

THE CHINA-ASEAN DYNAMIC

HOW IS IT EVOLVING? WHAT MIGHT IT PORTEND FOR NZ'S TRADE AND ECONOMIC ENGAGEMENT OVER THE NEXT 10-15 YEARS?

INTRODUCTION

To-date, much has been written on slowing economic growth in China and the country's transition towards a more market-oriented economy. China's modern economy was built on the strength of a solid and often low-tech manufacturing sector making it the world's single largest manufacturer today. As China continues to develop and move up the value chain – towards producing more high-tech manufactures and services and investing in more R&D – it is likely that some of the country's (lower-tech, labour intensive) manufacturing will be 'up for grabs'.

The ASEAN Economic Community (AEC) entered into force on 31 December 2015, commencing a new chapter in the region's 48-year history. The AEC will only slowly come into effect as ASEAN countries overcome domestic regulatory and political barriers to its implementation. But as it does, it is expected that ASEAN will emerge as the third pillar of Asian growth alongside China and India. The changing landscape of China's manufacturing sector will present significant opportunities for ASEAN (particularly, the smaller ASEAN nations) to supply the growing demand for low-skilled production work (i.e. to 'capture' some of China's manufacturing) and to become a major source of consumption for the world. In fact, ANZ has recently stated that South East Asia will "eventually be as important to Australia and New Zealand as China is today".

The purpose of this note is to describe the impact of China's rebalancing on the ASEAN nations, and to examine what bearing this might have on NZ's trading relationship with South East Asia.

WHAT'S HAPPENING IN CHINA?

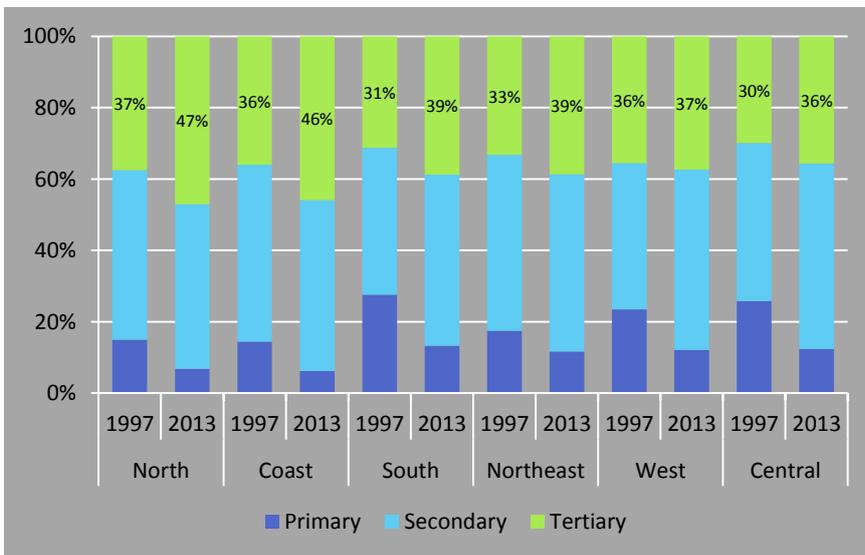
China's rise to become the world's largest manufacturer has been rapid. From lagging behind in 7th place as recently as 1980, China replaced the United States as the world's top producer of manufactured goods in 2011.¹ Today, however, China faces challenges as the country transitions toward a more sustainable growth model, resulting in slower economic growth. Furthermore, the country's working age population is declining (the number Chinese workers aged 16-59 dropped by a record 4.87 million – more than the population of NZ – to 911 million in 2015), export demand is weak and wages and other factor costs are on the rise. More fundamentally, as China becomes richer, the relative role of manufacturing (particularly, low-tech manufacturing) in the economy is declining.

¹ Source: http://www.mckinsey.com/insights/manufacturing/a_new_era_for_manufacturing_in_china

COASTAL PROVINCES LEAD THE WAY...

Firstly, it is important to bear in mind that China’s economic rebalancing is more than just a shift away from a production and export-intensive model to a more consumption-based one. It is also intended to be a “rebalancing of political and economic power beyond the coast to the ‘continent’”. In fact, many Chinese provinces could be considered ‘countries’ in their own right given population size, economic output and land area. These provinces vary in terms of their economic growth trajectories and stage of economic development. Examining China’s overall growth rate masks disparities between provinces. To date, the Northern and coastal provinces² have grown at a much faster pace than those that are inland, and are now moving up the value-chain and promoting the development of more sophisticated services.

