



THE KEY FACTORS AFFECTING THE ECONOMY OF
CHINA-ASEAN FREE TRADE AGREEMENT

BY
MISS JIA LI

A THESIS PRESENTED TO ASSUMPTION UNIVERSITY IN
PARTIAL FULFILLMENT OF THE REQUIREMENT
FOR THE DEGREE OF MASTER OF ARTS
(INTERNATIONAL LAW AND DIPLOMACY)

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ASSUMPTION UNIVERSITY

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Author : Ms. Jia Li
Major : Master of Arts (International Law and Diplomacy)
Advisor Committee : Dr. Thanes Sucharikul


Faculty of Law, Assumption University approves this thesis as the partial fulfillment of the requirement for the Degree of Master of Arts.

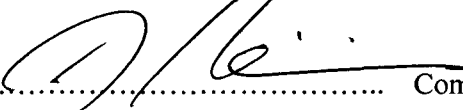

..... Director of the Graduate School of Law
(Assoc.Prof.Nattapong Posakabutra)

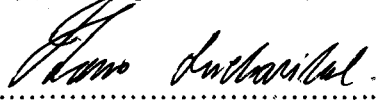
Committee:


..... Chairman
(Dr.Vilawan Mangklatanakul)


..... Committee
(Dr.Poonpat Leesombatpiboon)


..... Committee
(Assoc.Prof.Dr. Pisawat Sukonthapan)


..... Committee
(Dr.Disaphol Chansiri)


..... Advisor and Committee
(Dr. Thanes Sucharikul)

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Author : Ms. Jia Li
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Advisor Committee : Dr. Thanet Sucharikul

ABSTRACT

In January 2010, China and the ten member states of the Association of Southeast Asian Nations (ASEAN) officially signed and launched a free trade agreement. This free trade, known as China-ASEAN free trade agreement (CAFTA), has emerged as one of the most important in the world. The free trade agreement provides a framework within which the trade and investment between China and ASEAN will be conducted. Among other provisions, the free trade agreement significantly lowers tariffs and eliminates other non-tariff barriers between China and ASEAN.

The aim of the study was to investigate the factors that affect the economy of the China-ASEAN free trade agreement. To do this, two hypotheses were formulated and tested. There are a lot of factors affecting China ASEAN Free Trade Area (CAFTA), both economic and political ones, including economic theories, complementarity of the economies, intra and extra political conflicts, and other related factors. However, the CAFTA shall continue to prosper despite these factors. The first hypothesis was that China's rise to become the world's second largest economy is a major factor affecting the economy of CAFTA. The second one was that political issues in the eleven CAFTA member states (ASEAN 10 + China) play a very important role in shaping the economy of CAFTA.

The study used qualitative case study research design, and the data collected was mainly from secondary research. That is, after the data had been collected and analyzed, it was found that four key factors affect the economy of CAFTA. The four key factors that were actually determined as affecting the economy of CAFTA economic theories, complementarity of the economies, proliferation of China's and ASEAN as an International Organization and as ASEAN Member States' individually with outside

states, and political conflicts which may have economic impacts upon CAFTA. Based on the findings of the study, it was concluded that the hypotheses were true.

Key Words: Key Factors; Economy of China-ASEAN; China-ASEAN Free Trade Agreement (CAFTA).



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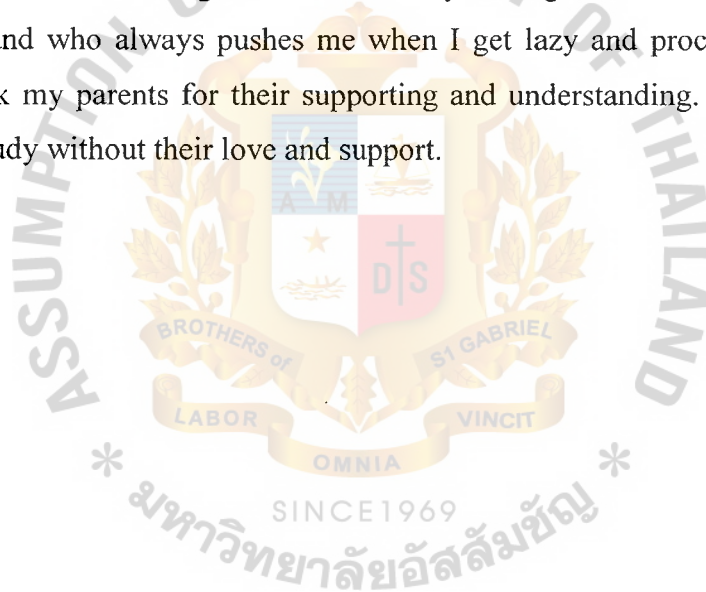


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Chapter 1

Introduction

This chapter introduces the whole thesis. It basically lays the foundation upon which all other chapters are laid.¹ It presents, among other issues, the background of the study, the research problem, the significance of the study, and the aim and objectives of the study. It also presents the hypotheses that were tested in the course of the study.

1.1 Background of the Study

Before the 1990s, there was no official relationship between China and Association of Southeast Asian Nations (ASEAN)². The year 1991 is the turning point in the relations between the People's Republic of China and the ASEAN member states. Mr. Qian Qichen, the then Chinese State Councilor and Foreign Minister attended the opening session of the 24th ASEAN Foreign Ministers' Meeting in Kuala Lumpur, Malaysia, which is China's first time official get in touch with ASEAN, and marked the beginning of China became ASEAN's consultation partner. Five years later, China became a full dialogue partner status of ASEAN³. In order to promote the China and ASEAN further dialogue and cooperation, China and ASEAN leaders signed the Framework Agreement on China and ASEAN Comprehensive Economic Cooperation⁴ in November of 2002,

¹ There are five chapters in total: Introduction, Literature Review, Methodology, Results and Findings, and Summary and Conclusion.

² Original ASEAN members are Indonesia, Malaysia, Thailand, Singapore, and the Philippines, Brunei joined in 1984. Vietnam joined in 1995. Myanmar and Laos joined in 1997. Cambodia joined in 1999.

³ China and ASEAN dialogue relations, 2010, China-ASEAN Centre website: http://www.asean-china-center.org/english/2010-06/23/c_13365143.htm.

⁴ The Framework Agreement on Comprehensive Economic Co-operation ("the Framework Agreement") between ASEAN and China signed by the Heads of Government/State of ASEAN Member States and China in Phnom Penh on the 4th day of November 2002.

determine to launch the building of China and ASEAN Free Trade Area (CAFTA) and complete the process by 2010. Marked China and ASEAN cooperation relations into a new and more deepen and institutionalized phase.

The free trade agreement between China and the Association of Southeast Asian Nations (ASEAN) has emerged as one of the most important in the world.⁵ Since January 2010 when the agreement came into force, the China-ASEAN free trade agreement (which will be abbreviated. CAFTA in this study) has been one of the most economically viable free trade agreements in the world. The China-ASEAN free trade agreement brings together China and the ten member states that form ASEAN.⁶ The states are Brunei, Myanmar, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

The initial framework for the China-ASEAN free trade agreement was signed in Phnom Penh, Cambodia⁷. This initial agreement was intent on creating a free trade area between China and ASEAN. Currently, the China-ASEAN free trade agreement is the third largest free trade area in the world as far nominal GDP is concerned. However, it is the largest in terms of population.⁸

In 2008, the combined Gross Domestic Product (GDP) for China and ASEAN was approximately US\$6 trillion.⁹ Basically, therefore, CAFTA had (in 2008) the world's third largest volume of trade behind the European Economic Area and the North American

⁵ Asmoro, A. "ASEAN-China free trade deal: let's face the music," The Jakarta Post. (December 2009), at <http://www.thejakartapost.com/news/2009/12/23/aseanchina-free-trade-deal-let%E2%80%99s-face-music.html>, (last visited 13 January 2012).

⁶ Brown, K. "Biggest regional trade deal unveiled," Financial Times. (1 January, 2010), at <http://www.ft.com/cms/s/0/823707e4-f6f1-11de-9fb5-00144feab49a.html#axzz35j477NWJ> (last visited 9 December 2012).

⁷ Moore, M. "China and South East Asia create huge free trade zone" The Daily Telegraph. (30 December 2009)., at <http://www.telegraph.co.uk/finance/china-business/6911721/China-and-South-East-Asia-create-huge-free-trade-zone.html>, (last visited 12 October 2011).

⁸ Ibid.

⁹ Li, M. and Kwa, C. G, China-ASEAN Sub-regional Cooperation: Progress, Problems and Prospect. (Singapore: World Scientific Co., 2011), p. 77.

Free Trade Area.¹⁰

The formation of the China-ASEAN free trade agreement has since impacted the economic fortunes of both China and the ASEAN member states. This economic boost has been occasioned largely by the fact that trade and investments among the eleven nations that form the China-ASEAN free trade agreement have been facilitated.¹¹

A notable change that has since taken place from the time the China-ASEAN free trade agreement came into force is the elimination of tariffs on approximately 90% (7,881 product categories) of imported products¹². This reduction in tariffs only affected China together with Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand (the six original ASEAN members). However, it is expected that it will be extended to the remaining four ASEAN member states that joined ASEAN only a few years ago. These are Burma, Cambodia, Laos, and Vietnam.¹³

Another far-reaching change that has taken place since the formation of the China-ASEAN free trade agreement is the reduction in average tariff¹⁴ rates for imports. For instance, there has been a decrease from 12.8% to 0.6% on tariffs imposed on goods imported to the above four nations from China. The tariff applicable for ASEAN exports to China has reduced from 9.8% to 0.1%.¹⁵ This tariff reduction is, however, only temporary and is expected to be reduced to zero once the new ASEAN member states are fully incorporated into ASEAN. That is, the tariff will be reduced to zero once these nations fully implement the free trade agreement.¹⁶

¹⁰ Ibid.

¹¹ Moore, M, op.cit., p. 2.

¹² Brown, K, op.cit., p. 2.

¹³ Ibid.

¹⁴ The free online dictionary defines a tariff as either a list or system of duties imposed by a government on imported or exported goods; or a duty or duties imposed in this manner.

¹⁵ Li, M., and Kwa, C. G, op.cit., p. 2.

¹⁶ Saw S. Hock, ASEAN-China Economic Relations (Singapore: ISEAS Publishing Institute of Southeast Asian Studies., 2007), p.86-112., at <http://www.google.co.th/books?hl=th&lr=&id=t5hMjFLaZG0C&oi=fnd&pg=PR5&dq=ASEAN-China+Economic+>

These changes in tariff regimes and fast-tracking of exchanges in foreign direct investment (FDI) between China and ASEAN have revolutionized the economic performance of China and ASEAN.¹⁷ The result has been that the China-ASEAN free trade agreement has become one of the most economically prosperous free trade agreements in the world. This prosperity has been further boosted by China's continued surge as a global economic power as well as the emergence of nations like Thailand and Singapore as strong economic powers in their own right.¹⁸

It is imperative to note at this point that China is a partner with ASEAN in the China-ASEAN free trade agreement¹⁹. This means that China is in a bilateral free trade agreement with an already full-fledged free trade area (FTA). Before China entered into the bilateral free trade agreement, ASEAN was a thriving FTA.

