not diversified and is very much resource-based. Most of the FDI has been invested only in resource sectors. The energy and hydropower sector absorbed more than half of the total investment (Table 6). The electricity generation sector takes up about 30% and mining sector accounts for 23% of the total investment in the country.

Table 4 FDI Inflow to Laos (1989-2015)

Year	*Value of Investment (US$ mil.)*	*No. of Projects*	*Year*	*Value of Investment (US$ mil.)*	*No. of Projects*
1989	29	9	2003	65	121
1990	3.9	25	2004	217	132
1991	28	34	2005	119	175
1992	69	54	2006	789	260
1993	78	80	2007	3128	347
1994	1313	120	2008	5000	531
1995	53	82	2009	1100	616
1996	114	33	2010	2850	442
1997	659	45	2011	3550	471
1998	1385	56	2012	1850	442
1999	186	58	2013	2640	96
2000	513	61	2014	500	56
2001	72	45	2015	100	56
2002	434	66			

Source: Investment Promotion Department, Ministry of Planning and Investment, Laos.

Table 5 Top Ten FDI by Countries (1989-2015)

Country	*Value of Investment (US$ mil.)*
China	5,484
Thailand	4,491
Vietnam	3,574
Malaysia	813
South Korea	751
France	491
Japan	438
Netherland	435
Norway	436
Britain	202

Source: Investment Promotion Department, Ministry of Planning and Investment, Laos

Table 6 FDI by Sector (1989-2015)

No.	*Sector*	*Value of Investment (US$ mil.)*	*Investment Share (%)*
1	Electricity generation	7,303	30
2	Mining	5,698	23
3	Agriculture	2,946	12
4	Service	2,544	10
5	Industry and handicraft	2,111	9
6	Hotel and restaurant	1,023	4
7	Construction	827	3
8	Telecom industry	663	3
9	Wood	410	2
10	Banking	372	2
11	Trading	325	1
12	Garment	95	0
13	Consulting	67	0
14	Public health	64	0
15	Education	31	0
	Total	24,479	100

Source: Investment Promotion Department, Ministry of Planning and Investment, Laos.

4. Literature Review

While foreign direct investment (FDI) is believed to play an important role for economic development by generating linkages and spillovers (Moran, 1998; Borensztein et al., 1998; Alfaro et al., 2004), it is also widely argued to have a negative impact on local economic growth (Alfaro et al., 2004; Usui, 1996; 1997). The negative impact came from the "Dutch disease" which appreciates the real exchange rate and leads to a contraction in the tradable sectors (Corden, 1981; 1982). In addition, FDI is also argued to have negative impacts on the environment, natural resources and sociality. Despite the existence of general discussions of FDI, there is very limited research on the specific impact of China's investment on the Lao economy in general, and poverty and local firms in particular.

Although scarce, the existent research on Laos can be divided into two groups, one of which is descriptive analysis of the FDI policy and situation and the other is quantitative analysis on the impact of FDI. The descriptive analysis on FDI policy and situation focuses on the current situation of FDI

in Laos and FDI policy/incentives (Suzuki and Keola, 2005; Norasingh, 2013; Vongpraseuth and Choi, 2015; Tan, 2012; Kyophilavong and Nozaki, 2015; Gunawardana and Sisombat, 2008a). The current situation, trends, issues and challenges of FDI in Laos have also been studied by various researchers (Gunawardana and Sisombat, 2008b; Goto, 2010; Onphanhdala and Suruga, 2013; Freeman, 2010; Andersson et al., 2009). Among them, Kyophilavong (2012) reviewed the FDI trends and FDI in the mining sector from 1993 to 2010 and identified the benefits and costs of FDI in this sector. The study found that Chinese FDI is largely concentrated in the mining and hydropower sectors.

The second group of studies focuses on the impact of FDI on the Lao economy, most employing macroeconomic and CGE models to investigate the impact of the natural resources sector on the Lao economy and poverty in Laos. Kyophilavong and Toyoda (2012) examined the impact of FDI in the mining and hydropower sectors on the Lao economy by using a macro-econometric model, and found that FDI in the mining and hydropower sectors had a positive impact on economic growth, export and budget revenues. However, this study also found that FDI in mining and hydropower sectors has a negative impact on long term development in Laos because FDI in mining and hydropower sectors tends to increase appreciation of real exchange rates, which will reduce the non-resources sector production and exports. Meanwhile, Warr (2006) used a simple CGE model to estimate the impact of resources on development in Laos and found that Laos might be affected by the "Dutch disease". Oh and Kyophilavong (2014) added the roles of FDI and trade facilitation to benefit trade liberalization between ASEAN and Korea. They found that FDI played important roles for poverty reduction and economic growth in Laos. In general, although many authors have the view that FDI in the mining sector has the potential to shrink the non-mining sector reflecting a vulnerability to the Dutch disease, their studies revealed very little of the total impact of Chinese FDI on Laos.

