

China and the Asian Economies: mutual acceptance, economic interaction and interactive dynamics

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The objective of this article is to explore the economic relationship between China and the surrounding dynamic Asian economies. It delves into China's influence over the Asian economies and whether this relationship has evolved in a market- and institution-led symbiotic manner. The three principal channels of regional integration analyzed in this article are trade, FDI and vertically integrated production networks. Another issue that this article explores is the so-called China 'threat' or 'fear' in Asia. The China threat implied that China was crowding out exports from the other Asian economies in the world market place. Also, as China became the most attractive FDI destination among developing countries, it was understood that China was receiving FDI at the expense of the Asian economies. These concerns were examined by several empirical studies and the inference was that they were exaggerated. The article concludes that China methodically expanded and deepened its economic ties with its regional neighbors. At the present juncture, China's integration with the surrounding Asian nations is deep. Both China and its dynamic Asian neighbors have benefited from this synergy.

I. Introduction

Over the preceding three decades, the mutual relationship between the People's Republic of China (hereinafter China) and surrounding Asian economies evolved in a pragmatic and productive manner, which has enormous economic and business significance and welfare implications. This article delves into the evolution process of mutual acceptance of China and its neighboring Asian economies as well as progressive economic interaction among them. The objective of this article is to examine how China is influencing its neighboring Asian economies through trade, investment and vertically integrated production networks and to see whether their economic relationship is developing into a market- and institution-led symbiosis. This article shows that both China and its dynamic Asian neighbors have benefited from this synergy.

Two relevant and interrelated economic realities are: first, China in 2011 is a large economy in both absolute and relative terms. Over three decades of macroeconomic

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reforms and the resulting dynamism turned it into the largest regional economy by mid-2010. Second, the recent economic transformations in China and the surrounding dynamic Asian economies have been nothing short of thoroughgoing. This group of Asian economies has turned into the most dynamic in the global economy. During and after the global financial crisis (2007–2009), the Asian economy proved to be a compelling and credible force in the global economy. It not only led the global economic recovery from what is being termed the Great Recession but also contributed to it.¹ It provided a pull force to the global recovery. Asia emerged from the global financial crisis a growth driver and an anchor of stability of the global economy.²

II. Asian crisis causing China's strategic policy shift

A defining moment in China's expression of its policy stance towards its Asian neighbors came at the time of the outbreak of the Asian financial crisis of 1997–1998. Until this time, economic growth and national security were regarded as two separate logical policy spheres rather than a single policy domain in China. Economic reform-led growth was given higher priority on the domestic policy agenda. However, the Asian crisis made it clear that it was impossible to disentangle China's economic fortunes and domestic economic stability from what happened in the rest of the Asian economy.³ This realization led to a significant conceptual and policy transformation. The Asian crisis made Chinese policy makers rethink the link between domestic and regional, including international, economic policy. Their understanding regarding the value and consequences of engagement with the regional economies grew.

Realizing the importance of interdependence, the Chinese policy mandarins came to the decision that regional economic engagement would eventually be in China's national economic self-interest. After the Asian crisis China began taking its regional role more seriously than ever before. Joining and actively participating in the regional and global economy had two realistic sides to it: benefitting from it and shouldering responsibilities. The term *fuzeren de daguo* or 'responsible great power' began appearing in official communications after the Asian crisis.⁴

III. China and the ASEAN-Plus-Three framework

The Japanese government was not only behind the Asian Monetary Fund (AMF) proposal but was also going to bankroll it. The AMF concept, an independent regional entity, was opposed by China. It was shelved in late 1997. The seeds of the

1. Dilip K. Das, *Asian Economy: Spearheading the Recovery from the Global Financial Crisis* (London and New York: Routledge, 2011).

2. Naoyuki Shinohara, 'Leading the global recovery: policy challenges facing Asia', presentation made at the Singapore National University, Singapore, 9 June 2010.

3. Wang Zhengyi, 'Conceptualizing economic security and governance: China confronts globalization', *The Pacific Review* 17(4), (2004), pp. 523–545.

4. Dilip K. Das, 'China: epitome of an emerging market', *Journal of Emerging Knowledge on Emerging Markets* 3(1), (2011b), pp. 57–81.

ASEAN-Plus-Three (APT)⁵ were sown in December 1997, in the backdrop of the failure of the AMF proposal. This was the period when a sense of regional identity and seeking regional solutions for regional problems was intensifying among the Asian economies. In Kuala Lumpur, Malaysia, an informal meeting of ASEAN leaders took place with the top political leaders of China, Japan and Korea. This was the genesis of the concept of the APT. It was the newest idea in regional economic cooperation and governance. The Chinese government supported it with enormous zeal.

In May 2000, during the Finance Ministers' meeting of the APT countries, held in Chiang Mai, Thailand, the Chiang Mai Initiative (CMI) was put together. It was the first ever regional agreement involving banking and finance and was made by 13 APT economies. The CMI was an innovative initiative of a network of bilateral swaps intended for mutual assistance among the APT economies at the time of any future crises. The APT countries agreed to draw on each other's dollar reserves to cover sudden outflows of foreign currency. The regional economies agreed to help and support each other through a network of currency swaps. In a future crisis situation they intended to depend less heavily on the IMF or World Bank assistance. Although this issue generated impassioned debate, the CMI was not made a regional alternative of the IMF. Asian economies did not repudiate access to the stand-by facility of the IMF. The expectation was that the CMI would provide emergency dollar liquidity to the APT economies in a currency crisis and serve as a regional crisis prevention and resolution mechanism. It was to be a second or parallel line of defense along with the IMF for the Asian economies.