Originally formed by six states, ASEAN is the most prosperous free trade area in Southeast Asia²⁰. In fact so important is the economic union that it is considering forming – in addition to being an economic union – a monetary union that would see all the ten member states of ASEAN adopting a common currency.²¹

On its part, China is currently the world's second largest economy after the US in terms of both nominal gross domestic product (GDP) and Purchasing Parity²² (PPP). It is also the world's fastest growing economy with an average of 10% growth per annum in the last 30 years. As such, China is an economic power which has been unmatched (except by the US) in the whole world.²³

[Relations&ots=zkn6aeDWt&sig=Ey3-ezfHqnlM81kJYeYDWr-coDg&rediresc=y#v=onepage&q=ASEAN-China%20Economic%20Relations&f=false](http://www.industryweek.com/global-economy/asean-china-open-worlds-largest-free-trade-area), (last visited 20 January 2011).

¹⁷ Coates, Stephen, "China-ASEAN open free trade area," [Agence France- Presse](http://www.industryweek.com/global-economy/asean-china-open-worlds-largest-free-trade-area) (December 30, 2009)., at <http://www.industryweek.com/global-economy/asean-china-open-worlds-largest-free-trade-area>, (last visited 21 June2012).

¹⁸ Brown, K, op.cit., p. 2.

¹⁹ Coates, S. op.cit., p. 4.

²⁰ Li, M., and Kwa, C. G, op.cit., p. 2.

²¹ Coates, S. op.cit., p. 4.

²² Purchasing power parity is an estimate of the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equal to each other.

²³ Li, M., and Kwa, C. G, Ibid., p. 2.

That aside, China is the world's largest exporter and the second largest importer (after the US) of goods. China is also the largest economy in the world when it comes to manufacturing. In this respect, China has overtaken the US' service-driven economy which used to be – until recently – the world's largest manufacturing economy.²⁴

In terms of per capita income, China is also among the most prosperous nations in the world. According to a 2012 report by the international monetary fund (IMF), China's per capita income ranks 92nd in terms of PPP and 87th in terms of nominal GDP.²⁵ It is evidently clear that China and ASEAN are both very prosperous.²⁶ Their decision to form a free trade agreement was therefore largely in order for them to capitalize on their own unique strengths and opportunities while minimizing their inherent weaknesses and possible threats²⁷. By working together as opposed to individually, both sides have been able to realize numerous advantages which have contributed to their economic prosperity.

Although ASEAN's ten member states are small in terms of size and bargaining power, their otherwise buoyant economies have been enhanced by their participation in ASEAN²⁸. The China-ASEAN free trade agreement is therefore an opportunity for these nations to expand their economies even more. This is because through ASEAN they have been able to consolidate their positions and enhance their bargaining power in trade and investment.²⁹

Since both ASEAN and China are largely dependent on trade for their economic growth, bilateral trade between them has been a major area of cooperation. In fact the free trade agreement between the two mainly covers the area of trade³⁰. In view of this, the two sides have put in place targets to be met in terms of volume of trade between them.³¹

One such target is to ensure that by the year 2015, total trade between the two

²⁴ Brown, K, op.cit., p. 2.

²⁵ For more details about China's economy, see William J. Bernstein, A Splendid Exchange: How Trade Shaped the World. (New York: Grove Press., 2008), pp. 24-46.

²⁶ Coates, S. op.cit., p. 4.

²⁷ Asmoro, A. op.cit., p. 2.

²⁸ Coates S, op.cit., p. 4.

²⁹ Asmoro, A. op.cit., p. 2.

³⁰ Li, M., and Kwa, C. G, op.cit., p. 2.

³¹ Coates, S. op.cit., p. 4.

reaches 500 billion US dollars³². They came very close to achieving this target in 2012 when the bilateral trade between them crossed the 400 billion US dollar mark to stand at 14.1 billion US dollars. According to the Ministry of Commerce of China, this value was 7.3 times more than that recorded ten years earlier in 2002³³.

This rapid increase in the volume of trade between China and ASEAN is a clear indication that the free trade agreement between them has indeed opened up new economic opportunities for each side³⁴. More specifically, the elimination or reduction of tariffs and other non-tariff barriers to trade between the two sides has served to increase the volume of trade transacted between them.³⁵

It is worthy illustrating how the free trade agreement³⁶ between China and ASEAN has helped improve bilateral trade between the two sides. Currently, China is ranked ASEAN's largest trading partner³⁷. On its part, ASEAN has become China's third largest trading partner. On average, bilateral trade between the two has been growing at a rate of over 20% per year.³⁸

In the last 20 years, trade between the two sides has increased 37 times.³⁹ Although it is true that economic cooperation between China and ASEAN began only about a decade ago (with a full free trade agreement taking effect only about three years ago), economic cooperation between them began a long time ago.⁴⁰

Investment is also a major area of economic cooperation between China and ASEAN. Although the two sides cooperated in this area even before the free trade agreement between them came into force, the rate of exchange of investments between the two has increased tremendously as a result of the free trade agreement. Currently,

³² Ibid.

³³ Asmoro, A. *op.cit.*, p. 2.

³⁴ Ibid.

³⁵ Li, M., and Kwa, C. G, *op.cit.*, p. 2.

³⁶ A free trade agreement is basically an arrangement between two or more nations that allows trade between them to be undertaken without payments (duty-free).

³⁷ Moore, M, *op.cit.*, p. 2.

³⁸ Ibid.

³⁹ Li, M. and Kwa, C. G. *op.cit.*, p. 2.

⁴⁰ Brown, K, *op.cit.*, p. 2.

China's FDI to ASEAN stands at 13 billion US dollars. This indicates that ASEAN states are obvious destinations for China's FDI.⁴¹

To underscore ASEAN's strategic FDI importance to China, China announced in 2009 its intention to provide funds for the establishment of a China-ASEAN Fund⁴². This Fund was to be used to enhance investment cooperation between the two sides. As the economically more advantaged partner in the China-ASEAN free trade agreement, China has been funding a number of development projects within various ASEAN states.⁴³

Currently, a total of 12.2 billion US dollars in loans has been extended to ASEAN states to fund various infrastructural projects like the construction of power stations, roads, and bridges. On its part, ASEAN is now the fifth largest export market for China when it comes to service trade.⁴⁴

1.2 Statement of the Problem

There is no doubt whatsoever that CAFTA is a thriving free trade area. This trend is expected to continue in the near future. This is because the eleven member states of CAFTA have effectively demonstrated their willingness and ability to work together for their own common good.

The future success or CAFTA, however, will be dependent on a number of factors (conditions). How well CAFTA member states meet these conditions will determine whether or not the current economic status of the free trade agreement is sustained or even enhanced in the future.

It is also possible that the current economic boom being witnessed in CAFTA could fizzle out sometime in the future. This could happen if CAFTA gets exposed to certain unfavorable conditions.

Bottom-line is that there are several factors or conditions upon which the overall economic performance of CAFTA is dependent. Some of the factors are positive – could lead to more economic prosperity for CAFTA. Others, however, are negative and could

⁴¹ Ibid.

⁴² Li, M. and Kwa, C. G. op.cit., p. 2.

⁴³ Ibid.

⁴⁴ Moore, M, op.cit., p. 2.

spell the doom of CAFTA. Simply put, CAFTA has its own strengths and weaknesses. Going forward, it also has opportunities and threats. The problem is that these factors are unknown. This is the problem which the current study addresses.

1.3 Significance of the Study

It is imperative to have this study carried out for various reasons. They all have to do with the role of free trade agreements (FTAs) in the facilitations of economic performance of nations.

First of all, the trend around the world has been for nations to come together and join FTAs. Generally, FTAs have been determined to offer nations better chances of economic excellence. However, there is possibility that some nations could perform better outside FTAs (as individuals) than inside.

It means, therefore, that the success or failure of FTAs is dependent on certain factors. Therefore, this study is important because it helps unravel some of these factors. This way, the study will be making valuable additions to the existing body of knowledge.

Secondly, this study is essential because it will help gauge the viability of CAFTA. Such knowledge will be helpful for future policy formulation regarding CAFTA.

Finally, this study will help other nations in South and East Asia make informed decisions regarding whether or not they would like to join the ASEAN (by extension CAFTA). If these nations determine (through this study's findings) that CAFTA is a viable FTA, then they are likely to consider joining it at one time. However, if they believe that CAFTA has more threats and weaknesses than strengths and opportunities, then they might decide to remain out of it – at least for the near future.

1.4 Aim and Objectives of the Study

The main aim of this study is to investigate the factors that affect the economic performance of CAFTA. That is, it explores the strengths, weaknesses, opportunities, and threats of CAFTA. The objectives of the study are outlined below:

1. To explore the economy of CAFTA.

2. To ascertain the causes of CAFTA's good economic performance in the region and across the whole world.
3. To gauge the viability of CAFTA as free trade agreement.

1.5 Research Hypotheses

In order for any study to be successfully carried out, the issue under investigation (the phenomenon) has to be identified and all focus placed on it. This in effect means that the study has to be narrowed down as much as possible. To achieve this, the following hypotheses were formulated. They were then tested throughout the course of the study. The testing of the hypotheses entailed seeking to find out whether they were true or not. The hypotheses are as follows:

There are a lot of factors affecting China ASEAN Free Trade Area (CAFTA), both economic and political ones, including economic theories, complementarity of the economies, intra and extra political conflicts, and other related factors. However, the CAFTA shall continue to prosper despite these factors

Hypothesis 1: China's rise to become the world's second largest economy is the major factor affecting the economy of CAFTA.

This hypothesis tests the role that China as a state has played in shaping the economy of CAFTA. China's economic reforms that began about 30 years ago have resulted in a nation that is very prosperous not just economically but also politically. China is today the world's second largest economy after the US. It is the world's fastest growing economy with an average annual growth rate of 10%.

That China has been able to achieve such a great feat in so short a time has raised a lot of interest. In the last few years, China's economy has been transformed from one of a struggling developing nation into the second largest in the world. It means a lot, therefore, that China decided – in the year 2000 – to approach ASEAN states with the proposal for a possible free trade agreement.

With the realization of this free trade agreement in 2010, it has become very clear that China plays a very important role in shaping the economy of the China-ASEAN free trade area. Without this role, it is clear that ASEAN would not have realized the level of economic growth that it currently boasts of. Therefore, this first hypothesis emphasizes the major role of China in shaping CAFTA's economic fortunes.

Hypothesis 2: Political issues in the eleven CAFTA member states play a very important role in shaping the economy of CAFTA.

This hypothesis contends that politics affects economic issues. It is in order to enhance their political interests in the region that both ASEAN and China choose to participate in CAFTA. This basically implies that participation in CAFTA is dependent on political goodwill on the part of the concerned nations.

Ultimately, political issues actually play a role in determining the economic fortunes of CAFTA. For instance, if China believes that it would be politically detrimental for it to invest in an ASEAN member state like Myanmar, then it would possibly compensate that by investing in Thailand instead.

Alternatively, China could consider reducing its investments in Myanmar and instead increasing investments in Singapore. The other scenario could be a total withdrawal of investments from the country. Ultimately, it would be political reasons may actually dictating the economic outcomes of the China-ASEAN free trade area. This is what this hypothesis is all about.

1.6 Study Methodology

This study was qualitative in design. As a qualitative study, its main focus was on collecting non-numerical data. This is unlike a quantitative study which is more concerned with numerical issues⁴⁵. The study was concerned with the exploration of issues, answering specific questions, and understanding phenomena.