5. The Impact of FDI on Nation-Wide Economy and Poverty

5.1. Methodology and Data

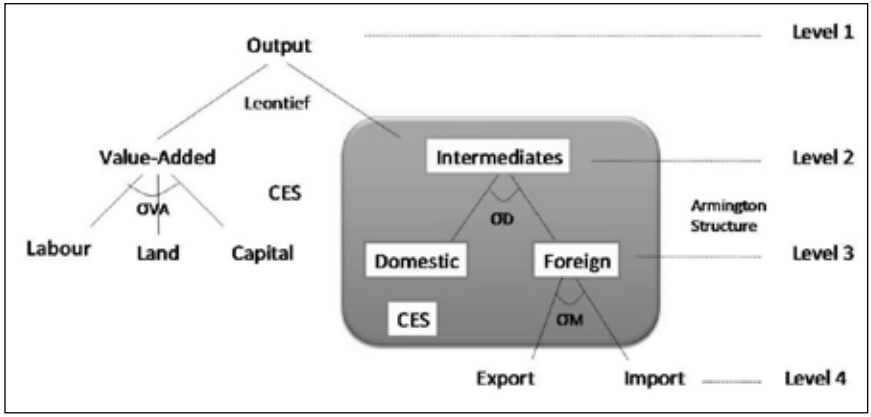
A computable general equilibrium (CGE) model was used for our analysis. It combines economic theory and empirical data to create an economic tool for policy analysis of issues such as changes in tariffs and their effects on whole economic systems. CGE models present the behaviour of economic agents (producers, consumers, and government), sectors (industry, agriculture, and services) and factors of production (labour, capital and land). The Global Trade Analysis Project (GTAP) model, a multi-regional computable equilibrium (CGE) model, is one of the most popular models for analyzing the

impact of trade policies.[4] There are various advantages to the GTAP model. Firstly, since it is a multi-regional model of world production and trade, it can take into account the overall trade implications of AFTA as well as third-party countries. Secondly, it contains a database for different sectors and thus can explore the trade implications for various sectors of interest.[5]

The GTAP model assumes perfectly competitive markets, where the zero profit condition holds, and that all the markets are cleared. The regional household allocates expenditure across three categories: private household, government and savings. It derives income from the "sale" of primary factors to the producers, who combine them with domestically produced and imported intermediate composites to produce final goods. These final goods are in turn sold both domestically to private households and the government, and exported to the rest of the world. Both the government and private households also import consumer goods from the rest of the world. A global bank intermediates between global savings and regional investments by assembling a portfolio of regional investment goods and selling shares in this portfolio to regional households in order to meet their savings demands. Finally, a global transport sector assembles regional exports of trade, transport and insurance services and produces composite goods used to move merchandise trade among regions (Hertel, 1997). The flowchart of and production structure in the GTAP model is illustrated in Figure 1. The factors of production in value-added function include labour, land and capital. The output function is combined from value-added and intermediate goods.

The latest version of the GTAP database, version 8, is used for this study. The GTAP model was run by the GTAP data base, which is a multi-country input output table containing production, consumption, bilateral trade,

Figure 1 Production Structure in the GTAP Model



Source: Hertel, 1997.

transport and protection linkages. The current release, the GTAP 8 database, features 2004, 2007 and 2011 reference years as well as 140 regions for all 57 GTAP commodities. To facilitate our analysis, regions have been aggregated into two separate sub-regions (Laos and the rest of the world). All 57 sectors remain as delineated in the GTAP database.

The model closure and free parameters are important factors that influence the simulation result in the CGE model. Macro closure is an important factor that influences the simulation result from the GTAP model. Closure divides the variables in the model into endogenous and exogenous variables. Endogenous variables are determined by the model, but exogenous variables are determined from outside the model. Macro closure is based mainly on the characteristics of the economy in the country of focus. The closure of the GTAP model has various elements such as population growth, capital accumulation, industrial capacity, technical changes and policy variables (tax and subsidies). However, in order to simplify the closure, we use the standard GTAP closure, which is called "neo-classical" closure. This closure assumes that all prices are flexible; there is perfect competition (all firms earn zero pure profit) and full employment and factor mobility within regions; investment expenditure is determined by savings rate; and tax rates are fixed.