An important benefit of the CMI was that it enabled regional financial resources to be utilized for meeting the needs of the regional economies in times of financial stress. In the aftermath of the global financial crisis (2007–2009), in May 2010, during the finance ministers' meeting of the APT countries, held in Chiang Mai, an extension of CMI to the Chiang Mai Initiative Multilateralization (CMIM) was agreed. This is regarded as a step forward and a move towards the creation of an AMF, which would be independent of the IMF. The CMIM is an important milestone signaling maturing of APT cooperation.⁶ Under the CMIM, a country could draw up to 20% of its quota without being subjected to the IMF conditionality for a maximum period of six months. Any borrowing larger than 20% would be tied to the IMF program conditionality.⁷

The significance of a swap line is that it acts to stabilize market concerns in a period when there are deleveraging pressures, which in turn cause pressure on international reserves and exchange rates.⁸ Therefore during the global financial crisis there was a possibility that some Asian central banks might draw on their CMI or CMIM swap lines. This would have made the CMIM more important and

5. ASEAN-Plus-Three (APT) comprises the ten members of ASEAN, plus China, Japan and Korea.

6. William W. Grimes, 'The Asian Monetary Fund reborn?', *Asia Policy* 11(1), (2011), pp. 79–104.

7. Joshua Aizenman, Yoithin Jinjarak and Donghyun Park, *International Reserves and Swap Lines: Substitutes or Compliments?*, Working Paper No. 15804 (Cambridge, MA: National Bureau of Economic Research, March 2010); and Chalongsob Sussangkarn, 'Chiang Mai Initiative Multilateralization: origin, development and outlook', *Asian Economic Policy Review* 6(2), (2011), pp. 203–220.

8. Aizenman et al., *International Reserves and Swap Lines*.

demonstrated that the Asian governments were serious about financial cooperation. However, no Asian economies have so far drawn on their bilateral swap lines. They were protected from the global financial crisis and the sovereign debt crisis (2010–2012) of the Eurozone largely by their own sagacious and thoughtful macroeconomic and financial policy frameworks as well as by their substantive forex accumulations. Given this backdrop, runs on Asian currencies were highly unlikely, if not impossible. Besides, the conservative fiscal policies pursued by them provided them with large fiscal space to maneuver.

However, the global financial crisis did reveal cracks in the evolving, if untested, regional financial institutions in Asia. Although Korea and Singapore were members of the APT and entitled to utilize the CMI, in the fall of 2008 they turned to the Federal Reserve Board (Fed) to ensure financial stability. Did that mean that the APT economies regarded CMI as inappropriate for their purpose? A defensive argument was that Fed's assistance was sought simply due to operational reasons by the two APT economies. The Bank of Korea needed dollar liquidity for its banking system while the CMI swap lines were denominated in yen–won, renminbi–won and renminbi–yen.⁹

Although Japan took a great deal of active interest in CMI and CMIM, the strong rivalry between China and Japan for the position of the first director of the APT Macroeconomic Research Office (AMRO) culminated in favor of China in May 2011.¹⁰ AMRO is the CMIM's macroeconomic surveillance secretariat. It is designed to have strong professional and analytical expertise and policy experience. AMRO is a critical component of the emerging regional architecture.¹¹ Although China, Japan and Korea have bankrolled this regional surveillance institution, China's leadership emblematically put it in the position of providing regional public good. At this point the APT finance ministers also decided to double the size of the CMIM to US\$240 billion.

IV. China and the evolving pattern of regional integration in Asia

The following exposition demonstrates how a market-driven symbiotic relationship has organically emerged between Asia and the neighboring Asian economies. Foreign direct investment (FDI), trade and regional and global production networks are the principal channels through which the Chinese economy has integrated with the neighboring Asian economies in a market-driven manner. Intra-developing economies FDI was not given a great deal of significance until the early twenty-first century. After it was the focus of the *World Investment Report (WIR) 2006*, other studies on this important issue were launched. Its relevance and significance was also seen in the context of FDI flows from the surrounding Asian economies to China. Since 2004 intra-developing country FDI has increased rapidly. In 2008 its volume

9. Grimes, 'The Asian Monetary Fund reborn?.'

10. Although Japan had a strong young candidate in Yoichi Nemoto, the hard-fought diplomatic battle ended in the appointment of Wei Benhua. A compromise was reached between China and Japan, while Wei Benhua will be the first director of AMRO.

11. Rajat Menon, 'Regional safety nets to complement global safety nets', paper presented at the opening ceremony of the AMRO, Monetary Authority of Singapore, Singapore, 31 January 2012.

reached 16% of the total FDI outward stock. Although global FDI flows contracted due to the global financial and economic crisis in 2009, FDI flows originating from the developing economies were affected less adversely. The intra-Asia increase in FDI is a relatively recent phenomenon, which has effectively worked toward integrating the region. This trend successfully advanced China's regional integration with its neighbors as well as general Asian integration.

A significant portion of FDI in the Asian economies comes from other Asian economies.¹² Although there are data gaps, the WIR of 2006 found that approximately half of the FDI inflows in the Asian economies were from the other regional economies, largely from the regional emerging-market economies (EMEs). According to this source, around 65% of inward stock of FDI in 2004 in Asia was from the other Asian economies. The same source estimated that between 2000 and 2004, average annual intra-Asian FDI flows amounted to US\$48 billion. The WIR of 2010 estimated that of the US\$875 billion FDI received intra-regionally by Asian economies in 2008, China was the source economy of US\$307 billion. Furthermore, the four newly industrialized economies (NIEs) of Asia, that have remained a lucrative source, accounted for US\$512 billion. China received a great deal of FDI—as much as 65% of total receipt—from the NIEs. Due to increasing labor costs, firms in the NIEs are motivated to invest in China and other Asian economies.¹³ Such a large proportion of intra-regional FDI contributed to integration of the real economy.

Taking a balance-of-payments approach, it was estimated that 35% of FDI flows into the developing Asia during the 1990–2005 period originated intra-regionally.¹⁴ China and Hong Kong SAR dominated both as hosts and sources. After the World Trade Organization (WTO) accession China became a significant source country, investing not only in the region but also outside Asia. China's role in outward FDI flows strengthened after 2004; in 2010 its share amounted to 8.5% of the total FDI stemming from the developing countries.¹⁵ Intra-regional FDI made by Hong Kong SAR and Singapore is obscured by the fact that it is often made by business firms from other countries, which are both based in Asia and outside. One general characteristic of intra-Asian FDI is that investing firms tend to prefer locating their affiliate operations in more labor-intensive industries.