In this case, the study tested the two hypotheses outlined in the preceding section. The phenomena being understood was the economy of CAFTA. Finally, the issues being explored were the factors that affect the economy of CAFTA. As a qualitative research, the study was mainly concerned with answering the 'why', 'what', and 'how' questions arising from and/or pertaining to the phenomena.

Data for the study was collected mainly through secondary research. Here, various documents – including journal articles, books, and websites – were researched and analyzed to reach the study's findings and conclusions.

⁴⁵ John W. Creswell, Research Design: Qualitative, Quantitative, and Mixed Methods Approaches. 3rd ed. (SAGE Publications, 2009), pp.17-24.

The data collected was analyzed by observer impression. This is where the researcher, acting as an independent observer, examined the data and interpreted it by forming certain impressions. Subsequently, a report was made based on the impressions made. More details about the research methodology are presented in the chapter dedicated to research methodology.

1.7 Scope and Limitation of the Study

The current study was restricted to the investigation of the economy of CAFTA. This is the territory occupied by the ten nations that are currently members of the Association of Southeast Asian Nations (ASEAN) and China. Any other nations that might have free trade agreements with either China alone or ASEAN (for instance ASEAN-India) are not included.

The study's scope is also limited to economic aspects of CAFTA only. That is, the study is concerned with investigating only those factors that affect the economy of CAFTA. Cultural, political, social and other non-economic issues are not included.

1.8 Expectations of the Study

Various findings were expected from this study. First of all, it was largely expected that factors related to China's recent rise (in the last three decades) as a leading player in the global economy would be among the most important determinants of the economy of CAFTA⁴⁶. China – the second largest economy in the world – is a very important partner in CAFTA. As such, any factors that affect China's economy were expected to also have an effect – albeit small – on the economy of CAFTA.

Some of the projected factors include both inward and outward FDI, volume of trade, and the economic relationship between ASEAN and other nations in the region as well the relationship between China and the other nations. For instance, the ASEAN-India free trade agreement and the possibility of an ASEAN-EU free trade agreement would

⁴⁶ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

greatly determine the direction of the economy of CAFTA.

Similarly, any possible economic cooperation and free trade agreements (FTAs) between China and other nations such as the EU, the US, Japan, Korea, and Australia (among others) is expected to enhance the economy of CAFTA. This means that the size of CAFTA (in terms of population) is expected to be a key determinant of its economic performance. The higher the population the more economically prosperous the FTA is projected to be. This is because it will prove to be a very large market as well as a source of labor.



Chapter 2

Literature Review

This chapter critically reviews the literature related to the subject matter under investigation. That is, it reviews the literature on and/or related to the economy in general and the economy of CAFTA in particular. The chapter begins by defining and explaining the key features of the both the dependent and independent variables being investigated. It then compares the theoretical frameworks that underpin the dependent and independent variables. From there, the chapter discusses the relationship between the independent and dependent variables. Finally, the chapter carries out a critical review of previous studies pertaining to the economy of CAFTA.

2.1 The Economy as the Dependent Variable

2.1.1 Definition and Features of Economy

The dependent variable⁴⁷ being measured in the current study is the economy. It is dependent because its very nature is determined by a host of other variables. In this case, economy as a variable is used to denote the state of the economy of or the performance of a place (economic performance). It includes economic growth, economic decline, economic prosperity, and economic stagnation. Simply put, 'economy' denotes an economic system. In fact 'economy' and 'economic system' have often been used interchangeably in a number of disciplines/studies.

The term has found widespread use throughout the world. In fact so widespread has been the use of the term that its meaning is almost universally accepted among all disciplines.

The term 'economy' basically refers to the process of production, trade (distribution), and consumption of goods and services in a specified territory or geographical region. The whole process is undertaken by agents which can be individuals, governments, firms, businesses, or organizations. An economy is also the whole range of various economic activities that are undertaken in a territory or geographical region (country, community, or region).

⁴⁷ The variable whose value is determined by the value of other variables.

One notable aspect of the goods and services that are produced, distributed traded, and consumed is that they are limited in supply. The limitation of supply is a critical economic concept which cannot be separated from any discussion of any economic theory. Limited resources and the unlimited wants explain the very concept of economics. In fact economics has been described as the attempt to use the limited resources to meet the unlimited wants.

Having noted that, it is important to point out the other commonly used definition of the term economy which is of great significance in the current study. An economy is a description of the manner in which the aforementioned resources are managed in the concerned territory or geographical region. That is, it describes how labor, money, or materials (resources) are managed with the intention of ensuring that they meet the unlimited wants. Effective management of available resources is the key to ensuring the economy of the concerned geographical region grows or remains within desirable limits.

2.1.2 Theories of the Economy

As was noted in the preceding section, the term economy finds widespread use in both contemporary and classical times. As such, there are many theories that explain or are related to the term. More often than not, these theories have been lumped together and jointly referred to as economic theories. There are many economic theories.

2.1.2.1 Classical Economic Theory

The classical economic theory⁴⁸ is one of the most notable theories of economics which finds application in the current study. This theory – put forth by Adam Smith – contends that when the government allows freedom to prevail in the market, then a lot of wealth will be created when every individual goes about his/her own business⁴⁹. The underlying argument in this theory is that a free market system (*laissez-faire*) where individuals and economic systems are free from control and regulation by state authorities

⁴⁸ For more information about this theory, see Smith, A. An Inquiry Into the Nature and Causes of the Wealth of the Nations, Volume, the Harvard classics Vol. 10. (Publisher: P.F. Collier & Sons. 1909), pp.121-145.

⁴⁹ Akerlof, George Akerlof, “The Missing Motivation in Macroeconomics,” American Economic Reviews, (March 2007), Vol, 97(1): 5-36.

is a better contributor to economic growth and development of nations around the world.⁵⁰

In his landmark book *The Wealth of Nations*, Adam Smith appeared to be advocating for capitalist tendencies in economic management⁵¹. For him, an economy would function at its very best when it was a capitalist economy and not a socialist one. This, he argues, is because socialism entails state control especially with respect to determination of how much an individual can produce in a day.⁵²

On the contrary, capitalism sees every individual independently and willingly choosing not just how much to produce per day but also the way to produce it and the extent to which it is produced. Smith was critical of government interference in commercial activities.⁵³ Living at a time when socialism was widespread, he was concerned in about this. Therefore, he was in a way advocating for a change of attitude on the part of the state.⁵⁴

The theory further has it that in a free market, there is self-regulation which occurs on its own. This self-regulation is what Smith described as the 'invisible hand'. It is this invisible hand that has been equated to capitalism in the contemporary world. Smith noted that it would be imperative for the government or state to adopt a free market attitude.⁵⁵

This way, the so-called 'free hand' would then act as the main guiding factor in the people's economic endeavors⁵⁶. Ultimately, the invisible hand would enable the creation of wealth and the greatest good for the majority of the people. More importantly, economic growth would be generated.⁵⁷

⁵⁰ Hollander, Samuel, *Classical Economics*, 6th ed. Oxford: Blackwell.,1987). pp. 319-338.

⁵¹ Smith, A, op.cit., p. 13.

⁵² Ritzer, G, *Encyclopedia of Social Theory*, 1st ed. (Publisher: SAGE Publications, August 19, 2004). Volumes 1-2.

⁵³ Smith, A. op.cit., p. 13.

⁵⁴ Hollander, S, op.cit., p. 14.

⁵⁵ Solimano, A, *Social Inequality: Values, Growth, and the State*, illustrated. (Publisher: University of Michigan Press., 1998), pp.135-170.

⁵⁶ Smith, A. op.cit., p. 13.

⁵⁷ Hollander, S. op.cit., p. 14.

2.1.2.2 Keynesian Theory

Another very important economic theory is the Keynesian theory⁵⁸ which was put forth by Keynes. According to this theory, the government has a very key role to play in the shaping of the economy.⁵⁹ Through its monetary and fiscal policies, every government can directly and indirectly affect the state of its economy.⁶⁰

For instance, favorable fiscal and/or monetary policies could result in employment creation. When more people are employed in a given country, then the outcome is that fortunes of that country improve. However, a country with high rates of unemployment is at a greater risk of economic decline.⁶¹

Keynesian thoughts were clearly opposed to those of Smith in various ways, the most notable being the role of government⁶². While Smith advocated for a control-free, free-market system, Keynes believed that state control would actually help spur more economic growth and development by enhancing the role of the public sector.⁶³

Keynes—in *The General Theory of Employment, Interest and Money*—takes the general view that without public involvement in economic activities, the private sector alone cannot be trusted to make sound decisions. Therefore, Keynesian economists often adopt the view that at least some degree of state control is necessary to ensure the smooth running of any economy.⁶⁴

According to Keynesian economists, the private sector is prone to

⁵⁸ John M. Keynes, *The General Theory of Employment, Interest and Money*, (Publisher: BN Publishing. 19 January 2009), pp.136-251.

⁵⁹ Fletcher, G, *The Keynesian Revolution and Its Critics: Issues of Theory and Policy for the Monetary Production Economy*. 2nd ed. (London: Palgrave Macmillan., 1989), pp. 24-39.

⁶⁰ Ibid.

⁶¹ Sullivan, A and Sheffrin, S. M, *Economics: Principles in action*. 2nd ed.(Upper Saddle River: Pearson Prentice Hall., 2003), p.411.

⁶² Ibid.

⁶³ Fletcher, G. op.cit., p.15.

⁶⁴ Akerlof, G. A. (2007). "The Missing Motivation in Macroeconomics." *American Economic Reviews*, 97(1): 5-36.

making very erratic decisions when it comes to economic planning and policy responses.⁶⁵ Such decisions more often than not lead to significant inefficiencies in macroeconomic issues.⁶⁶

In this context and in such cases, it becomes imperative for the public sector (the state and state-controlled organizations) to intervene actively. For instance, monetary policy and fiscal policy of the central bank and the government (respectively) are needed to ensure stability of the economy by ensuring that production (output) is stabilized over all business cycles.⁶⁷

Keynesian theory is especially emphatic of the role that government plays in influencing aggregate demand.⁶⁸ Generally, aggregate demand is a strong influencer of economic output especially in the short run (more so in times of recessions as was the case during the Great Depression).⁶⁹

However, it is not always true that aggregate demand⁷⁰ – which is a measure of any economy's total expenditure – equals the concerned economy's productive capacity.⁷¹ On the contrary, aggregate demand is influenced by many other factors which make it to be erratic and difficult to predict.⁷²

In fact aggregate demand affects inflation, employment, and production by virtue of its erratic behavior⁷³. Such erratic movements in aggregate demand could be stabilized by the government when they do occur or before they occur. Therefore, the public sector is equally important – if not more important – in shaping economic outcomes of a nation just like the private sector.⁷⁴

⁶⁵ Fletcher, G, op.cit., p.15.

⁶⁶ John M. Keynes, op.cit., p. 15.

⁶⁷ Sullivan, A., and Sheffrin, S. M., op.cit., p. 15.

⁶⁸ John M. Keynes, op.cit., p. 15.

⁶⁹ Ibid.

⁷⁰ The total amount of products that are bought in an economy.

⁷¹ Fletcher, G, op.cit., p.15.

⁷² Sullivan, A., and Sheffrin, S. M., op.cit., p. 15.

⁷³ John M. Keynes, op.cit., p. 15.

⁷⁴ Ibid.

In accordance with Keynesian theory, it is imperative to examine some of the notable instances when the role of the state is (or could be) important in the stabilization of the economy. In times of crises, government (central bank) policy regarding issues such as interest rates becomes a very important determinant of the direction that the economy takes.