Parameters are one of the most important considerations in a CGE model. Basically, some parameters for this study are calibrated from the country's Social Accounting Matrix. However, some parameters for the CGE model are not available in Laos. As there is no estimate of a free parameter in Laos[6], we used the free parameter from Warr (2006).

A multi-sector CGE is an appropriate tool to assess the effects of Chinese FDI on the Lao economy. The model applied in this paper was developed by the Global Trade Analysis Project (GTAP) as mentioned before. The solver of this model is GEMPACK modeling software (Harrison and Pearson, 1996). The database (GTAP database version 8) was collected from a variety of international sources and it consists of more than 100 regions and 57 sectors on a global level. We aggregated regions into three – Laos, China, and the rest of the world – and aggregated sectors into 10.

From the Economic Census in 2012 (NSB, 2012), the share of Chinese investment in total investment was about 13% (Table 7). The GTAP model is formulated in percentage change which requires that exogenous shocks are also defined in relative terms. We assumed that there is increasing capital endowment from Chinese FDI in Laos[7]. In this simulation, we assumed that there is no technology transfer which would have increased total factor productivity (TFP) in those sectors which actually receive Chinese FDI. It is important to note that there are some issues in Chinese FDI shocks for the model. First is that the exercises are conducted at the aggregated level.

Table 7 Ratio of Chinese Investment in 2012

Sector	*Chinese firm*	*All firm*	*Ratio of Chinese firm (%)*
Agriculture, Forestry and Fishing	384.6	3,400.8	11.3
Mining and Quarrying	249.8	3,163.7	7.9
Manufacturing	1,490.2	10,232.5	14.6
Electricity and gas	150,000.0	153,176.8	97.9
Water supply and sewerage	0.0	91.4	0.0
Construction	224.5	1,076.0	20.9
Wholesale and retail trade	326.1	513,756.8	0.1
Transportation	182.9	434.0	42.1
Accommodation and food services	165.9	1,320.7	12.6
Information and communication	12.4	17,903.6	0.1
Finance and insurance	37.5	458,799.6	0.0
Real estate	19.0	159.6	11.9
Professional, scientific and technological activities	4.6	91.4	5.1
Administrative and support services	32.3	191.5	16.9
Education	0.03	349.0	0.01
Human health and social works	3.2	29.5	11.0
Arts, entertainment and recreation	5.3	1,503.6	0.4
Other services	1.2	28.1	4.3
Total	153,139.5	1,165,708.5	13.1

Source: National Statistic Bureau (NSB).

Second, it is not clear whether Chinese FDI primarily contributes to an increased supply of variable inputs (short-term liquid assets, overall value of fixed assets, total capital stock). But if Chinese FDI consists mainly of fixed assets (buildings and large machinery), the shocks implemented in the simulations are relatively low. If Chinese FDI becomes fully effective immediately as production capital, the relevant percentage increases in local capital would be significantly higher.

5.2. Simulation Results

The result of the impact of Chinese FDI on selected macroeconomic variables is shown in Table 8. The increase in Chinese FDI has positive impacts on GDP, welfare, trade balance and household income. Chinese FDI increased real GDP by 2.67%, welfare (equivalent variation) by US$51.14 million, household income by 1.69%, and trade balance by US$58.80 million. It indicates that Chinese FDI contribute to macroeconomic variables in Laos.

Table 8 Macroeconomic Results due to Increase in Chinese FDI

Macroeconomic variables simulation	*Increase due to Chinese FDI*
Real GDP (%)	2.67
Welfare (equivalent variation) (US$ million)	51.14
Household income (%)	1.69
Trade balance (US$ million)	58.80

Source: Authors' simulations.

Table 9 Impact of Chinese FDI on Sectoral Output

No.	*Sectors*	*Increase due to Chinese FDI*
1	Grains and crops	0.78
2	Livestock and meat products	0.82
3	Mining and extraction	11.3
4	Processed food	2.47
5	Textiles and clothing	14.72
6	Light manufacturing	15.34
7	Heavy manufacturing	10.46
8	Utilities and construction	0.15
9	Transport and communication	5.01
10	Other services	3.9

Source: Authors' simulations.