International trade is one of the principal channels through which the Chinese economy integrated with and influenced the GDP growth performance of its neighboring Asian economies. In the 1970s and early 1980s Japan overwhelmingly dominated Asian trade. It accounted for almost 60% of the regional exports and imports. This scenario morphed as the other Asian economies began liberalizing and improving their trade performance. For successful integration of China with the

12. Robert E. Lipsey and Fredrik Sjöholm, 'South–South FDI and development in East Asia', *Asian Development Review* 28(2), (2011), pp. 11–31.

13. Ting Gao, 'Foreign direct investment from developing Asia', *Economic Letters* 86(1), (2005), pp. 29–35; Wiboon Kittilaksanawong, 'FDI in high-tech firms from newly-industrialized economies in emerging markets', *African Journal of Business Management* 5(4), (2011), pp. 1146–1157.

14. Robin Hattari and Ramkishan S. Rajan, 'Understanding bilateral FDI flows in developing Asia', *Asia Pacific Economic Literature* 23(2), (2009), pp. 73–93.

15. Maria Aleksynska and Olena Havrylychuk, *FDI from the South: The Role of Institutional Distance and Natural Resources*, Working Paper No. 2011-05 (Paris: Centre d'études Prospectives et d'Informations Internationales, March 2011).

Asian economies, it is a necessary condition that they liberalize their external sector as well. Significant trade and investment liberalization took place in Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand in the mid-1980s. Vietnam embarked on reforms in the early 1990s. These economies took the initiative in unilateral trade liberalization, which was done in a non-discriminatory manner. They were also full participants in the multilateral liberalization measures initiated first by the General Agreement on Tariffs and Trade (GATT) and, since 1995, by the WTO.

Trade among the East and Southeast Asian economies, which includes China, began expanding from the 1980s. Trade among this group of economies was paltry in 1975, at less than 1% of their total trade. It began increasing and reached 10% of their total trade in 2001 and 13% in 2004.¹⁶ During this period China produced almost half of the regional GDP and a third of exports. High and sustained GDP growth of the Chinese economy in the decade of the 1980s was the principal driver of intra-regional trade. The Chinese economy was outward-oriented and by the time it acceded to the WTO had become trade dependent. The obvious benefit of WTO accession was improvement in access to export markets and reduction in import costs of raw materials and intermediate products. The latter helped it in its production and exports of manufactures. This made Chinese products more competitive in the world markets vis-à-vis exports from the other regions of Asia.

Developments in the early 1990s were important in this regard. China began improving its complicated and restricting trade regime after 1990 and also its export structure began to diversify towards capital- and skill-intensive products. This was the time point when China began to emerge as a major player in the global economy. The 1990s were a turning point in that during this period liberalization of trade and FDI was accelerated in China and the ASEAN economies. The two liberalizing together created obvious synergy. In the early 1990s, exports from the ASEAN economies to China began picking up in value terms. A significant amount of new ASEAN exports to China were in the category of medium-technology manufactures. More technologically advanced ASEAN economies, like Malaysia, the Philippines, Singapore and Thailand exported semiconductors and computer components. The other ASEAN economies exported natural resources to China.

In 1995, exports from Japan and the four NIEs to China accounted for 10.6% of all exports. This group of five economies is resource-poor. In the case of the ASEAN-4¹⁷ economies this proportion was merely 3.5%.¹⁸ Therefore, in relative terms the larger ASEAN economies were less integrated with the Chinese economy in 1995 than Japan and the NIEs. Principal exports to China from the ASEAN-4 economies were mostly low- and medium-technology manufactured goods. However, ASEAN-4 essentially exported durable goods to Japan and the NIEs.

As for China's exports to these two groups of Asian economies, Japan and the NIEs accounted for 31% of the total exports to the region, while the ASEAN-4 for only

16. The source of these statistical data is Ian Coxhead, 'A new resource curse? Impact of China's boom on comparative advantage and resource dependence in Southeast Asia', *World Development* 35(7), (2007), pp. 1109–1119.

17. The ASEAN-4 economies are Indonesia, Malaysia, the Philippines and Thailand.

18. P. E. Robertson and J. Y. Xu, *In China's Wake: Has Asia Gained From China's Growth?*, Discussion Paper No. 10 (University of Western Australia, Adelaide, 15 June 2010).

4.2% in 1995. China's exports as a fraction of its total multilateral exports were again much higher to Japan and the NIEs (8.4%) than to the ASEAN-4 (3.9%) economies. These statistics show that in 1995 Japan and the NIEs were far more closely integrated with the Chinese economy than the ASEAN-4 economies. What is noteworthy is that the trade structures of China and the ASEAN-4 economies were identical at this juncture. This state changed by the middle of the decade of 2000s. China had become the region's principal engine of growth. In fact, China had grown to be come the principle engine of growth to the global economy.¹⁹

By 2006, China had become the fifth largest export market of the ASEAN economies and the third largest source of imports. A direct influence of China on ASEAN economies was giving an impetus to their exports to its large domestic market. In fact, as imports and exports of the ASEAN economies are increasingly becoming more China-centric, some scholars have questioned the relevance of the ASEAN grouping.²⁰ Members of ASEAN have greater trade with China than they have with each other. A quantitative examination using highly disaggregated trade data revealed that a lot of changes occurred in intra-industry trade over the 2000–2005 period between China and the ASEAN-5 economies. These were the five founding economies of ASEAN for which disaggregated data were available. This demonstrated the unique importance of China for the ASEAN economies, both as a market for exports and source for imports. This empirical study concluded that there was no crowding out of bilateral trade among the five members of ASEAN due to their increasing trade with China. If anything, increased integration with the Chinese economy resulted in an increase in the intra-ASEAN-5 trade. Thus viewed, while China has influenced and altered trade flows within the ASEAN region, it has not 'significantly reorganized trade flows away from intra-ASEAN-5 to that of ASEAN-5–China. There are grounds for suggesting that the ASEAN-5–China trade interaction can be considered an important driver for intra-ASEAN-5 export expansion'.²¹

The on-going wave of globalization became another instrument of regional integration in Asia. Globalization enabled latecomer economies like China to regionally and globally integrate through expansion of production networks. They developed fast over the decade of the 1990s and became extensive in Asia, *a fortiori* in East Asia. They involved Asian business firms as well as multinationals from the European Union (EU) and the United States (US). These multinationals changed their operational strategy from exporting to international production. Their newly structured and reorganized businesses in different parts of the global economy enabled them to reduce costs and improve their ability to react to technological advancements. They could meet the requirements of their global markets more swiftly by way of globally integrated production and distribution networks.