Lowering interest rates would in effect signal to the commercial banks that they, too, need to lower their lending rates.⁷⁵ The economy then experiences less liquidity challenges as more credit is available (as a result of the ease with which credit is available). Since interest rates are indicative of the cost of money, lower rates mean cheaper money in circulation.

It is this higher liquidity that is necessary in jumpstarting an otherwise stagnating or even receding economy⁷⁶. Yet only the central bank (essentially a state or government institution) (through monetary policy) can intervene and set interest rates at a given level.⁷⁷

Regarding fiscal policy⁷⁸, a decision by the government to – for instance – channel more resources into stalled infrastructural projects or to bail out struggling firms would have the effect of jumpstarting an economy in recession or that is stagnating⁷⁹. Through such investments and/or bailouts, liquidity is enhanced.

Furthermore, bailouts of struggling organizations could help save many jobs which would have been lost. The overall result is that the economy recovers significantly⁸⁰. Therefore, this theory is in fact true that state involvement in economic activities cannot be dispensed with.⁸¹

⁷⁵ Ibid.

⁷⁶ Ibid.

⁷⁷ Ibid.

⁷⁸ A policy of the government regarding revenue expenditure. It is how taxes are set and spent in order to influence the economy.

⁷⁹ Fletcher, G, op.cit., p.15.

⁸⁰ John M. Keynes, op.cit., p. 15.

⁸¹ Fletcher, G, op.cit., p.15.

2.1.2.3 Marxism and Social Exploitation Theory

Although the economic theories that Karl Marx fronted have not been as effective in explaining economic issues in contemporary times as in the past, they nonetheless offer great insights into the workings of economies across the modern world. According to Marx, capitalism is largely exploitative of the labor force.⁸²

When capitalists – whom he described as the owners of large enterprises and production processes – have finished setting up their businesses or ventures, they do nothing else to add to the production process⁸³. Instead, they recruit workers who do all the work on their behalf. The workers are then paid not on their terms but on the terms of the employers. According to Marx, this is exploitative.⁸⁴

Marx basically means that although the capitalist sets the means of production, he/she does not produce anything or add any value. All the value is produced by the laborers. Since they were the real creators of value, Marx could have wished that the workers get the most pay. Since, however, they get only a meager fraction of the profits generated as pay, they are exploited.

For Marx, therefore, the notion of a profit-making or the profit-oriented organization was unacceptable⁸⁵. The class struggle which Marx argues is at the very heart of capitalism led Marx to contend that a socialist society where ownership of resources is by the society was the best approach to any economy.⁸⁶

In a way, Marx's views could explain the idea of nations forming free trade agreements. Although the most talked about issue in free trade agreements is the aspect of trade, there is a lot more to contemporary free trade agreements. One such issue is with regard to labor.

Free trade agreements in effect consolidate the labor force and make it possible for there to be a large pool of laborers from which a firm or organization can

⁸² Solimano, A, op.cit., p. 14.

⁸³ Sawalha, N.Nassri, The Role of the Multinational Corporations in Economic Development for Countries with Limited Resources, (United States: ProQuest Information and Learning Co., 2008), pp.7-25.

⁸⁴ Solimano, A, op.cit., p. 14.

⁸⁵ Sullivan, A., and Sheffrin, S. M., op.cit., p. 15.

⁸⁶ Ritzer, G, op.cit., p.14.

get its employees⁸⁷. It is more like nations are struggling to come together so that they could increase their bargaining power in a world where globalization has reshaped virtually all conventional ways of commerce.⁸⁸

Unlike Marx who predicted that the class struggle would ultimately lead to the collapse of capitalism, the kind of struggle being witnessed today is likely to give employees more bargaining power because they have a chance to choose between various employers.⁸⁹ Having noted that, though, it is worth adding that FTAs have the potential of actually frustrating the workers just as Marx predicted.⁹⁰

This could happen if the opening up of international borders lets in workers from other countries where the cost of labor is generally cheaper⁹¹. The local workers have to choose between accepting lower pay from the firms or risk losing their jobs to the foreign (immigrant) workers.

In CAFTA, this is a likely outcome because Chinese workers are likely to pose a serious threat to workers in nations like Singapore and Thailand where wages are comparatively higher than in China. If this happens – and it is highly likely – then exploitation of the workers will no doubt take place because they will have to receive lower pay.⁹²

The result could be for employees to gang up against their employers. While this cannot and will not destroy capitalism as Marx predicted, it nonetheless could have far-reaching, negative implications for the economies of the affected countries.⁹³

Marx also argues that as firms become more efficient, they make a lot more money and grow larger over time. Owing to economies of scale, the large firms are capable of withstanding cyclical crises that face the economy⁹⁴. Over time, a two-class

⁸⁷ Ibid.

⁸⁸ Solimano, A, op.cit., p. 14.

⁸⁹ Ritzer, G, op.cit., p.14.

⁹⁰ Solimano, A, op.cit., p. 14.

⁹¹ Hollander, S, op.cit., p. 14.

⁹² Solimano, A. op.cit., p. 14.

⁹³ Sawalha, N.Nassri, op.cit., p. 18.

⁹⁴ Hollander, S, op.cit., p. 14.

system results. The first class is made up of the owners of the firms who – by virtue of their prosperous firms – are wealthier. The second class is of the laborers who – as a result of systematic and deliberate exploitation – are very poor, underprivileged, and underpaid.⁹⁵

For Marx, this state of affairs encourages people to overthrow the elites and take over the ownership of the production process. That is, the ownership of resources becomes communal. It is by the workers themselves. When ‘the people’ own the means of production in a communist system predicted by Marx, the need for exploitation of labor for individual gain (profit) ceases.

This view by Marx spurred (and even inspired) communist-style approaches to economic issues in the former Soviet Union⁹⁶. Then, communism was seen as the only way to a prosperous society. This was because there was no real sense of individual ownership of property (assets) or the production process. Instead, people were the real owners of the society’s resources with the state acting as the trustee.⁹⁷

In modern-day FTAs, the concept envisaged and supported by Marx could be seen (albeit to a limited extent). This happens when different nations or even regions come together so that they can act as one whole unit as opposed to several disintegrated units. The motive of coming together, however, is different.⁹⁸

In communist Soviet Union⁹⁹, greater integration was to give people a sense of community. Today, though, integration is largely for capitalist reasons – the very capitalism that Marx was opposed to.¹⁰⁰

Although formation of FTAs has helped increase workers’ bargaining power, this power is only applicable or utilizable in negotiating for better working conditions and not necessarily better pay. Actually, facilitation and expansion of trade among the members of the FTAs is the main motive for integration in the 21st century.¹⁰¹

⁹⁵ Solimano, A. op.cit., p. 14.

⁹⁶ Ibid.

⁹⁷ Ritzer, G, op.cit., p.14.

⁹⁸ Sawalha, N.Nassri, op.cit., p. 18.

⁹⁹ The Soviet Union disintegrated in 1989.

¹⁰⁰ Solimano, A. op.cit., p. 14.

¹⁰¹ Ibid.

2.2 Foreign Direct Investment as the First Independent Variable

2.2.1 Definition and Features of Foreign Direct Investment

Foreign direct investment, commonly abbreviated as FDI, is one of the main factors that determine the state of the economy of a region. FDI is basically a form of investment which is done directly inside a given nation or region by another nation or region. The direct investment is made into either a production process or a business.

Although the investment is taken as coming from or being made by a country or a group of countries or even a region, the actual source of foreign direct investment could be an individual firm or company of the given country or region. The company or firm is able to carry out foreign direct investment in two main ways. The first one is by purchasing another firm or company in the target country or region. The second is by expanding its (already existing) operations in the foreign country.¹⁰²

At this moment in time, it is worth pointing out that foreign direct investment is different from portfolio investment in that the latter is a passive form of investment in the securities of another country. This could entail, for instance, the purchase of another country's bonds and/or stocks on the country's stock and/or bond market.

Another feature that sets apart FDI¹⁰³ from other forms of investment is that firms engaging in FDI usually have a significantly large (or even full) level of control and/or influence over the entity in which they invest.¹⁰⁴ That is, the investing entity basically acquires some level of ownership and control over the entity in the foreign country by virtue of investing directly into it. This is unlike in portfolio investment where in spite of an entity owning investments in a foreign firm it has little or no control or influence over the foreign firm's affairs.

The most common method through which foreign direct investment is carried out is mergers and acquisitions¹⁰⁵. However, it is also undertaken through the reinvestment of profits earned from overseas operations and through the establishment of new facilities.

¹⁰² Sawalha, N.Nassri, op.cit., p. 18.

¹⁰³ Foreign direct investment can be direct or indirect, outward or inward.

¹⁰⁴ Sawalha, N.Nassri, op.cit., p. 18.

¹⁰⁵ Ritzer, G, op.cit., p.14.

Some analysts tend to define foreign direct investment in a narrow sense as the building of new facilities. With regard to GDP, FDI can be defined as the net inflow of investments into an economy such that it is possible for the economy to acquire a management interest that is lasting.¹⁰⁶

According to the Organization for Economic Cooperation and Development (OECD), the minimum amount of FDI relationship is 10%. This basically means that any foreign investor is to own no less than 10% of the ordinary shares or voting stock of the company in which one is investing. This basically means that FDI (with respect to GDP) is the difference between the investments a country or region makes outwards and those that are channeled inwards.

There are three main types of foreign direct investment. These are horizontal FDI, vertical FDI, and platform FDI. Horizontal FDI occurs when a firm undertakes a duplication of the activities (at the same value chain stage) it carries out in its home country in the host country. Vertical FDI occurs when the concerned firm uses its FDI to move either downstream or upstream in different value chains. A notable example of vertical FDI is where value-adding activities are carried out stage by stage (vertically) by a firm in the host country.

Platform FDI is a kind of FDI derived from a source country and channeled to a destination country with the sole purpose of exporting to another (third) country. Together with vertical FDI, platform FDI is used to stimulate international trade between two or more countries/regions¹⁰⁷. On the contrary, horizontal FDI actually lowers international trade. This is because all the benefits or products of horizontal FDI are aimed for the host country.

As a general rule, the level of FDI that is channeled into a country or region is directly dependent on that country's or region's attractiveness to foreign investors.¹⁰⁸ A good or favorable investment climate attracts more foreign investments than a less

¹⁰⁶ Sawalha, N.Nassri, op.cit., p. 18.

¹⁰⁷ Ritzer, G, op.cit., p.14.

¹⁰⁸ Balasubramaniam, Arunnan., Puah, Chin-Hong., and Mansor, Shazali.Abu, "Economic Interdependence: Evidence from China and ASEAN-5 Countries," Journal of Modern Economy 3 (2012): 122-125.

favorable or bad investment climate¹⁰⁹. More specifically, economies that are open, those that have good prospects of growth, and those with skilled workforces are more attractive to FDI than those economies which are highly regulated, closed, and/or with unskilled or only semi-skilled workforces.¹¹⁰

It is for this reason that a nation like the US has been the leading destination for FDI in the world. Recently, though, it has been overtaken by China because China has significantly improved its openness, has a fairly skilled (semi-skilled) workforce, and its growth prospects are much better compared to those of the US¹¹¹.

2.2.2 Foreign Direct Investment Theories

There have been many theories put forward to try and explain the existence of FDI. The most common theoretical issues discussed have centered on the need for FDI. That is, FDI theories have tended to deal the decision by firms to invest directly in foreign countries as opposed to – for instance – exporting their products to those foreign countries or even engaging in portfolio investment.