Figure 1: Visible structural change in China
GDP by sector, Source: National Bureau of Statistics of China

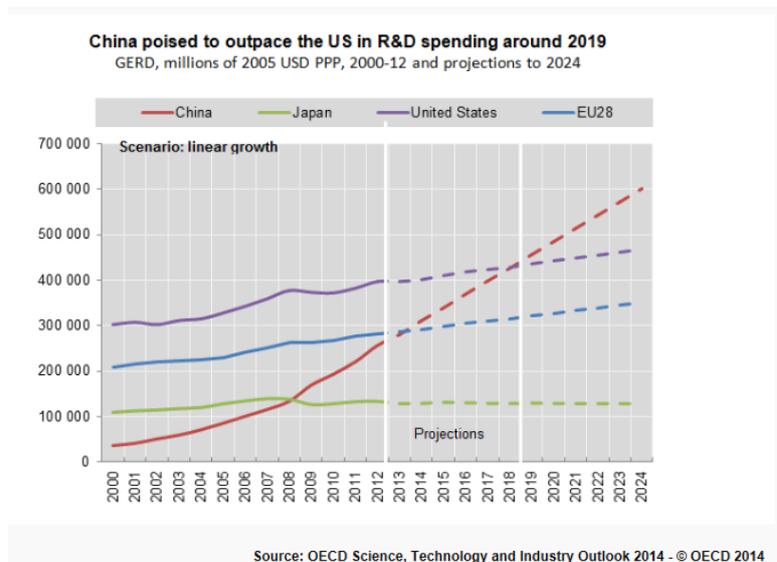


Special initiatives such as the Special Economic Zones (which allows for proximity to trading partners such as Hong Kong, Macau and Taiwan) and industrial parks have helped the coastal provinces attract foreign investment, spur mass production and become more export-oriented over time. This is evidenced in the progression of structural change (see Figure 1), where it is shown that for the coastal provinces predominantly, the importance of the primary

sector has diminished; while the share of industry and manufacturing (secondary) and services (tertiary) in GDP has risen over time.

China is also becoming an R&D hub – further evidence to suggest that the country is rapidly moving up the value chain. The OECD found that China remains on track to be world’s top R&D spender by around 2019 – as squeezed budgets in the EU, Japan, US are reducing the weight of these countries in science and technology research, patent applications and scientific publications (Figure 2 refers). China’s R&D spending has doubled

Figure 2: Projections of gross domestic expenditure on R&D for select economies



² Coastal provinces are: Shandong, Jiangsu, Shanghai, Zhejiang, Fujian, Guangdong and Hainan. Northern provinces refer to: Beijing, Hebei, Inner Mongolia, Shanxi and Tianjin.