19. Ross Garnaut and Ligang Song, *The Turning Point in China's Economic Development* (Canberra: Asia Pacific Press, 2006).

20. Tambunan, T. 'The likely impact of the ASEAN plus China on Intra-ASEAN trade'. Paper presented at the conference held on WTO, China and the ASEAN Economies, in Beijing, June 24–25, 2006; Tambunan, T. 'Is ASEAN still relevant in the era of the ASEAN-China FTA?' Paper presented at the Asia-Pacific Economic Association conference in Seattle, WA, July 29–30, 2006.

21. Evelyn S. Devadason, 'Reorganization of intra-ASEAN-5 trade flows: the China factor', *Asian Economic Journal* 25(2), (2011), pp. 129–149.

Many Asian economies, including China, were their preferred locations for setting up such cross-border networks. They were initially intra-firm, but increasingly grew to become arm's-length inter-firm networks. They made an invaluable contribution to the integration of Asian economies.

One direct consequence of the spread of regional production networks was the rapid expansion and increase in both FDI and trade between the Asian economies. An influential empirical study concluded that production networks in the region accounted for a large proportion of trade flows in most member countries. They entailed both intra-firm and arm's-length trade.²² The Asian production and distribution networks are idiosyncratic in following three traits: first, they are enormously significant for the regional economies; second, they tend to cover a large part of the region and number of countries; and third, over the years they have grown exceedingly sophisticated in terms of covering intra- and inter-firm transactions of regional manufacturing firms. No doubt other parts of the global economy also successfully developed such production and distribution networks. The most salient examples are the Mexico–US networks and Western–Central-Eastern Europe corridor. They are yet to reach the level of sophistication that Asia has been able to achieve.²³

China was a latecomer, last to be a part of the regional division of labor in Asia. However, it conclusively illustrated how splitting the value-added chain between different countries, at different stages of growth and having different comparative advantage, can drive the process of industrial development, along with regional economic integration.²⁴ One direct consequence of the expansion of production and distribution networks in Asia was the evolution of a systemic pattern of triangular trade. Japan and the NIEs, that were technologically at a higher strata, exported advanced capital goods, complicated intermediate goods, particularly parts and components, to the relatively less technologically advanced economies like the ASEAN and China. The latter group of economies processed them and got the final products ready for export to the global markets, particularly the largest ones, the EU and the US. This triangular trade further reinforced regional integration in Asia. Over the 2000s, the importance of China in the regional production networks increased substantially for the neighboring Asian economies.

IV.1. China's integration into Asian production networks

While calibrating China's impact on the regional economies, most studies took into account the traditional horizontal trade, which is trade in goods and services that are produced in their entirety in an economy and traded. This observation applies to the empirical studies cited in the preceding section. A well-known fact is that growing complementarities of production processes leading to vertical fragmentation of

22. Mitsuyo Ando and Fukunari Kimura, 'The formation of international production and distribution networks in East Asia', in T. Ito and A. Rose, eds, *International Trade* (Chicago, IL: University of Chicago Press, 2005), pp. 177–213.

23. Fukunari Kimura, 'International production and distribution networks in East Asia: eight facts', *Asian Economic Policy Review* 1(2), (2006), pp. 326–344.

24. Guillaume Gaulier, Françoise Lemoine and Deniz Unal-Kesencu, *China's Integration in East Asia: Production Sharing*, Working Paper No. 2005-09 (Paris: Centre d'études Prospectives et d'Informations Internationales, June 2009).

production and trade have turned China into a hub or major assembly center for Asia (Section IV). This fact was ignored by many studies that tried to reckon China's impact over the regional economy. This was serious negligence because during its reform phase China integrated rapidly into the regional production networks. It does have a great deal of impact over its regional neighbors through the regional production chains or network production. It has come to acquire a unique position as Asia's production platform for export of final goods regionally and even more globally. China's prominent role in Asia's production networks has been methodically examined by numerous scholars.²⁵

Due to expansion of production networks, global trade in parts, components and subassemblies has increased quickly in recent decades, faster than trade in manufactures. It has come to have increasingly wide product coverage. In keeping with this trend, intra-regional trade in components in Asia is large and it has also grown rapidly. In fact, trade in parts, components and subassemblies played a more important role in trade expansion in Asia than in any other region of the global economy.²⁶ With a rising level of network production, the importance of the Asian economies has increased for the matured industrial economies. Strengthening bonds of network production between China and the NIEs and ASEAN economies have also helped in raising the global status of Asia in the economic and business world.²⁷

In several product lines in the SITC 7 category, Asia's export dynamism was primarily driven by vigorous regional production networks. Their active functioning served to closely integrate this group of Asian economies with the global economy. These SITC product lines essentially comprised machinery and transport equipment, particularly information and communication technology (ICT) products and electrical goods. These products fall under SITC 75, 76 and 77 categories.

Trade in components is a function of demand for final products. Since the early 1990s China's importance as the leading final assembly center in Asia has increased. It imported components from the neighboring Asian economies to export the final products. As China was assembling a variety of manufactured products, the share of parts, components and subassemblies in its imports of manufactures grew large. Over the years this process has also made Asian economies highly integrated and interdependent. Many of them have also reduced production of final products because China was doing so. This production paradigm of the region is essentially controlled by TNCs.