Like most other theories, there is no single theory that has been generally accepted as being the best placed to explain FDI in general and FDI motives in particular. Instead, newer theories have evolved to improve, replace, or correct older ones. Having noted that, though, three FDI theories stand out. These are the eclectic paradigm theory, the internalization theory, and the monopolistic advantages theory.

2.2.2.1 Monopolistic Advantage Theory

According to the monopolistic advantages theory¹¹², firms decide to engage in FDI because they have monopolistic tendencies¹¹³. That is, they are large enough, enjoy both economies of scale and economies of scope, and have the financial

¹⁰⁹ Ritzer, G. op.cit., p. 14.

¹¹⁰ Sawalha, N.Nassri, op.cit., p. 18.

¹¹¹ Ibid.

¹¹² See, for more details, Verbeke, Alain, International business strategy, (Cambridge: Cambridge University Press., 2009), pp. 123-279.

¹¹³ Alan. M. Rugman, “Motives for foreign investment: The market imperfections and risk diversification hypothesis,” Journal of World trade Law (1975): 9 (5) 567-573.

and technological capacity to withstand any challenges in the foreign country they wish to operate in.¹¹⁴

In essence, the theory contends that it is as result of firms having what it takes to compete effectively in the foreign country that they choose to invest their directly as opposed to exporting or using portfolio investments. Advanced by Hymer (1960), this is one of the oldest theories explaining FDI. These firms own advantages which are not available to other firms. Therefore, they have the capacity to use these advantages to their benefit.¹¹⁵

2.2.2.2 Internalization Theory

The internalization theory argues that firms engage in FDI because they find it more beneficial for them to make use of the monopolistic advantages which they possess as opposed to letting other firms use these advantages on their behalf¹¹⁶. That is, firms will decide to engage in FDI because they realize that they have immense advantages which they can make effective use of in the foreign country.¹¹⁷ Yet it is less costly for them to use these advantages by themselves compared to through second parties.¹¹⁸

These advantages are unique to the firms only and so are likely to give them competitive edge in the country where they seek to invest directly. While these firms have the option of using joint ventures as opposed to investing directly, they nonetheless choose the latter because they have determined that the advantages they have can only be maximized when they are used by the firms themselves and not through

¹¹⁴ Verbeke, Alain, op.cit., p. 23.

¹¹⁵ Alan M. Rugman and Verbeke, Alan, Internalization theory and its impact on the field of international business. In J.J. Boddewyn (ed.) International Business Scholarship: AIB Fellows on the First 50 years and Beyond (research in Global Strategic Management, Volum 14) (pp. 155-174). (Emerald Group Publishing Limited., 2008).

¹¹⁶ Ibid.

¹¹⁷ Ibid.

¹¹⁸ John H. Dunning, Alliance capitalism and global Business, (London: Routledge., 1997), pp.1-23.

second parties.¹¹⁹

So the advantages are internalized. This forces the firms to invest abroad on their own or by themselves as opposed to – for instance – through a licensee or a joint venture. Advanced by Buckley and Casson¹²⁰, this theory basically builds on Hymer's monopolistic advantages theory which emphasizes ownership of firm-specific advantages.

2.2.2.3 Eclectic Paradigm

The most widely-used and widely-accepted theory of FDI is the eclectic paradigm. Proposed by Dunning,¹²¹ this is a theory which essentially brings together all the other theories of FDI into one (it is a paradigm, not a theory). This explains the earlier argument that FDI theories have been improving over time.¹²²

According to the eclectic paradigm, firms choose to invest directly into foreign nations because they have three different advantages. These are ownership advantages, location advantages, and internalization advantages.¹²³

Ownership advantages are similar to those that Hymer lays out in the monopolistic advantage theory.¹²⁴ These are those advantages which are unique to a specific firm. They include technological know-how, economies of scale, economies of scope, and a large capital base.

Internalization advantages refer to those benefits that accrue to a

¹¹⁹ Verbeke, Alain, op.cit., p. 23.

¹²⁰ Peter J. Buckley and Mark Casson, The Future of the Multinational Enterprise, (London:Macmillan.,1976), pp. 42-87.

¹²¹ John H. Dunning, "The eclectic paradigm as an envelope for economic and business theories of MNE activity," International Business Review, (2000): 9 (1), 163-190.

¹²² Ibid.

¹²³ Vintila, Denisia, "Foreign Direct Investment Theories:An Overview of the Main FDI Theories," European Journal of Interdisciplinary Studies (1 December 2010): 2 (2), 104-110.

¹²⁴ Alan M. Rugman, "Reconciling Internalization Theory and Electic paradigm," Multinational Business Review (2010): 18 (2), 1-12.

firm when the firm itself utilizes its ownership advantages¹²⁵. These are the same advantages advanced by Buckley and Casson¹²⁶ in the internalization theory. They are advantages which a firm enjoys when it carries out the production process on or by its own as opposed to through licensees or franchisees.¹²⁷

Finally, location advantages are those which a firm enjoys only by operating from a specific location (often in a foreign country). Such advantages cannot accrue to a firm by operating in its current (home country) location. The firm has to move to a place where it can make use of these location advantages¹²⁸. They include mineral deposits and other natural resources.¹²⁹

The gist of the eclectic paradigm (also referred to as the OLI theory) is that firms engage in FDI because they want to make effective use of all three advantages: ownership (O) advantages, location (L) advantages, and internalization (I) advantages.

Basically, therefore, a firm will engage in FDI if it has a number of ownership advantages. However, these ownership advantages may or cannot be fully utilized in the firm's home country. So it has to find a new location or country where its ownership advantages can be put to effective use.¹³⁰

Once a decision has been made to invest in the foreign country, the firm finds that it is more advantageous to it if it internalizes the ownership advantages than if it leases them out to a second party¹³¹. Therefore, instead of licensing its operations abroad, the firm decides to carry out the operations by itself or on its own¹³².

¹²⁵ Peter J. Buckley and Mark Casson, *op.cit.*, p. 24.

¹²⁶ *Ibid.*:

¹²⁷ Alan M. Rugman, *op.cit.*, p.25.

¹²⁸ Vintila, Denisia, *op.cit.*, p. 25.

¹²⁹ Verbeke, Alain, *op.cit.*, p. 23.

¹³⁰ Alan M. Rugman, *op.cit.*, p.25.

¹³¹ Imad A. Moosa, Foreign Direct Investment: Theory, Evidence and Practice, (UK: Palgrave Macmillan., 2002), p. 87-158.

¹³² Vintila, Denisia, *op.cit.*, p. 25.

2.3 Trade as the Second Independent Variable

2.3.1 Definition and Features of Trade

Trade is defined as the exchange of capital, goods, and services. Trade entails the transfer of goods and services from one entity (person, firm, and/or nation) to another in exchange for some kind of reward or payment. When it is done on the international level (between two countries), it is described as international trade.¹³³

The sale of goods produced in one nation to another nation is largely dependent on the manner in which the two nations cooperate. Although trade is generally supposed to be free from any form of political interference, international trade has inevitably come to be determined to a very large extent by politics and international relations. This is because nations have learnt to use trade as a political weapon to punish other nations.

Therefore, trade is largely carried out in the context of cordial political relations. It is almost impossible for two nations to effectively engage in trade without having formal political relations. In not a few instances, the desire for trade has been the driving force for the formation of good political/diplomatic relations between states.

Since trade is basically the main means through which nations can grow their economies (by selling surplus produced), it is a major determinant of the state of any country's or region's economy. How established a country or region's trade is determines how much foreign currency it earns and so how much resources it has at its disposal to use for investments in other sectors of its economy.

Different nations approach trade differently depending on the goals they seek to achieve. Some nations have open economies where trade with other countries is free and largely unregulated. Other states, however, have closed economies and as such normally closely regulate their trade.

As a rule, free trade tends to promote economic growth more than restricted trade.¹³⁴ Restriction of trade usually occurs through the imposition of different barriers. These barriers serve to make it hard or impossible for certain nations to sell their goods to

¹³³ William J. Bernstein, *op.cit.*, p. 5.

¹³⁴ Ong, H..B., and Habibullah, M. S. "Is China compatible with ASEAN+5? A gradual cointegration analysis," *Journal of Economic Studies* 39 (2012): (3) 356-367.

other nations. This is done to achieve different objectives such as to protect domestic industries and discourage dumping. Tariffs and quotas imposed by governments are among the common restrictions to trade available.

Actually, trade restriction has become more of the rule and not the exception in modern commerce. As a result, it is more of a favor or a deviation from the norm when two or more nations (or groups of nations) decide to form a free trade area. In fact there are so few free trade agreements/areas in the world that they can be easily counted.

Free trade areas and free trade agreements are formed to give nations or regions the chance to increase the level of trade between them. Free trade basically ensures that the cost of trading or selling and buying one's products from the other nation becomes lower. This is because restrictions such as quotas and tariffs are either removed or lowered significantly.

2.3.2 Theories of Trade

A number of theories have been put forth in an attempt to conceptualize trade in general and international trade in particular. These theories vary significantly in a number of aspects. However, they also converge in many ways.

Like most other theories, older theories have been improved by newer ones. This does not mean that older theories no longer hold true. It means instead that the times have changed and some of the issues addressed at the time might have changed. Since international trade is the focus of the current study, theories explaining international trade will be the focus of this section.

2.3.2.1 The Absolute Advantage Theory

This theory, advanced by Adam Smith, contends that nations engage in trade because they have some kind of absolute advantage over each other¹³⁵. This basically means that a nation will only trade (sell or buy capital, goods, and services) with another country if one of the countries has an absolute advantage over the other with regard to what is being traded. Nations that are on the same level cannot trade with each other because each will find itself satisfied with what it has.¹³⁶

¹³⁵ William J. Bernstein, *op.cit.*, p. 5.

¹³⁶ *Ibid.*

Absolute advantage¹³⁷ is in this case a measure of how cheaply one nation can produce and sell a product relative to another nation. That is, a country has absolute advantages over others if it can produce the same product using fewer resources. The country with absolute advantage in the production of a given product will be able to produce that product more cheaply than a country that lacks such absolute advantage.¹³⁸

In view of this, it will be much easier and less costly for the country with absolute advantage to produce a product for sell to other countries that lack absolute advantage in the production of the same product. The idea is to produce only what one is able to beneficially produce. Otherwise buying from another country would be more beneficial.

Therefore, only countries with absolute advantage in certain areas of production will produce products in those areas¹³⁹. They will then sell the surplus to the countries without absolute advantage.

Similarly, countries without absolute advantage will buy those products which they cannot produce from those countries with absolute advantage. This way, trade becomes inevitable¹⁴⁰. Since different countries are endowed with different resources, their absolute advantage varies. The outcome is that countries rely on each other to satisfy their needs. This satisfaction is achieved mainly through international trade.¹⁴¹

This theory is one of the best when it comes to explaining international trade. Absolute advantages that states have could be brought about by economies of scale and availability of large natural deposits. Technological know-how could also add to a country's absolute advantage. This absolute advantage means that some nations will always have an upper hand in the production of specific products¹⁴². Others will not have such advantages. So the need for trade arises.

The other notable success of this theory is that it actually portrays trade as a positive-sum game. This is as opposed to mercantile theories which contend

¹³⁷ Smith, A, op.cit., p. 13.