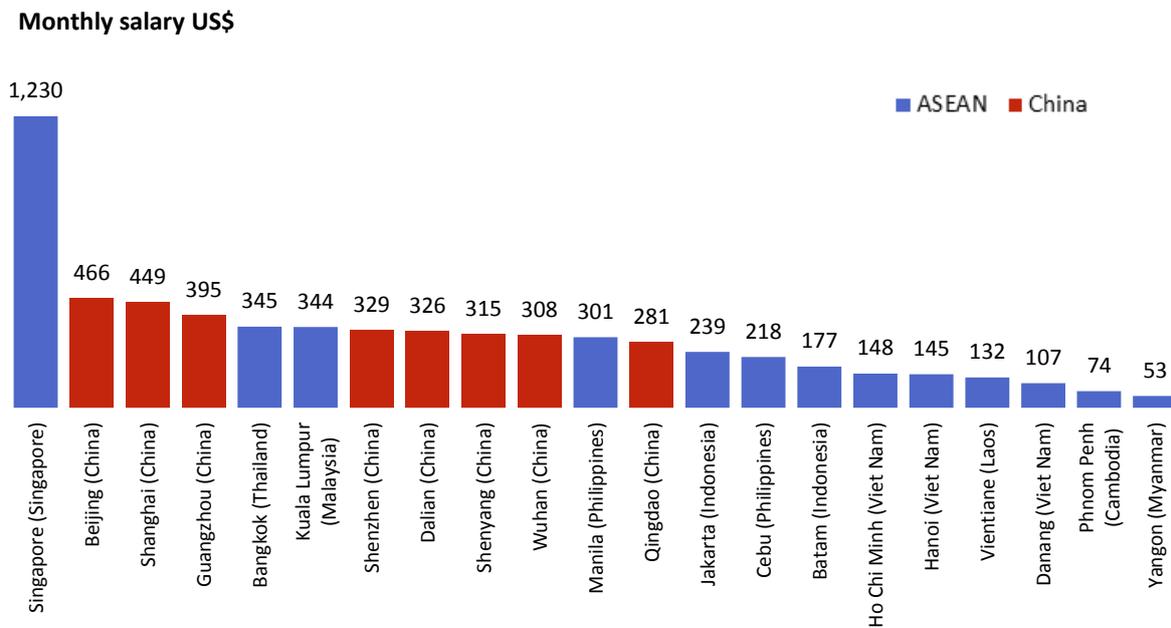
over 2008-12 (cf. annual growth of around 1.6% across OECD countries over the same period). In 2012, China's Gross Domestic Expenditure on R&D was US\$257 billion, while the equivalent figure for the US was US\$397 billion, US\$282 billion for the EU, and US\$134 billion in Japan. Expenditure on R&D is not, of course, the same as R&D outputs but clearly there is a relationship to R&D spend even if it is not linear.

IMPLICATIONS FOR SOUTH EAST ASIA

SOME OF CHINA'S MANUFACTURING IS UP FOR GRABS...

China's low-cost labour (stemming from a large supply of workers) is one of the key factors that made it the manufacturing powerhouse it is today. However, as the coastal provinces continue to develop and move towards being increasingly service-based, wages in these provinces are rising. Higher labour costs (and hence, increased input costs) means that some of China's (labour-intensive) manufacturing is up for grabs and some firms are already pursuing lower wages in South East Asian countries as well as, deeper into China.³

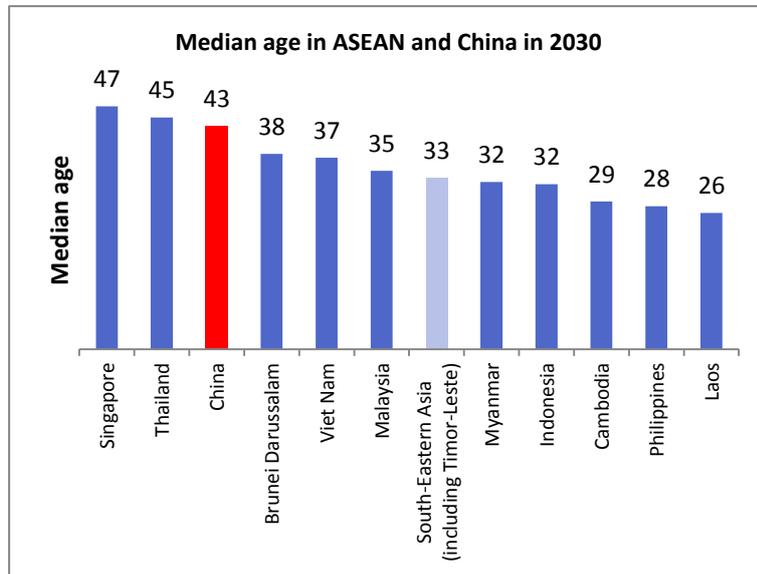
Figure 3: Monthly base salary for a factory worker, US\$
Source: Japan External Trade Organization (JETRO)



³ Inland cities/provinces in China use tax breaks and cheap land to attract foreign investors. They also have a large labour pool, good transport links and a reliable supply of inputs. As a result, firms are pursuing lower wages deeper into China. Foxconn once based its China operations mostly in Shenzhen, the manufacturing hub near Hong Kong. It now has large plants in Henan and Sichuan provinces, and is building a facility in Guiyang, one of China's poorest regions.