25. For instance, see Sven W. Arndt, 'Production networks and the open economy', *Singapore Economic Review* 53(3), (2008) pp. 509–521; Peter K. Schott, 'The relative sophistication of Chinese exports', *Economic Policy* 53(1), (2008), pp. 5–49; Prem-chandra Athukorala, 'The rise of China and East Asian export performance', in P. C. Athukorala, ed., *The Rise of Asia* (London and New York: Routledge, 2011), pp. 267–291; Prem-chandra Athukorala, 'Production networks and trade patterns in East Asia', *Asian Economic Papers* 10(1), (2011), pp. 65–95; Alexander J. Yeats, 'Just how big is global production sharing?', in S. W. Arndt and H. Kierzkowski, eds, *Fragmentation: New Production Pattern in the World Economy* (Oxford: Oxford University Press, 2001), pp. 63–109; and Francis Ng and Alexander Yeats, 'Production sharing in East Asia: who does what for whom?', in L. K. Cheng, ed., *Global Production and Trade in East Asia* (Boston, MA: Kluwer Academic Publishers, 2001), pp. 63–109.

26. Yeats, 'Just how big is global production sharing?', pp. 63–109; and Nobuaki Yamashita, *International Fragmentation of Production* (Cheltenham: Edward Elgar, 2010).

27. Dilip K. Das, 'China in the domain of international business', in M. Warner, ed., *Management in China* (Amsterdam: IOS Press, 2011), pp. 71–84.

As the export volume of China grew, it caused a marked shift in the division of labor in the network production in Asia. The pace of final assembly of products in China accelerated rapidly, *pari passu* the role of the NIEs and ASEAN economies also grew in producing parts, components and subassemblies. As China exports the final products, it runs a deficit in components trade with the regional trade partners. The global financial crisis had a large impact over Asian trade. Beginning in the last quarter of 2007, Asian economies suffered a severe trade contraction. It was caused by precipitous deceleration (down to 2.1%) in multilateral exports in 2008 and decline in 2009 (-12.2%). Decline in world trade in manufactures was over 20% in 2009, although in the last quarter of 2008 it was only 10.4%. This decline in world trade was the steepest in seven decades.²⁸ The synchronized pattern of trade contraction in Asia was consistent with the close trading relationship among China and the other Asian economies that regional production networks had created and the triangular pattern of trade that had evolved over the last two decades. The global financial crisis destabilized and enervated it for sure, albeit it did not squelch it. As the EU and the US economies begin a normal recovery and resolve the sovereign debt-related financial stress, respectively, the triangular trade pattern can potentially resume normalcy. In the post-crisis era, both trade and investment relationships between Asia and China can be expected to deepen further.

Regional and global production networks in Asia existed before the emergence of China as a manufacturing powerhouse. With the rise of the Chinese economy a new dimension was added to Asia's standing in global production networks. As proved by the following statistical data, China's trade in components grew at a rapid pace, as its involvement in production networks increased. Between 1992/93 and 2005/06 China's share of world exports of components increased from 1.1% to 10.9% and its share of world imports of components increased from 2.4% to 11.5%. Also, components were a larger share of China's imports in 2005/06 (60.4%) than they were in exports (34.8%). Unlike China, in the other Asian economies percentage shares of components in exports and imports were largely similar.²⁹ The largest concentration of Asian trade in components is presently in electrical machinery and electronics. Also, in the ASEAN Free Trade Area (AFTA) trade in components is more concentrated in electronics.

Trading activity by global production networks has risen steadily since the early 1990s. Table 1 in Athukorala³⁰ reveals how production networks in China and Asia enhanced their status in multilateral trade. In global networks production and exports, Asia's share increased from 32.2% in 1992/93 to 40.3% in 2006/07. This occurred despite notable decline in Japan's share from 18.4% to 9.5% over the same period. Apparently the dynamism of the Chinese economy was a major driving force for the Asian economy, whose share had increased from 2.1% to 14.5% during the period under consideration. These statistics show that China's role in Asian production

28. World Trade Organization (WTO), *International Trade Statistics*, Press Release PRESS/598 (Geneva: WTO, 26 March 2010).

29. Prem-chandra Athukorala and J. Menon, *Global Production Sharing, Trade Patterns and Determinants of Trade Flows*, Working Paper No. 2010/06 (Canberra: Australian National University, Crawford School of Economics and Government, July 2010).

30. Athukorala, 'Production networks and trade patterns in East Asia'.

networks was vital. Among the Asian economies, world market share of the ASEAN economies grew faster than the regional average. Singapore was an exception in this regard because its world market share declined. The reason was its changing role from active participation in the production networks to performing an oversight function, product design and capital-intensive tasks in the production process. These functions fall under the services category and are not recorded in merchandise trade.

V. Premonition of China threat for the Asian economies

Whether China has crowded out the exports of its neighbors was fervently debated in the academic and policy conclaves. Likewise, whether it has absorbed an increasing proportion of FDI flowing to the region was a controversial point. Whether China was growing at the cost of its neighboring Asian economies and having a negative effect on their GDP growth was an open question. For a long time it has remained the most alluring destination for FDI in the global economy. One source of this concern was the fast growing exports of China to the US, the largest market. Between 1990 and 2005 China's share of the US market increased from 3.1% to 15%. Over this period the shares of Japan and the NIEs declined. China crowding out other smaller Asian economies was a large concern. This was because the trade structure of economies like the ASEAN-4 was less complementary to that of China. This was responsible for the so-called China 'threat' or 'fear' for the Asian economies. It was intuitively felt that China was growing at the cost of its Asian neighbors and eating their lunch. This premonition was seriously examined by many analysts.