¹³⁸ Ha-Joon Chang, Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism, (United States: Bloomsbury Publishing Co., 2010), pp.79-158.

¹³⁹ Ibid.

¹⁴⁰ Ibid.

¹⁴¹ William J. Bernstein, op.cit., p. 5.

¹⁴² Ibid.

that international trade is a zero-sum game where only one country reaps the benefits while the other country suffers losses.¹⁴³

There is positive gain for both countries engaging in international trade. The one with absolute advantage may have the advantage in producing a given product. However, that product cannot totally benefit the country unless it can sell it to another (different) country.¹⁴⁴

Absolute advantage in the production of a product almost always results in excess or surplus production. This calls for export. If all other countries in the world had absolute advantage in the production of that same product, then there would be nowhere to sell. The excess or surplus product would go to waste. However, the fact that some nations have absolute advantage while others lack it means that there is no wastage of any resources.¹⁴⁵

Having argued that way, though, it is worthy pointing out some flaws in the absolute advantage theory. The question that arises is with regard to what would happen if all countries in the world had no absolute advantage in the production of a certain commodity. If this was the case, it is evident that trade would not take place because every country would find it uneconomical to produce the concerned product. To overcome the flaws of the absolute advantage theory, the comparative advantage theory was postulated.¹⁴⁶

2.3.2.2 Comparative Advantage Theory

Put forth by Ricardo, the comparative advantage theory focuses on the advantages that nations have in terms of their marginal costs and opportunity costs.¹⁴⁷ The theory argues that two different nations will possibly be able to produce the same

¹⁴³ Ha-Joon Chang, op.cit., p. 28.

¹⁴⁴ Laurenceson, J, "Economic Integration between China and ASEAN+5," ASEAN Economic Bulletin 20 (2003) (2), 103-111.

¹⁴⁵ William J. Bernstein, op.cit., p. 5.

¹⁴⁶ Ha-Joon Chang, op.cit., p.28.

¹⁴⁷ Bondreaux. Joseph Boudreaux, Greenwood Guides to Business and Economics, 2nd ed. (Greenwood press Co., 2008), pp.37-117.

product at the same level of efficiency.¹⁴⁸ However, they cannot produce that product at the same relative efficiency.¹⁴⁹ So this difference necessitates trade between the two countries.

The gist of this theory is that in spite of the possibility that a country could produce a product more efficiently than another country, a lot of gain will be obtained through trade. This is as long as the two countries' relative efficiencies differ.¹⁵⁰

Opportunity cost is a very important factor in this theory¹⁵¹. Nations will carefully consider their production processes and determine the opportunity costs they might incur by producing certain items and not others¹⁵². This then helps them to focus only on those products which they can produce at no or very minimal opportunity cost. This then means that trade with other countries will be necessary to overcome any shortages arising from decisions to concentrate on one product and not the other¹⁵³.

The theory of comparative advantage is based on two main assumptions. The first is that the main input into the process of production is labor¹⁵⁴. The second is that there are country-specific and government-specific differences in the relative labor ratios at which it is possible to trade off the production of one product for the production of another product.¹⁵⁵

Like the absolute advantage theory, the comparative advantage theory explains exhaustively why nations will inevitably trade with each other¹⁵⁶. The theory underscores the fact that regardless of the efficiencies any specific country might

¹⁴⁸ Ha-Joon Chang, op.cit., p.28.

¹⁴⁹ Dondreaux. J. Boudreaux, op.cit., p. 30.

¹⁵⁰ Paul A. Samuelson, "A Ricardo-Sraffa Paradigm Comparing the Gains from Trade in Inputs and Finished Goods," *Journal of Economic Literature* 39(2001): (4)1204-1214.

¹⁵¹ Dondreaux. J. Boudreaux, op.cit., p. 30.

¹⁵² Shiozawa, Yoshinori. "A New Construction of Ricardian Trade Theory: A Many-country, Many-commodity with Intermediate Goods and Choice of Techniques," *Evolutionary and Institutional Economics Review* 3 (2007): (2), 141–187.

¹⁵³ Dondreaux. J. Boudreaux, op.cit., p. 30.

¹⁵⁴ Ha-Joon Chang, op.cit., p. 28.

¹⁵⁵ Shiozawa, Yoshinori op.cit., p. 30.

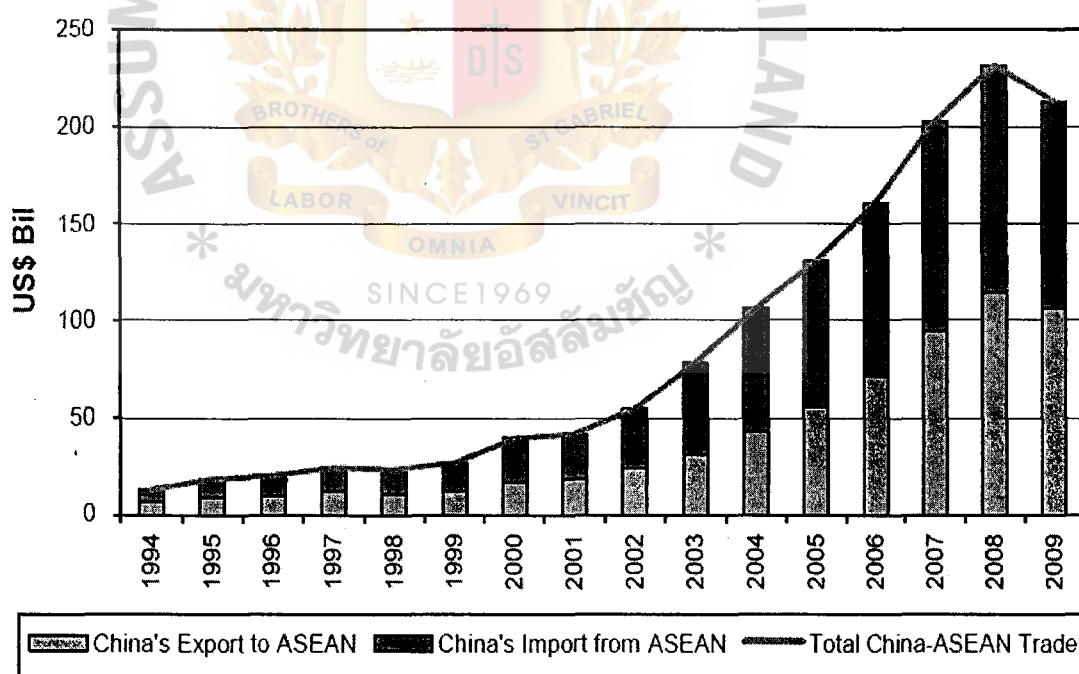
¹⁵⁶ Ibid.

have in the production of certain goods, it will still – at one time or another – have to depend on other countries for certain products which it finds uneconomical to produce on its own. The theory emphasizes the fact that interdependency among nations is inevitable.¹⁵⁷

When applied to the current study, it can be clearly established that ASEAN states cooperate with China for more-or-less the same reasons. Either they cannot produce certain products at all or if they do produce them they do so at a higher opportunity cost than if they were to buy them from China. The converse is also true.¹⁵⁸

This, then, means that China needs ASEAN just as ASEAN needs China.¹⁵⁹ Of course there is the possibility that one side could potentially do without the other. However, that side would still have to find another trading partner as a replacement.¹⁶⁰

This is because the volume of trade between the two sides is high and increasing (see figure 1 below). ASEAN needs China because China has become one of its major markets. On the other hand, China needs ASEAN because ASEAN is providing China with the much-needed raw materials needed to fuel its growing industrial sector. This mutual relationship has to be sustained somewhat.



¹⁵⁷ Ha-Joon Chang, *op.cit.*, p. 28.

¹⁵⁸ Shiozawa, Yoshinori, *op.cit.*, p. 30.

¹⁵⁹ Dondreaux. J. Boudreaux, *op.cit.*, p. 30.

¹⁶⁰ Ha-Joon Chang, *op.cit.*, p. 28.

Figure 1: China-ASEAN Total Trade.

Source: China's Customs Statistics.

2.3.2.3 The Heckscher–Ohlin Theory

According to this theory that was put forth by Eli Heckscher and Bertil Ohlin, nations are inclined to export those products which they can produce more cheaply and import those which they find more costly to produce¹⁶¹. This means that this theory is based on country-specific differences in factor endowments. Ultimately, those countries with more (and comparatively cheaper) resources (such as labor and raw materials) will produce and export more of those products resulting from those particular resources.¹⁶²

On the contrary, the same countries will not produce (and sell) any products whose factors of production are either very costly in the country or are in short supply (or both). This means that international trade is inevitable.¹⁶³

The theory is based on the assumption that the concerned countries are identical in everything else but their resource endowment. One country is resource-rich while the other is not. Therefore, the resource-rich country produces more and sells the surplus to the other country.¹⁶⁴

This theory also succeeds in explaining the motivation for international trade.¹⁶⁵ The fact that some nations are more materially-endowed or resource-endowed than others means that they can produce certain products more efficiently¹⁶⁶. As a result of this unique capability, they cannot help but generate surplus

¹⁶¹ Dennis R. Appleyard, International Economics, 8thed. (McGraw-Hill Education., 2013), pp.234-467.

¹⁶² Robert C. Feenstra, "The Heckscher–Ohlin Model". Advanced International Trade: Theory and Evidence. (Princeton: Princeton University Press.,2004), pp. 31-111.

¹⁶³ Dennis R. Appleyard, op.cit., p. 32.

¹⁶⁴ Ibid.

¹⁶⁵ Robert C. Feenstra, op.cit., p. 32.

¹⁶⁶ Ibid.

production. It is this surplus that they have to sell to other nations – those nations which find it a lot more costly to produce the same products at the prevailing market conditions.¹⁶⁷

In the case of China and ASEAN, it is more advantageous for ASEAN to buy electronics from China because China produces them more cheaply owing to its abundant labor (cheap labor) and overall low cost of production¹⁶⁸. On the other hand, China finds it more advantageous to import raw materials such as cotton (which is abundant in a number of ASEAN states) from ASEAN. So trade between the two thrives on the differences in resource-endowment between them.¹⁶⁹

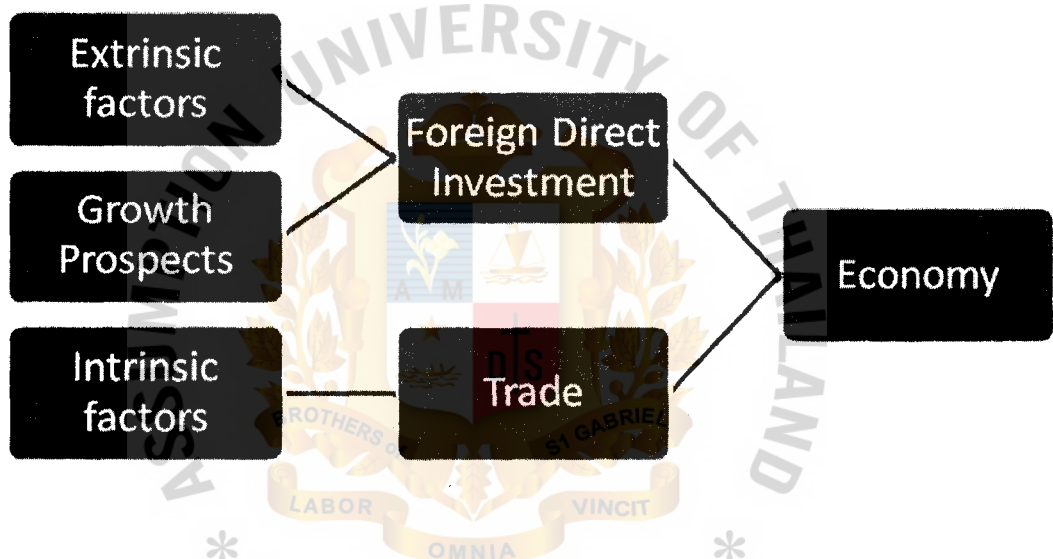


Figure 2: A conceptual Framework showing the relationship between the independent and dependent variables.