Figure 4: Median age

Source: UN World Population Prospects, Medium Fertility Variant



Southeast Asia offers a large labour pool with low wages (see Figure 3). The Economist has calculated that China's average factory worker earns US\$27.50 per day, compared with US\$8.60 in Indonesia and US\$6.70 in Viet Nam.

Demography is another advantage – it is expected that by 2030, half of the 720 million people in Southeast Asia will be under the age of 33.⁴ In comparison, the median age in China is projected to be 43 in 2030. ASEAN is also strategically located in the centre of the burgeoning Asia-Pacific region with an estimated US\$5.3 trillion of global trade passing through ASEAN waterways each year.

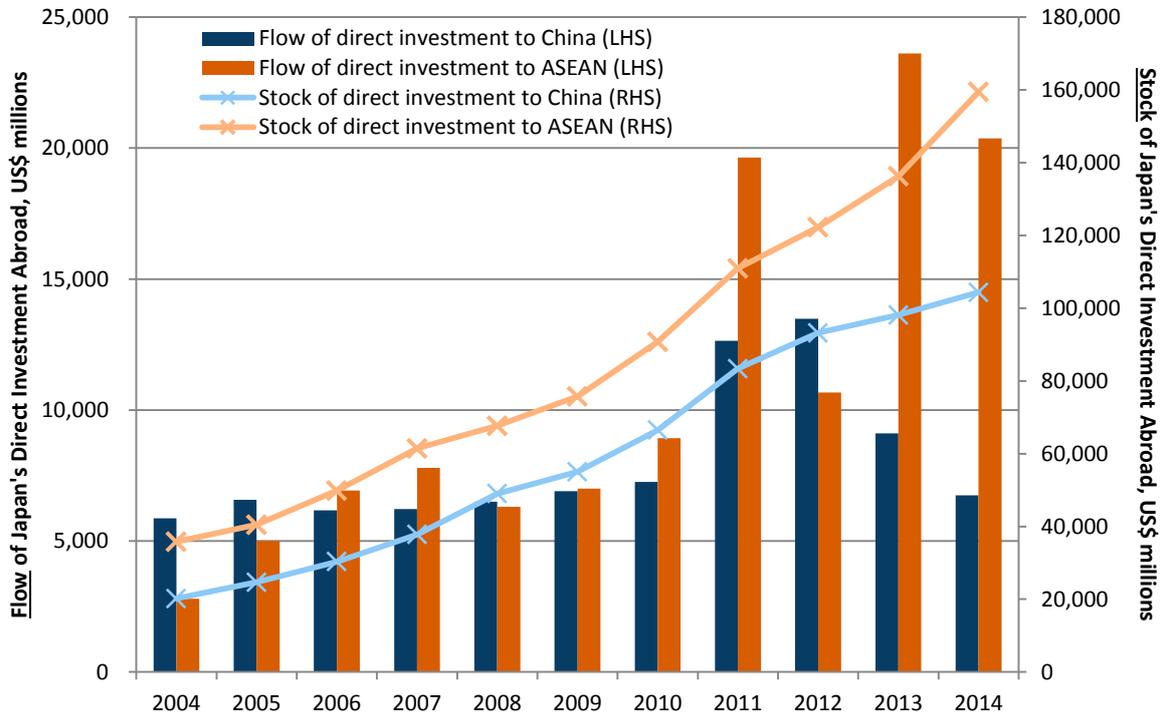
INVESTMENT IS FLOCKING TO ASEAN

Already, foreign investors are seizing ASEAN's potential. In fact, the region saw the strongest rise in FDI flows in 2014, with levels exceeding inflows to China for the first time since 1993 – making ASEAN the largest recipient of FDI in the developing world. Strong regional economic fundamentals, cost advantages and market factors including regional integration are the key forces attracting investment and influencing corporate strategy in ASEAN, and particularly in the CLMV (Cambodia, Lao PDR, Myanmar and Viet Nam) countries. Regional initiatives such as the development of the ASEAN Infrastructure and Investment Bank (AIIB), are also likely to continue to support capital and overseas direct investment into the region.