V.1. China threat in multilateral trade

Some of the early empirical studies classified exports of Asian economies in different categories to determine the levels of threat from China's burgeoning exports. One of them concluded that the trade performance of neighboring Asian economies was facing a threat from China's competitive exports in the global market place.³¹ Another methodology that was deployed to examine the crowding out effect was simulation exercises. Both Ianchovichina and Walmsley and Ronald-Holst and Weiss³² provided evidence of China's rapid trade expansion having a favorable impact over trade of Japan and the NIEs, particularly improving their terms of trade. Conversely, the relatively less developed ASEAN economies having similar endowment structure to China faced keen competition from the exports of China. Their terms of trade also worsened, although Ronald-Holst and Weiss were dismissive of the proposition that China's successful exports and increasing share in multilateral trade were adversely affecting the comparative advantage of the neighboring Asian economies in higher value-added goods or skill-intensive

31. Sanjaya Lall and Manuel Albaladejo, 'China's competitive performance: a threat to East Asian manufacturing exports', *World Development* 39(9), (2004), pp. 1441–1466.

32. Elena Ianchovichina and Terrie Walmsley, 'Impact of China's WTO accession on East Asia', *Contemporary Economic Policy* 23(2), (2005), pp. 261–277; and D. Ronald-Holst and John Weiss, 'People's Republic of China and its neighbors: evidence on regional trade and investment effect', *Asia-Pacific Economic Literature* 19(2), (2005), pp. 18–35.

activities. Limited theoretical foundations of these empirical exercises made it difficult to come to a final inference regarding economic policy responses of the Asian economies.

Other empirical studies³³ employed more advanced methodologies like the gravity model to examine the effect of China's fast growing exports on the surrounding Asian economies. Of these three large empirical studies, Eichengreen *et al.* and Greenaway *et al.* concluded in a positive manner. According to their results, this small crowding out effect of China's exports was felt by Asian economies that were exporting consumer goods and not by those that were exporting capital goods. Thus, this effect was more intense over the ASEAN-4 economies but much less so on Japan and the NIEs. They also concluded that China's exports had a positive impact over the exports of high- and middle-income Asian countries.

There were other broad analyses that revealed that the fear of China crowding out the East and Southeast Asian economies from their export markets seemed unfounded. For 1969/70 and 2006/07, Athukorala and Hill (2010) computed that the share of East and Southeast Asia including China's exports and imports in total Asian exports increased from 42% to 76% and in imports from 38% to 80%.³⁴ During this period Asia accounted for 40% of the total increase in multilateral exports.

Unquestionably China's rise as a large trading economy had a lot to do with its structural transformation, but the other Asian economies also increased their global market shares in exports. This includes the NIEs and the larger members of the ASEAN. Athukorala reported that the apprehension of China's exports crowding out those from the other Asian economies was highly exaggerated in the policy debate. Viewed in the global context, market share growth of the Asian economies, including that of China, occurred essentially at the expense of the rest of the world, particularly advanced industrial economies.³⁵ Interestingly, during this period the combined share of the other non-Asian developing countries in the global trade also increased, but at a much slower pace than that of the Asian economies. China and the East and Southeast Asian economies were the major drivers of rapid export growth in Asia. After the 1970s the export structures of this group of Asian economies experienced an intense shift towards manufacturing products. Their share of exports of manufactures in total multilateral trade increased from 12.9% in 1969/70 to 36.6% in 2006/07. Conversely, during this period, the share for Japan declined from 8.9% to 7.8%.

As the detailed discussion above demonstrates, whether rapidly growing China became a threat to its Asian neighbors has been an intensively analyzed issue in empirical studies. More recent studies like Kong and Kneller³⁶ have addressed the

33. Barry Eichengreen, Yeongseop Rhee and Hui Tong, 'China and the exports of other Asian countries', *Review of World Economics* 143(2), (2007), pp. 201–226; David Greenaway, Aruneema Mahabir and Chris Milner, 'Has China displaced other Asian countries exports?', *China Economic Review* 19(1), (2008), pp. 152–169; and Prem-chandra Athukorala, 'Asian trade and investment', in Athukorala, ed., *The Rise of Asia*, pp. 11–57.

34. Athukorala, P. C. and H. Hill. 2010. 'Asian Trade and Investment', in P. C. Athukorala (ed.), *The Rise of Asia* (London: Routledge, 2010), pp. 11–57.

35. Prem-chandra Athukorala, *Asian Trade Flows: Trends, Patterns and Projections*, Working Paper No. 2011/05 (Canberra: Australian National University, March 2011).

36. Yong Fong Kong and Richard Kneller, 'China's export expansion: a threat to its Asian neighbors?', paper presented at the conference on *Trade, Investment and Production Networks in Asia* at the University of Nottingham, Kuala Lumpur Campus, Malaysia, 15–16 February 2012.

weaknesses and errors of the earlier studies and concluded that there was little displacement effect by Chinese exports. If anything, complementarity in trade benefited the neighboring Asian economies. It was logical that China succeeded in penetrating labor-intensive manufactured goods at the cost of high-wage NIEs, but it did not have the same effect on the low-wage-and-income Asian economies.³⁷ Furthermore, China's active participation in the regional and global production chains and emergence as the assembly center created opportunities for the other Asian economies to become a part of various segments of the value chains in line with their comparative advantage and boosted their trade volumes.

V.2. *China threat in foreign direct investment*

Owing to their economic dynamism, Asian economies became the progressively significant recipients of FDI from the advanced industrial economies during the late 1980s. A lion's share of these FDI flows went first to the NIEs, spreading subsequently to the ASEAN-4 economies in the early 1990s. Intra-regional FDI flows in Asia also intensified. FDI has been a valuable instrument of both regional integration as well as global integration for Asia. In 1992, China recorded an upturn in its FDI receipts, which soon turned into a surge. By the mid-1990s it became the largest developing country recipient of FDI. The developing country investors, those from Hong Kong SAR and Taiwan, accounted for a disproportionately large proportion of FDI in China until the mid-1990s. In the initial years China suffered from difficulties in the enforcement of contracts. The Chinese Diaspora in Hong Kong SAR and Taiwan felt privileged because they had old ties with the Chinese society and businesses and informal means and channels of enforcement of agreements. Therefore, FDI to China from these economies was large. Subsequently the proportion of FDI from these economies declined. An overwhelmingly large proportion, over 80%, of FDI flows to Asia originated in the advanced industrial economies.³⁸