Source: Created by author

2.4 Previous Studies

The whole issue of the relationship between China and ASEAN has attracted a fair share of literary attention. Although not many scholarly studies have been done on the economies of the combined China-ASEAN FTA, media interest has been immense.

¹⁶⁷ Dennis R. Appleyard, *op.cit.*, p. 32.

¹⁶⁸ Robert C. Feenstra, *op.cit.*, p. 32.

¹⁶⁹ Dennis R. Appleyard, *op.cit.*, p. 32.

Various themes have kept coming out with regard to what has been researched in the past. Some of the common literary commentaries on the subject are discussed in this section.

2.4.1 Closer and Tightening Bilateral Ties

That China and ASEAN are moving ever closer together and tightening their bilateral relations is in not in doubt. Many commentators have written on this subject extensively, pointing out some of the factors that are responsible for the thaw in relations between the two sides. Generally, the fact that both China and ASEAN are in need of reliable trading partners for the betterment of their respective economies has been a major driver of closer ties between the two.

On its part, China's economic rise and its growing demand for raw materials to drive its burgeoning industrial sector have been two critical factors cited as pushing the country into deeper and closer relationship with ASEAN¹⁷⁰. In ASEAN China sees an opportunity to tap raw materials from near its own territory. With an expanded territory (from five members in 2004 to 10 in 2010), China perceives ASEAN as one of the largest sources of its raw materials and other imports it needs to drive its growing economy.

In ASEAN China has also found a critical market for its exports. Since ASEAN is made up of mostly emerging economies that include Philippines, Burma and Vietnam, China considers it a trading and investment partner which has a lot of potential for growth.

On its part, ASEAN finds China to be not only an indispensable trading partner but also an investment one. China's economic rise of the recent past has added impetus to the ASEAN-China relationship.

ASEAN finds China to be a reliable and more proximate partner than other former economic partners such as the US. China's growth and expansion means that ASEAN can be assured of a ready market for its exports – most of which are raw materials that are in high demand in China.

2.4.1 Compatibility between China and ASEAN

The other theme that has found significant scholarly attention is with regard

¹⁷⁰ Li, M., and Kwa, C. G, op.cit., p. 2.

to the compatibility between China and ASEAN. Generally, argue Ong and Habibullah¹⁷¹, any successful economic community such as CAFTA ought to be compatible. That is, the member states that make up the economic community or the free trade area ought to be compatible with each other at least in the economic sense.

Compatibility helps ensure that the nations converge on most (if not all) issues of great mutual interest¹⁷². Macroeconomic compatibility is especially important for China and ASEAN especially in view of their intended continued integration. To this end, it has been established that China and ASEAN have been compatible in most ways.

Although the compatibility could change as more members are included in the agreement, it is known that there was significant compatibility between China and five of the current ten members of ASEAN. These are Indonesia, Malaysia, Philippines, Singapore, and Thailand.

Continuous compatibility is essential for the future collaboration between China and ASEAN.¹⁷³ In this study, it was also found that continuous macroeconomic interdependence between China and the five partners is necessary if the economic cooperation between China and ASEAN is to work. If similar treatment could be extended to the other five member states, then the better for CAFTA's future prosperity.

The basis for this kind of reasoning is that any smooth transition that takes place in the China-ASEAN free trade agreement will in effect be complementary to the ASEAN free trade area. As such, a very effective ASEAN-China coordination plan is essential for the endorsement of a coalition between China and ASEAN. This study used business cycles to measure the compatibility between China and ASEAN+5.

The other studies which deal with issues of compatibility are those conducted by Ong and Habibullah¹⁷⁴ as well as by Balasubramaniam, Puah and Mansor¹⁷⁵.

¹⁷¹ Ong, H. B., and Habibullah, M. S., op.cit., p. 27.

¹⁷² Li, M., and Kwa, C. G, op.cit., p. 2.

¹⁷³ Ibid.

¹⁷⁴ Ong, H. B., and Habibullah, M. S, "The ASEAN-5 Economic Alliance: A Time Varying Convergence Analysis," International Research Journal of Finance and Economics, 8 (2007): 97-106.

¹⁷⁵ Balasubramaniam, A., Puah, C., and Mansor, S. A. "Economic Interdependence: Evidence from China and ASEAN-5 Countries" Modern Economy 3(2012): 122-125.

Both studies are in agreement that ASEAN+5 and China have common business cycles. The five ASEAN states used in both studies are Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

The implication of the findings is that going forward China and these five ASEAN states will be able to complement each other as far as business cycles are concerned. They further imply that it is a good thing for China and the five to forge even greater and closer economic cooperation between them.

The issue of convergence is underscored in these studies. Regional convergence – especially among nations forming an economic union (such as a free trade area) – is paramount as it enhances the future success of the economic union. As such, understanding the possible long-term implications of any continued economic cooperation between China and the five is paramount.

Although both studies emphasize the five and leave out another five, it does little harm to the current and future state of CAFTA because the older five covered here could be expected to lead the other five that were left out. That is, even if the five member states of ASEAN not covered in these studies were to be incompatible with China (with regard to business cycles) there would not result any significant business cycle divergences between China and ASEAN.

There are some differences between the two studies, though. Habibulah¹⁷⁶ finds that although there is general convergence between China and ASEAN+5, the level of convergence is slightly different for each of the five. More specifically, he finds that three states are more economically coordinated with China than the other two. The three are Malaysia, the Philippines and Thailand.

Using real GDP to measure convergence, Habibulah also finds that it is these three nations that will inevitably have to drive forth the CAFTA free trade area. It is therefore for the three to come up with appropriate and workable guidelines regarding further integration if cooperation efforts at the regional level are to be accelerated.

Habibulah also finds that owing to the obvious differences between the older ASEAN states and the newer ones¹⁷⁷, it would be for the benefit of the new

¹⁷⁶ Ong; H. B., and Habibullah, M. S, op.cit., p. 35.

¹⁷⁷ For a list of the ASEAN states, see Gerald W. Fry, The Association of Southeast Asian Nations, (New York: Chelsea House 2008), pp. 41-105.

coalition (China-ASEAN) to have separate guidelines for the new ASEAN states such as Vietnam, Laos, Myanmar and Cambodia. In conclusion, Habibulah makes a very important argument. According to him, the future success of CAFTA will also depend not just on the economic convergence but also on how sincere the political leaders are and how natural disasters and their impact will affect the economy of CAFTA.

The two studies undoubtedly point out very important issues pertaining to the China-ASEAN coalition. It is not debatable that convergence is paramount especially when it comes to business cycles.

However, another important area of convergence would be politics as (Habibulah notes). Political goodwill is particularly important given the historical background of a number of ASEAN states and China.

As the largest state in the Asian continent and the dominant player in the Southeast Asian region, China is largely considered a 'big brother' by the other ASEAN states. Therefore, what it has done outside economic circles could negatively affect CAFTA.

More specifically, the security concerns that exist in some ASEAN states (such as the Philippines) ought to be resolved in an amicable manner¹⁷⁸. China has from time to time insisted that it would use diplomacy to address its conflict with the Philippines regarding the South China Sea dispute. How China follows this up is no doubt going to determine how the relationship between China and ASEAN will fare.

Regarding natural disasters, it is very clear that they have had a very negative impact on the economy of ASEAN states in particular¹⁷⁹. Natural disasters have also generally been known to cause as serious economic repercussions as recessions.

In Asia, a number of states have been economically affected by natural disasters. They include Japan (the Fukushima nuclear plant disaster) and the Philippines (earth quakes and tropical storms). Therefore, the threat of natural disasters on the economy of China-ASEAN is very real¹⁸⁰. The aftermath of disasters will be a very important determinant of how CAFTA fares economically¹⁸¹.

¹⁷⁸ Moore, M, op.cit., p. 2.

¹⁷⁹ Ibid.

¹⁸⁰ Coates, S. op.cit., p. 4.

¹⁸¹ Moore, M, op.cit., p. 2.

2.4.3 Getting Priorities Right: ASEAN's Place in China

There has been significant literary attention on the issue of how each side of the China-ASEAN divide regards the other with respect to critical international issues. More often than not, ASEAN states have tended to imply – or even openly claim – that China is not giving them the kind of attention they desire or deserve.¹⁸²

They have pointed out from time to time that ASEAN is never on China's agenda whenever China deals with or addresses critical issues of international magnitude. According to ASEAN, China seems to be giving more priority to other nations at their expense.

The accusations and concerns have generally resulted in proactive and deliberate measures by Beijing aimed at assuring ASEAN that it is a very important partner of China. China has been using high-powered delegations to visit ASEAN states as a way of passing the message that ASEAN is a very important partner of China. Promises to upgrade the trade and investment level between the two have also underscored China's commitment to ASEAN.

Having noted that, however, it is imperative to add that China has not been able to allay all the concerns that at least a number of ASEAN states have. The pertinent issue of security has kept emerging and is threatening any future integration efforts between the two sides. Sino-Philippines relations have especially been rocky as a result of disputes in the South China Sea.¹⁸³

However, every other member of ASEAN has been positive that the conflict notwithstanding, CAFTA is going to remain on course with regard to deepening of relations. This underscores not only the concerns that both sides might have regarding continued cooperation but also points out some of the most strategic interests that will ultimately determine how the free trade agreement fares in future.

For China, it is evident that strategic interests are very important¹⁸⁴. They are even more important when they touch on the issue of China's security. Moreover, China would not love to have any meddling by the US in the region. Therefore, the issue

¹⁸² Coates, S. *op.cit.*, p. 4.

¹⁸³ *Ibid.*

¹⁸⁴ Moore, M, *op.cit.*, p. 2.

of Philippines – which is threatening not only Chinese-ASEAN relations but also Sino-US relations – is likely to receive careful attention.¹⁸⁵

So far, China has been taking a cautious approach to the dispute, not wanting to be seen as the cause of tensions. Such perceptions are surely bound to negatively affect China's relations with ASEAN.

Still, China will have to defend its non-economic interests such as security in the South China Sea. That China has been very emphatic on the need for all disputes pitting it and ASEAN states to be resolved amicably is the clearest indication ever that it prioritizes its economic issues more than security ones.

In the past – specifically before China joined the WTO – it would have been difficult or even impossible for China to risk its security for economic gains¹⁸⁶. That this is happening now means that China is realizing that it has more to gain by cooperating with ASEAN than by being in conflict with it¹⁸⁷. Going forward, it will be interesting to see how the delicate balancing act by China plays out.

2.4.4 Community of Common Destiny

China and ASEAN have also been operating from the framework of a common future destiny¹⁸⁸. Both sides are in agreement that they want their relations to go beyond the present to include all future activities. What this means in effect is that China is not just seeking economic prosperity from ASEAN. There is much more to the cooperation.