Japanese foreign direct investment, for instance, has been surging into ASEAN while growing at a much slower pace into China (amid rising Chinese wages, a slowing economy and political tension between Beijing and Tokyo). In 2014, for example, the flow of Japanese direct investment into ASEAN (US\$20 billion) was three times as much as that into China (US\$6.7 billion). And for the three years ended 2014, Japan was the second largest foreign investor in the ASEAN-10, after the European Union – accounting for 15% of total FDI inflows in ASEAN during that period. Growth in the stock of Japan's direct investment to ASEAN over 2004-14 has been driven primarily by increased FDI to Thailand and Singapore (note: Japan's Bank of Tokyo-Mitsubishi acquired Thailand's Bank of Ayudhya in 2013).

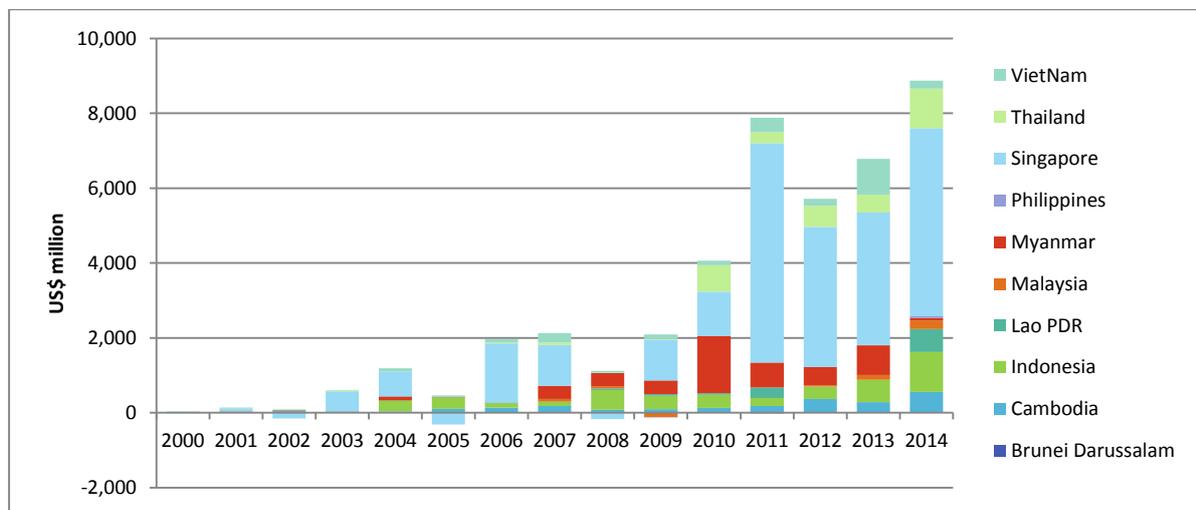
⁴ Note : This estimate includes Timor-Leste.

Figure 5: Japan's investment abroad (stocks and flows) by country, US\$ millions
 Source: Japan External Trade Organization (JETRO)



In order to tap into the relatively low labour costs, more foreign companies (including those companies with existing operations in China and in higher-cost ASEAN Member States) are making significant manufacturing investments in the CLMV countries. **Chinese** investment currently dominates in Cambodia, Lao PDR and Myanmar. An important feature of this rise in manufacturing FDI in CLMV countries is that it strengthens regional value chains and expands regional production networks – increasing the region's manufacturing competitiveness overall. Since 2012, total Chinese direct investment inflows to ASEAN have increased by 55% from US\$5.7 billion in 2012 to US\$8.9 billion in 2014.

Figure 6: Flows of Chinese direct investment to ASEAN Member States, 2000-14
 Source: ASEANstats Database



FROM TEXTILES TO HIGH-TECH MANUFACTURING

The garment and textile industry is the most obvious candidate for moving production out of China to other Asian countries. As an industry, garments/textiles require low-skilled workers, have relatively low costs of production and is a highly transportable industry, and countries which are just beginning to industrialise – like Myanmar – offer an early test potential. Myanmar’s clothing exports jumped from US\$700 million to US\$1.7 billion between 2011 and 2014. H&M, a European retailer, recently shifted sweater production from China to the Myanmar Century Liaooyuan Knitted Wear factory, a Chinese-run facility in outer Yangon. According to the production manager, staffing such factories in China has grown difficult as Chinese workers now have “other, better jobs”.⁵