The impact of Chinese FDI on output in Laos is shown in Table 9. Most of the sectors increased their output as a result of Chinese FDI, especially in textiles and clothing, light manufacturing, mining and extraction and heavy manufacturing. Increasing Chinese FDI stimulates investment and production and leads to increase output in Laos.

As our model does not disaggregate household by income, it is quite difficult to assess the impact of Chinese FDI on poverty and income gaps. However, according to the literature (Strutt et al., 2008), returns to unskilled labour reduces poverty and if increasing returns of unskilled labour is greater than returns of skilled labour the impact is to narrow the income gaps. The impact of Chinese FDI on poverty and income gaps are shown in Table 10. Chinese FDI increases returns to unskilled labour and skilled labour, which shows that Chinese FDI reduces poverty. In addition, because the increase

Table 10 Change in Returns to Factors of Production

Factors of production	*Increase due to Chinese FDI*
Returns to unskilled labour	2.39
Returns to skilled labour	0.56

Source: Authors' simulations.

in returns to unskilled labour is higher than the returns to skilled labour, the income gap is reduced by Chinese FDI.

6. Summary

As one of the top contributors to overall FDI in Laos, China has invested significantly in the mining and hydropower sectors. While the Chinese FDI has increased significantly in Laos, there are few studies of the impact of Chinese FDI on the national economy and poverty in Laos. Therefore, the main objective of this paper is to investigate the impact of Chinese FDI on the national economy and poverty in Laos using a CGE model. Our analysis suggests that Chinese FDI has a positive impact on GDP, welfare, income and exports in Laos. The simulation also indicates that Chinese FDI contributes to poverty reduction and reducing income gaps in Laos. However, as Chinese FDI is largely concentrated in resource-based investment, it may have a negative impact on the Lao economy as the FDI in resource sector tends to appreciate Laos' exchange rate and decrease production and exports of non-resource sector products, such as agricultural products and manufacturing goods. In addition, Chinese FDI has the potential to damage the natural environment and natural resources.

Given the positive impact of Chinese FDI on Laos' economy, it is important to promote Chinese FDI by improving the domestic investment climate. However, as Chinese FDI is largely concentrated in the natural resources sector (mining and hydropower sectors), it is also necessary to diversify Chinese FDI by encouraging Chinese investment in non-resources sectors, such as agriculture and manufacturing, to mitigate the negative impact of the Dutch disease and ensure the long term development of Laos. However, although this study has performed a relatively thorough assessment of Chinese FDI and its impact on the economy and poverty in Laos, the study can be further strengthened by examining externalities from the Chinese investment environment. It is suggested that a future study can be conducted to capture more economic factors influenced by the capital inflow to deepen our understanding of Chinese investment in Laos.

Notes

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1. More details about financial issues, and monetary and exchange rate policies in Laos are discussed in Kyophilavong (2010).
2. According to the World Bank (2014), the resources sector contributed about 2.83 percentage points to the growth rate over 2008 to 2013. The resources sector also accounted for about 60% of all exports in 2013, a share that is expected to increase under expected ongoing development in the hydroelectricity and mining sectors. Revenues from the resource sectors as a share of total revenues rose to 2.6% of GDP in 2010, a share that is expected to rise with continued growth in the sector.
3. The main reason for the increase in FDI projects during the global crisis was that the Lao government had revised the FDI Law in 2009. This new FDI law provides more incentives to invest in Laos especially in the agriculture and services sector (Nozaki and Kyophilavong, 2015).

4. The GTAP model is based on the ORANI model, a single country CGE model for the Australian economy (Dixon et al., 1982). The GTAP model extended the ORANI model by allowing international trade, which introduced a global transportation sector and savings institution.
5. For more details, see Hertel, 1997. A graphic presentation of the GTAP model, with particular emphasis on the accounting relationships, is given by Brockmeier (1996).
6. The free parameter is a parameter not produced from the data in the model. The author used this parameter which is based on the literature.
7. It is important to note that we analysed only FDI and not FEI (foreign equity investment) and FC (foreign credit).

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Book Review

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Book Review

Michael Useem, Harbir Singh, Neng Liang and Peter Cappelli, *Fortune Makers: The Leaders Creating China's Great Global Companies*, New York, NY: PublicAffairs, 2017, 288 pages.

Chinese private companies in the early days of reform period in the early 1980s had to operate in a Chinese market significantly influenced by Marxist ideology and under party control. Facing a hostile business environment, the founders of these companies did not have a business model to follow. Therefore, how these business leaders managed to build a system for running their businesses and achieving major successes is a story well worth telling. This is precisely what this book sets out to do.