Many of the Asian neighbors understood that China's large and growing FDI receipts were depriving them of FDI. The perception among the antagonists was that China was gaining at the expense of its Asian neighbors. This was based on the assumption that FDI was a zero-sum game.³⁹ Some Asian governments, like Korea and Singapore, were strident in expressing their uneasiness on this count. If this assumption was correct, every year there was an increase in FDI to China, there should have been a fall in FDI flows in the neighboring Asian economies. Casual empiricism failed to establish such a correspondence. This assumption was flawed because there were periods when both ASEAN and China recorded higher FDI flows. For instance, one such period was 1989–1997, when both shared an increasing FDI trend. In China's case FDI receipts soared from US\$3.4 billion to US\$44.0 billion, while for the ASEAN economies it soared from US\$7.6 billion to

37. Athukorala, 'Asian trade and investment', pp. 11–57.

38. Loren Brandt, Thomas G. Rawski and X. Zhu, 'International dimension of China's long-term boom', in W. W. Keller and T. G. Rawski, eds, *China's Rise and Balance of Influence in Asia* (Pittsburgh, PA: The Pittsburgh University Press, 2007), pp. 14–46.

39. Charles Kramer, 'Asia's investment puzzle', *Finance and Development* 43(2), (2006), pp. 38–46.

US\$27.0 billion.⁴⁰ These statistical data do not support the assumption that China benefitted at the expense of the other Asian economies.

That China was not pulling FDI at the expense of the other Asian economies can be shown by making a long-term comparison of FDI stock data. A comparison of quinquennial FDI statistics confirms that for China, while initially affecting FDI inflows to the rest of the Asian economies, this did not become a trend. During the 1990–1994 quinquennium, China's FDI stock averaged US\$43.9 billion a year, which reached US\$348.6 billion a year. For the ASEAN economies the corresponding amounts were US\$8.7 billion and US\$85 billion. Also, in the other developing Asian economies, the average annual FDI stock increased from US\$10.8 billion a year in the 1990–1994 quinquennium to US\$55.7 billion a year in the 2005–2009 quinquennium.⁴¹ Although China became increasingly important and attractive after the WTO accession, the FDI stock of the other Asian economies did not shrink.

Several regression analyses and other exercises were attempted in order to resolve the issue of China crowding out FDI flows into the Asian economies. Regression analysis by Chantasasavat *et al.*⁴² attempted to estimate the impact of inward FDI flows in China on Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand for data for 1985–2001. Their strategy was to control for all the standard explanatory variables of FDI in the Asian economies. To proxy for China's effect, they chose the level of FDI inflows into China. Their estimates found that the value of coefficient for inward FDI into China was positive and highly significant in all the specifications. They concluded that a 10% increase in FDI inflows into China would raise the level of FDI inflows into the eight Asian economies they considered for their study by 2–3%. Thus, the increases in FDI in China did not occur at the expense of the Asian economies but, if anything, they benefitted from such increases. One obvious explanation for this increase was the regional production networks of which China was an integral and active part. As the Asian economies were heavily involved in vertical trade specialization with China, their production processes were interconnected. Therefore, it was logical and feasible that an increase in FDI in China could lead to an increase in FDI in them. This complementarity hypothesis was based on the fact that the factors that made China a more attractive FDI destination also made other Asian economies more attractive destinations.

The same complementarity between China and the surrounding Asian economies was reported by Zhou and Lall.⁴³ Supporting this premise, Ianchovichina and Walmsley⁴⁴ argued that with China liberalizing FDI inflows, the investing

40. Dilip K. Das, 'Foreign direct investment in China: its impact on the neighboring Asian economies', *Asian Business and Management* 6(3), (2007), pp. 285–302.

41. The source of these statistical data is Table 2.3.1 in Asian Development Bank (ADB), *Asian Development Outlook 2011* (Manila, The Philippines: ADB, 2011), p. 66.

42. Busakorn Chantasasavat, K. C. Fung, Hironi Lizaka and Alan Siu, 'The giant sucking sound: is China diverting foreign direct investment from other Asian economies?', *Asian Economic Papers* 3(3), (2005), pp. 122–140.

43. Yuping Zhou and Sanjaya Lall, 'The impact of China's FDI surge on FDI in South-East Asia: panel data analysis for 1986–2001', *Transnational Corporations* 14(1), (2005), pp. 41–65.

44. Ianchovichina and Walmsley, 'Impact of China's WTO accession on East Asia'.

transnational corporations (TNCs) began rationalizing their production processes in Asia, which in turn facilitated and encouraged complementary FDI flows to the Asian economies. Likewise, Mercereau⁴⁵ also concluded that China had not diverted FDI inflows from its Asian neighbors. In his study, Singapore and Myanmar were the only two exceptions. His results regarding complementarity were similar to those arrived at by Chantasasavat *et al.*⁴⁶

Other studies⁴⁷ took a larger number of Asian economies in order to estimate the impact of FDI inflows into China and found that due to complementarities China may have crowded *in* FDI into the Asian economies not crowded *out*. They also explained complementarities by the vertical nature of production fragmentation in Asia. Another large empirical exercise concluded that the changing direction of FDI in Asia could lead to welfare losses in the ASEAN-4 economies ‘only if the ASEAN-4 economies fail to absorb new foreign technologies quickly and to engage in indigenous technical innovation’.⁴⁸ The ASEAN-4 economies remained technology conscious in the past. There is no reason why they should not continue to be so in the face of a Chinese challenge. Salike⁴⁹ applied a dynamic panel model to investigate the crowding out effect of Japanese FDI going to Asia. He examined this with industry-level data on Japanese FDI. His results show a significant crowding out effect in three of the 12 industrial sectors, which included electronics and the electrical industry. In two industries a complementary effect was found, which included transport. Chemicals did not show any kind of impact. Salike also inferred that vertically fragmented industries in the region would benefit from China’s rise and large receipt of FDI.