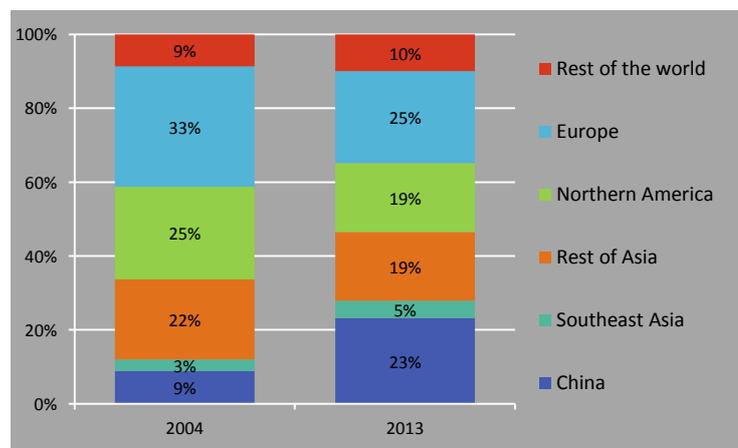
There are also examples of intermediate-input and other tech manufacturing leaving China with countries like Viet Nam, Thailand and Indonesia picking up electronics work. In fact, Viet Nam has capitalised on increasing labour costs in China and was ranked the world’s top outsourcing location (in terms of costs, risks, and business conditions) for the first time earlier this year according to research from global real estate adviser Cushman & Wakefield (rising from 5th place in 2014). According to the report, Viet Nam has become particularly attractive due to reforms that have been implemented by the Vietnamese government. And with wages still below some of its Southeast Asian neighbours, this has firmly established Viet Nam as an offshore destination that offers some of the best quality-to-cost ratios. Its TPP membership is likely to further enhance its profile/attractiveness. The Philippines (ranked 2nd) has also become an established destination for outsourcing – now absorbing demand from India’s voice and call centre operations.

ASEAN’S REGIONAL COMPARATIVE ADVANTAGE

ASEAN comprises of ten diverse nations with wide disparities in terms of economic development (and other factors such as political systems, culture, language and religion). However, this economic diversity could prove to be an advantage rather than an impediment when it comes to manufacturing. It is likely that no single country will replace China’s role in global manufacturing – it remains a global manufacturing powerhouse (see Figure 7) – but nor does any one country need to as advances in technology will likely give rise to even more fragmentation of production across countries within a region.

The concept of comparative advantage – where countries specialise in what they’re good at producing – is important in this context. Today’s world is more globalised than ever before meaning that the notion of ‘national comparative advantage’ is increasingly outmoded. Rather, as supply chains continue to permeate national borders, regional comparative advantage matters even more.⁶ The spreading supply chain across Asia is already resulting in increased capability and production quality in the countries closest to China. Continued

Figure 7: Share of global manufacturing output
Source: UN National Accounts database



⁵ Source: <http://www.economist.com/news/briefing/21646180-rising-chinese-wages-will-only-strengthen-asias-hold-manufacturing-tightening-grip>

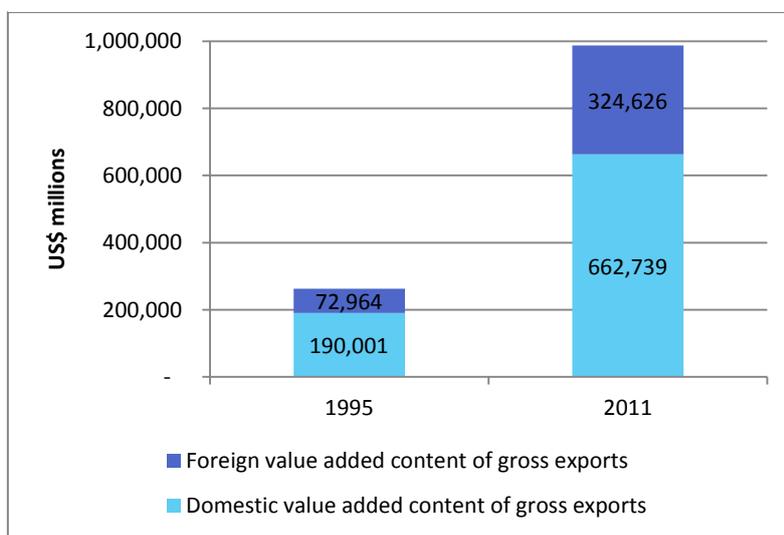
⁶ This concept was pioneered by the economist Richard Baldwin.

investment, the right partnerships and new trade agreements will likely bring to the wider South East Asia region a degree of the economic advancement China is already enjoying.