In Chapter one, the authors present the reasons that aroused entrepreneurs' interest in business in China. Firstly, compared with state-owned enterprises (SOEs) with strong government intervention and involvement, non-SOEs are more like private companies in the West with traditional self-interest objectives. Making a comparison of their leadership styles are more direct. Secondly, since the economic reform started from 1980s, private-owned companies are coming to play an increasingly dominant role in China's economy. Thirdly, with the continuous privatization of SOEs, the private-company models are becoming increasingly significant in driving China's economy forward. Thus, the private companies represent a case worthy of study if only to help foreign managers and investors understand Chinese entrepreneurs' distinct way of doing business.

To achieve its objectives, the book uses direct interviews with top executives at China's largest private companies to understand the mindsets of the top executives of China's companies. The authors found that there are different business models that contrast sharply with the mindsets of managers in modern western companies, which they summarized as seven distinguishing features shown in chapters 2 to 8. Thus, the book successfully fills a crucial knowledge gap and brings forth insightful reflections on the business models of China's private companies.

Firstly, Chapter 2 identifies the most different feature of Chinese business model as Chinese entrepreneurs having a strong learning capability, building a sustainable organization by learning from their own experiences. The economic market was highly influenced by Marxist ideology and dominated by the party in the early years of economic reform, so that Chinese

entrepreneurs could not directly employ the pre-existing western business models in China. Without the proven models to emulate or roadmaps to follow, the entrepreneurs had to teach themselves how to do business, and learn to lead through trial and error. In doing so, the quest for continuous self-development among entrepreneurs form one of the most competitive advantage for Chinese private companies.

Then, in Chapter 3, the book highlights the characters of Chinese learning company. Because no pre-existing model can be emulated by Chinese companies, the business leaders realized that they had to make more effort to learn and catch up. In doing so, an important difference between Chinese business leaders and their counterparts outside China is that they take learning more seriously, especially their own learning. There are three important channels of Chinese private companies learning about leadership, i.e., self-directed learning, instructive experience for lieutenants, and leadership coaching. The chapter gives two successful cases of Alibaba and Lenovo to understand how Chinese companies build a learning mindset in practice. The character of entrepreneurs' own learning plays a crucial role on the success of their business.

In addition, the book shows that the leadership style of the Chinese business model, which are the charismatic leadership of the founding CEO and a clan-like corporate culture. Compared with Western companies with well-established architectures for organizing work, appraising performance, and rewarding success, Chinese companies lack experience and hence without such sophisticated employee management practices. The authors argued that it may be because of their emphases on customers, product development or finance. But there are glaring problems arising with Chinese paternalistic leadership styles that are simply impossible to ignore. For instance, "Will strong company cultures continue to be enough to manage a new generation of employees who have grown up with capitalism, who did not experience the material deprivation of the years before the market economy, and who have many more choices regarding where to work?" Then, in Chapter 6, the book further describes the big-boss model in Chinese privately-owned companies. In China, the business leaders play an outsized role in the companies compared to leaders in other countries, which have an ironic combination of hierarchic and ostensibly humble management.

Moreover, in Chapter 7, the book finds that Chinese executives place a greater premium on company growth rather than shareholder returns, and they are more focused on business strategy. They pay much more attention on how to expand their current markets and provide more of a product to companies and/or customers. But the authors argued that this management ideology of corporate growth may be transitory, more a historic stage than an enduring mindset. As more professional investors establish private companies,

the management ideology of growth may weaken and turn back towards shareholder value. Finally, the book presents a specific characteristic of Chinese business governance in Chapter 8, where the executives in Chinese companies are more stressed to help lead the companies and improve growth rather than shareholder value. At the same time, Chinese executives are bored with reports to be written or committees to meet; generally on the board, they present their ideas and guidance more than review and approval, which may improve the competitiveness of the executives to move faster.

Overall, this is an insightful and interesting book which provides readers not only a fresh knowledge of the development of Chinese private companies but also many actual cases such as Alibaba, Huawei, Xiaomi, Wanke to help readers know what is the real situation in China. The book is persuasively presented through direct interviews with the top executives at China's largest private companies. It found a different business management mentality that differs significantly from the mindsets prevalent in the West. But, the book lacks a systematic theoretical anchor to explain these differences. Nevertheless, this book will attract a wide audience amongst investors, companies, policy makers and scholars particularly interested in China.

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