Similarly, Chen’s empirical regression results demonstrated that FDI inflows into China tended to have a statistically significant positive effect on FDI inflows into other Asian economies.⁵⁰ The regression results also revealed that *ceteris paribus* marginal effect of the host countries location variables of FDI inflows was far greater than the China effect. The results of these empirical analyses demonstrate that China not only did not receive higher volumes of FDI at the expense of the other Asian economies, but also enabled them to benefit. On the whole, large FDI inflows into China had a significant positive and complimentary effect on the Asian economies. It was caused by two factors, first, increased resource demand for a growing China and, second, deepened integration of production networks in China and its Asian neighbors.

China’s neighbors are regarded as high-performing economies and have earned global accolades for their post-World War II economic dynamism. Many of them

45. Benoit Mercereau, *FDI Flows to Asia: Did the Dragon Crowd out the Tigers?*, Working Paper No. WP/05/189 (Washington, DC: International Monetary Fund, 2005).

46. Chantasasavat *et al.*, ‘The giant sucking sound’.

47. Barry Eichengreen and Hui Tong, ‘Is China’s FDI coming at the expense of other countries?’, *Journal of Japanese and International Economics* 21(1), (2007), pp. 153–172; and Chengang Wang, Yingqi Wei and Xiaming Liu, ‘Does China rival its neighboring economies for inward FDI?’, *Transnational Corporations* 16(3), (2007), pp. 35–60.

48. Warwick J. McKibbin and Wing Thye Woo, ‘The consequences of China’s WTO accession on its neighbors’, *Asian Economic Papers* 12(2), (2003), pp. 1–38.

49. Nimesh Salike, ‘Investigation of the “China effect” on crowding out of Japanese FDI: an industry level analysis’, *China Economic Review* 21(3), (2010), pp. 582–597.

50. C. Chen, *Foreign Direct Investment in China* (Cheltenham: Edward Elgar, 2012).

created successful niches for themselves in the global economy.⁵¹ The NIEs did so even before China did. Besides, China demonstrated eagerness for regional acceptance and was/is sensitive to allegations of disrupting and dislocating the performance of its neighboring economies (Section III). Since 2000, China has endeavored to manage its economic relations with them by proposing free-trade agreements (FTAs) of a different kind. This lack of insouciance towards its neighbors' welfare demonstrated China's commitment not only to the lofty ideals of good neighborliness, but also to responsible conduct in the community of nations.

VI. Summary and conclusions

This article explores the relationship between China and the surrounding Asian economies. It delves into their mutual acceptance, economic interaction and dynamics. It examines how China is influencing its neighboring Asian economies and attempts to establish whether their economic relationship is synergetic and has a market- and institution-led symbiosis. Of the two, the symbiotic relationship has been more market-driven than institution-driven. In following this trend, Asian economies have conformed to their past pattern and predilection. That said, the political factors have recently begun reinforcing this trend and their impact is on the rise in enhancing the interactions between Asia and China.

When the Chinese economy began its resurgence to become the largest regional economy, some of its smaller neighboring Asian economies were on their way to being among the 'miracle' economies of the future. As the Chinese GDP growth picked up momentum, it began influencing its Asian neighbors in a significant manner. The two groups that were affected most due to its rapid growth were Japan and the NIEs on the one hand and the ASEAN economies on the other. China becoming a regional economic powerhouse was unquestionably a significant and sensitive issue. Although during the pre-reform era China did not have close economic and political relations with its Asian neighbors, during the reform period the Chinese political leadership consciously decided to engage and cooperate with the surrounding regional economies.

China regarded soft power as important and its status as a soft power in the region was on the rise. With that, acceptance by the other Asian economies was enhanced. The Asian crisis (1997–1998) proved to be an opportune period for China to cultivate close economic ties with neighboring Asian economies. Mishandling of the crisis and bail-out packages by the IMF had made Asian governments resentful. They were disaffected with the International Financial Institutions (IFIs), particularly the IMF. As an alternative to the IFIs and IMF, they were anxious to create regional frameworks for any future crises. They clearly saw a pressing need for self-reliance and regional mutual support. The Asian crisis was also a reminder to China that it was impossible to disentangle its economic fortunes and domestic economic stability from what happened in the rest of Asia. Importance of regional interdependence dawned on the Chinese policy mandarins. China joined its regional neighbors in their

51. Dilip K. Das, *Asian Economy and Finance: A Post-Crisis Perspective* (New York: Springer Publications, 2005).

quest for mutual economic reliance. Its partnership and collaboration endeavors with them increased.

China methodically expanded and deepened its economic ties with the regional neighbors. This served to win their trust as well as helped in developing a symbiotic economic relationship with these dynamic economies. To that end China adopted an open trade policy stance. It also unilaterally reduced its tariff rates. Keeping the economy open was instrumental in cultivating regional and global interdependence. Developing a close APT grouping and strengthening it was another policy measure that brought China close to the regional economies. The APT helped develop a sense of regional identity. This regional framework also made it possible to seek regional solutions for regional problems.

International trade and FDI were two of the most important channels that integrated China with its regional neighbors. Trade among the East and Southeast Asian economies, which included China, began increasing in the 1980s. With the passage of time a China 'threat' or 'fear' perception developed in Asia. This implied that China was crowding out exports of the other Asian economies in the world market place. Also, as China became the most attractive FDI destination among the developing countries, it was understood that China was receiving FDI at the expense of the Asian economies. These concerns were examined by several empirical studies and the inference was that they were exaggerated.

China adopted vertical fragmentation of production and came to be an important part of regional production networks. Over the last two decades, Asian economies have become highly active and successful in innovative regional cooperation through production networks. Due to rapid clip expansion in them, intra-regional trade in parts, components and subassemblies increased quickly in recent decades. Regional and global production networks in Asia existed before the emergence of China as a hub, or central assembly platform. However, with the rise of the Chinese economy a new dimension was added to Asia's standing in global production networks. Trading activity by global production networks rose steadily from the early 1990s. Production networks in Asia and China successfully enhanced their status in international trade, in that dynamism of the Chinese economy assisted Asian economies. Thus, evidence abounds that rapid growth in China added to Asia's dynamism and the two have evolved a symbiotic relationship.