The ASEAN Economic Community (AEC) is one of, if not the most important, vehicle through which South East Asia could build integrated supply and value chains that span the entire region – taking advantage of the differing strengths and capabilities of each ASEAN member (akin to the automotive sector in the European Union where manufacturing capacity was created in Eastern Europe to take advantage of lower labour costs, while keeping some of the more strategic and R&D intensive activities in the region’s more developed countries). Once fully implemented, ASEAN’s ambitious AEC integration plan will create an open market of over 620 million consumers and a seamless production base which will likely spur increased intra-regional and global trade flows.⁷

Figure 8: ASEAN's growing share of value added export

Source: OECD TIVA database



In fact, OECD analysis shows that participation by ASEAN economies in global value chains has already grown across the board (see Figure 8). Natural resource rich economies such as Indonesia and Brunei Darussalam are engaged in upstream activities through sales of raw materials, while others such as Singapore are engaged in the sale of high-skill intensive products and services. This diversity suggests there are good opportunities to exploit complementary sectoral specialisation patterns through further regional economic integration.

HOWEVER, ASEAN CANNOT COMPETE ON LOW WAGES ALONE...

Wages are also increasing in ASEAN – eroding the region’s cost advantages. This means that ASEAN needs to compete on efficiency. Research shows that despite fast-rising wages, China’s workers are still much more efficient than those in emerging countries: excluding Singapore and Brunei, average labour productivity in ASEAN countries is still approximately 40% lower than in China.⁸ Chinese factories are also taking steps to further improve their productivity by investing in automation (i.e. working smarter). For instance, China became the biggest market for robots in 2013, buying 20% of all those made that year, according to the International Federation of Robotics. However, it still has just 30 robots per 10,000 manufacturing workers, compared with 437 in Korea and 323 in Japan. Furthermore, import/export costs (clearing customs, port fees, inland transportation, and so on) are 24% higher in ASEAN than in China, and the region’s Customs procedures take 66% longer than the OECD average.⁹

The opportunity for Southeast Asia to ‘grab’ some of China’s manufacturing is ripe. However, the region will need to become more efficient in order to capitalise on this opportunity. And as research by McKinsey points

⁷ When fully implemented, the community will comprise more than 620 million people with a combined GDP of almost US\$2.6 trillion (cf. China’s population of 1.4 billion and GDP of US\$10.4 trillion).

⁸ Source: *South East Asia at the crossroads: Three paths to prosperity*, McKinsey Global Institute (November 2014).

⁹ Source: <http://www.economist.com/news/briefing/21646180-rising-chinese-wages-will-only-strengthen-asias-hold-manufacturing-tightening-grip>

out: “the ASEAN countries with higher labor costs (notably Malaysia and Thailand) will need to move up into more sophisticated and value-adding operations to offset these costs”.¹⁰

It is also important to bear in mind that wages are just one factor in relocation decisions. Production (and business) is also affected by the cost and availability of capital, size and demographics of the labour force (linked to achieving economies of scale), quality of infrastructure, and the risks of operating in-market. In this sense, ASEAN offers a viable alternative to China for those companies wanting to penetrate the Asian market but are deterred by the challenges associated with doing business in China. The World Bank, for example, ranks China 84th on the Ease of Doing Business Index (which covers business regulation and reform) – below Singapore (which tops the index), Malaysia (18th) and Thailand (49th), and in equal place with Brunei Darussalam. To note, Viet Nam ranks 90th and the Philippines 103rd.

WHAT DOES THIS MEAN FOR NZ?

China is currently a more significant trading partner for NZ than ASEAN but commentators expect this gap to narrow over the next 10–15 years.

ASEAN currently accounts for 9% of NZ’s total goods and services exports. On the other side of the ledger, NZ is already importing goods from ASEAN (today, 14% of our total goods and services imports come from ASEAN – albeit, the majority of our goods imports (31%) from the region is petroleum).

NZ is well positioned to make the most of the changing landscape in ASEAN (notably the implementation of the ASEAN Economic Community). According to a recent ANZ report, strong demand growth, rising living standards and a sizeable infrastructure deficit in the ASEAN region presents opportunities for business and consumers in NZ (and Australia). Specifically, an expanding middle class in ASEAN is expected to increase demand for food, tourism, education and energy – not all of which will be satisfied in the region. Looking ahead, NZ’s import mix from ASEAN could change – towards more manufactures – as certain ASEAN members take advantage of their ‘low-cost manufacturer’ status.

Along with these opportunities, a fully functioning AEC would enhance the scope for productivity improvements in the region by promoting greater economies of scale across the bloc, cooperation (between businesses/organisations), and knowledge spillovers. A more productive and competitive AEC would be beneficial for NZ as it provides NZ businesses with a competitive location to set up and take advantage of production and value chain operations. In fact, some NZ firms, such as Beca engineering, already have established operations in ASEAN and have created a regional hub from which to service the entire South East Asia region. As ASEAN continues to improve on its investment regimes to become a single investment destination, it is possible that this will encourage other kiwi firms to expand operations into South East Asia. Firms setting up operations in ASEAN could also benefit from a more integrated market as transaction costs would be lowered.

In addition, it is likely that the AEC will also assist the reduction of development gaps among ASEAN member states via the creation of well-functioning regional production networks and resulting productivity improvements. This, combined with South East Asia’s rapidly growing middle class, will likely create a growing consumer base for NZ’s exports and may encourage more NZ firms to set up operations in ASEAN in order to be closer to the consumer.

Furthermore, as ASEAN integrates further, services will be an area of particular interest to NZ companies. Developing the free flow of services is one of the five core principles of the AEC. Barriers to international trade in services generally occur ‘behind the border’ (such as working visa restrictions, regulation concerning data

¹⁰ Source: *South East Asia at the crossroads: Three paths to prosperity*, McKinsey Global Institute (November 2014).

location, etc). To the extent that these barriers to services trade are lowered and regulation harmonised across ASEAN members, this would make it easier for NZ services providers to establish operations in ASEAN and/or enter the market.

NZ remains well-poised to take advantage of these increased efficiencies as we already have a well-established regional trade agreement with the bloc (AANZFTA) – complete with a built-in agenda which offers the opportunity to further negotiations and deepen our engagement with ASEAN. We also have bilateral arrangements with Singapore, Thailand and Malaysia, as well as a trade agreement currently under negotiation with ASEAN and its FTA partners.

However, slowing growth and structural transformation in China will present challenges to ASEAN, at least in short- to medium-term, which in turn may have flow on effects to NZ. It is expected that China's rebalancing will dampen export demand in ASEAN countries. FDI flows from China may also slow and financial markets and other capital flows could be affected in the region. Most ASEAN countries, however, have some room for monetary and fiscal stimulus to support growth in the near term.

CONCLUSIONS

- Much of China's growth in the last decade can be attributed to areas in East China (e.g. Beijing, Shanghai and Guangdong). These provinces are now in the 'latter' stages of development – moving up the value chain and developing the services sector.
- Already, there is evidence of companies shifting production out of China into 'cheaper' Southeast Asian countries (as well as, towards China's hinterland) as China's coastal provinces become less competitive due to sharply rising wages and a persistent labour shortage.
- ASEAN has the potential to become one of the world's key manufacturing hubs. The region has favourable demographics, comparatively lower wages, is strategically located, and boasts production synergies (i.e. low-cost labour along with production sophistication which will likely lead to the increased fragmentation of production across national borders). The region can also offer an alternative to those companies wishing to expand into Asia but are confronted by the (regulatory and legal) challenges of doing business in China.
- However, ASEAN cannot compete on low wages alone. To attract more global production and remain competitive with China, deeper efficiency improvements will need to be implemented in the region. Initiatives such as the AEC, when fully implemented, would create economies of scale across the bloc and improve productivity by removing barriers to trade and investment.
- In general, NZ remains well placed to capitalise on these opportunities as we already have trade agreements in place with ASEAN – providing us with a means through which we could deepen our linkages with the region. Moreover, it is likely that NZ businesses may establish operations or expand existing operations in ASEAN in order to benefit from the region's growth and its low costs of production.

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FEBRUARY 2016