For China, sharing a common future side by side is also a major drive for deepening Sino-ASEAN relations. Analysts believe that this is a very ambitious venture on the part of China; and will be the inevitable determinant of all future engagements. If China-ASEAN relations can indeed achieve this goal of sharing a common future side by side, then the alliance will have attained a very elusive goal and made a major breakthrough.

One issue that comes to the fore whenever China and ASEAN express a

¹⁸⁵ Saw S. Hock, op.cit., p. 3.

¹⁸⁶ China Daily “China-ASEAN FTA pact set to boost trade volume,” *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

¹⁸⁷ Saw S. Hock, op.cit., p. 3.

¹⁸⁸ Moore, M, op.cit., p. 2.

desire to work together on a level playing field is the question of how their differences will be resolved. Analysts believe that China is still not a trustworthy political partner for ASEAN even though it may be (and has proven to be) a very reliable economic partner.¹⁸⁹

There is evidently more to a shared future – side by side – than just economic cooperation. How could China possibly share a future with ASEAN states it has bullied in the past (and might still want to bully if they persist in seeking closer ties with China's arch rival in the region (the US)?

Well, that is where the stumbling block actually lies. Will China- ASEAN relations manage to steer clear of the political differences inherent between the two sides?

As has been noted before, a common destiny will have to include a common security goal. Yet China's security goals are generally regarded as being dissimilar to those of ASEAN. At least since the end of the Cold War, China no longer needs the cooperation of ASEAN states in forming a mutual defense pact. In fact there is no such significant security threat now as there used to be in the Cold War¹⁹⁰ days.

However, the fact that states such as Cambodia and Vietnam (active participants in past conflicts) means that China does not really need to be concerned about new security threats. The only viable threat lies in Philippines's continued provocations by 'snatching' islands in the South China Sea. This provocation will have to be addressed sooner rather than later by China.

Clearly, the counterbalancing role of the US in the region is something China wants to see an end to. Since it is this US presence that has apparently emboldened the Philippines to act as it has been doing, China will have to make a decision regarding its security along its eastern and Southeastern coasts. That decision will inevitably have to impact its relations with ASEAN because the Philippines will be affected.

If and when China takes action to reclaim its territory from the Philippines, the rest of ASEAN will undoubtedly interpret the move as China bullying the smaller Philippines. This will undoubtedly have implications for China-ASEAN relations. Bottom-line is that the situation is very delicate and potentially explosive depending on how China reacts.

¹⁸⁹ Ibid.

¹⁹⁰ The Cold War, which pitted the US against the Soviet Union, effectively ended in 1989 with the collapse of the Soviet Union.

As a rising nation with high-standing on the international arena, China is also keen to portray itself as a nation warranting international recognition and respect. To achieve this, it has to demonstrate that it is no longer the China that engaged in expansionist tendencies as was the case in the past. China will have to prove that it respects its neighbors and treats them – regardless of their smaller size – with mutual respect. More importantly, China's human rights record will have to be improved significantly.

Through closer ties with ASEAN, China hopes to redeem itself at least in some of the areas where it has failed in the past. More importantly, by courting ASEAN states closely, China seeks to demonstrate not just to ASEAN but to the whole world that its priorities have changed from political issues to economic ones.

Peace and stability in the greater Eastern Asia region is paramount for China. Without such stability there will be no economic benefits to be enjoyed. So China is keen to use ASEAN to advance the peace and stability of the region.¹⁹¹

2.4.5 Competing Rather than Complementary: ASEAN Concerns

Another theme that has attracted attention from mostly economist is that regarding the nature of the free trade agreement between China and ASEAN. Although the agreement has been lauded by both sides as a milestone in trade ties between them, some analysts are skeptical about the mutual benefits expected.¹⁹²

It is generally believed that this cooperation is largely based on competition as opposed to complementation¹⁹³. That is, Chinese goods and investments pose a direct threat to those of ASEAN states. This has in turn been more destructive to ASEAN states' economies than would have been expected.

Any free trade agreement is best suited for nations with complementary

¹⁹¹ Ibid.

¹⁹² China Daily "China-ASEAN FTA pact set to boost trade volume," China Daily (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

¹⁹³ China Daily "China-ASEAN FTA pact set to boost trade volume," China Daily (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

cycles of trade and business. This way, the shortcomings of one side are naturally overcome by the other side.

In the case of CAFTA, though, Chinese products will be in competition with ASEAN products. This is because both sides produce and export a number of similar products.

For instance, China imports a lot of energy products. ASEAN does the same. Furthermore, China produces many consumer and industrial products. ASEAN states have the same. This means that competition is going to be enhanced, and this could spell trouble for the less buoyant economies of a number of ASEAN states (especially the new entrants).

Indonesia, for instance, has been on record opposing the free trade agreement between ASEAN and China.¹⁹⁴ This has been on grounds that Chinese cheap imports will flood the domestic market in Indonesia and possibly help kill local industries.

Indonesia's concerns are a cause for concern. This is because they are in every sense true. China is currently ranked the world's largest exporter and the second largest importer. It is also the world's leading destination as far as FDI is concerned. This is because China is favorable for manufacturing and other production process. This means that the cost of production in China is far less than that anywhere in the world.

Compared to China, ASEAN will face higher costs of production¹⁹⁵. This will mean that Chinese exports to ASEAN will indeed be very cheap compared to products produced locally in ASEAN. Industries like electronics, steel, iron, and textiles are likely to suffer the most because China produces and exports products produced from similar industries.

The only hope that ASEAN states have – especially those with industries similar to those of China such as Indonesia – is to renegotiate their tariff plans with China. This way, they would ensure that some tariffs remain in place until such a time as

¹⁹⁴ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

¹⁹⁵ Alexander J. Yeats. *Just How Big is Global Production Sharing?* In S. Arndt and H. Kierzkowski (eds.), *Fragmentation: New Production Patterns in the World Economy*, (Oxford University Press., 2001), p.63-178.

when the local industries are established enough to compete with Chinese goods.¹⁹⁶

Although the above argument is true, it is nonetheless worth pointing out that such concerns have been taken into consideration. There is no doubt that both sides considered the pros and cons of their free trade agreement before the agreement was implemented. Therefore, these concerns could be unfounded.¹⁹⁷

In fact it might be better for ASEAN states that China is included in the free trade agreement. This basically means that these states have no option but to restructure their economies so as to become more competitive.

Competition has a way of helping otherwise struggling economies to get established and become more resilient. This is likely to happen to ASEAN states. As Chinese investments and exports are likely to compete with theirs, they will have to find very clear-cut ways of ensuring that they are not out-competed.

Summary

Having critically reviewed the literature, a number of conclusions can be drawn at this moment. First of all, it is clear that a number of issues regarding CAFTA have been written about in the literature. These include the challenges facing CAFTA, the possible reasons why CAFTA was formed, and the determinants of continued mutual cooperation between China and ASEAN.

From the literature, a number of theories explaining critical variables like trade, FDI, and economy were also found to be widely available. Generally, therefore, there is a significant amount of literature available on the subject of China-ASEAN free trade area. This literature is mostly commentary by the media, key players in the CAFTA agreement, and economists.

Having examined this literature in a critical capacity, however, there are evident gaps. For instance, there is only scant literature on the factors that affect the economy of CAFTA. Even the scant literature there is on the subject is not specific on CAFTA but adopts a broader view and general perspective. Therefore, the current study will be filling this gap by expressly researching the factors that affect the economy of

¹⁹⁶ Ibid.

¹⁹⁷ The free trade agreement, in my view, benefits both ASEAN and China. They need each other in more ways than just trade.

CAFTA.

It is worthy adding here that from an examination of the three main theories explaining the economy, it can be deduced that socialism and capitalism are a core aspect of the China-ASEAN free trade agreement. On the one side, China is heavily socialist. On the other side, ASEAN is capitalist. This might appear to be a challenge for the two sides regarding trade and investment.

However, research indicates that the two models are actually complementary in the case of China and ASEAN. This means that the weaknesses of the capitalist model are overcome by the socialist model. In the same way, weaknesses of the socialist model are overcome by the strengths of the capitalist model.



Chapter 3

Research Methodology

The methods used to collect data for any study are the main determinants of the overall success of the study. This chapter lays out the methodology adopted in the research. It covers the methods of collecting data, the research design, and the research strategy. It also includes an explanation of the method used to analyze the data.

3.1 The Research Design

This study was qualitative in design. As a qualitative study, its main focus was on collecting non-numerical data. This is unlike a quantitative study which is more concerned with numerical issues¹⁹⁸. The study was concerned with the exploration of issues, answering specific questions, and understanding phenomena¹⁹⁹. The issues that were explored were the factors that affect the economy of CAFTA. In this case, the study tested the hypotheses are as follows:

There are a lot of factors affecting China ASEAN Free Trade Area (CAFTA), both economic and political ones, including economic theories, complementarity of the economies, intra and extra political conflicts, and other related factors. However, the CAFTA shall continue to prosper despite these factors.

Hypothesis 1: China's rise to become the world's second largest economy is the major factor affecting the economy of CAFTA.

This hypothesis tested the role that China as a state has played in shaping the economy of CAFTA. China's economic reforms that began about 30 years ago have resulted in a nation that is very prosperous not just economically but also politically. China is today the world's second largest economy after the US. It is the world's fastest

¹⁹⁸ John W. Creswell, Research Design: Qualitative, Quantitative, and Mixed Methods Approaches, 3rd ed. SAGE Publications., 2009. p. 3-22.

¹⁹⁹ Norman K. Denzin., and Yvonna S. Lincoln, The Sage Handbook of Qualitative Research, 3rd ed. (Thousand Oaks, CA: Sage., 2005), pp. 7-23.

growing economy with an average annual growth rate of 10% in the last 30 years.²⁰⁰

That China has been able to achieve such a great feat in so short a time has raised a lot of interest among businesses and nations. In the last few years, China's economy has been transformed from one of a poor, struggling, developing nation into the second largest in the world. It means a lot, therefore, that China decided – in the year 2000 – to approach ASEAN states with the proposal for a possible free trade agreement.

With the realization of this free trade agreement in 2010, it has become very clear that China plays a very important role in shaping the economy of the free trade area. Without this role it is clear that ASEAN would not have realized the level of economic growth that it currently boasts of. Therefore, this first hypothesis emphasizes the major role of China in shaping CAFTA's economic fortunes.

Hypothesis 2: Political issues in the eleven CAFTA member states (China + ASEAN 10²⁰¹) play a very important role in shaping the economy of CAFTA.

This hypothesis argued that politics affect economic issues. It is in order to enhance their political interests in the region that both ASEAN and China have chosen to participate in CAFTA. This basically implies that participation in CAFTA is dependent on political goodwill on the part of the concerned nations.

Ultimately, political issues actually play a big role in determining the economic fortunes of CAFTA. For instance, if China believes that it would be politically detrimental to invest in an ASEAN member state like Myanmar, then it would possibly compensate that by investing in Thailand instead. Alternatively, China could consider reducing its investments in Myanmar and instead increasing investments in Singapore.

The other scenario could be for China to totally withdraw all its investments from the country. Ultimately, it would be political reasons actually dictating the economic outcomes of the China-ASEAN free trade agreement. These are the issues which this hypothesis sought to test.

The choice of qualitative research as opposed to quantitative research was because the study required qualitative data. Qualitative data can only be collected using (or from)

²⁰⁰ Wayne, M. Morrisson. "China's Economic Rise History, Trends, Challenges, and implications for the United States," Congressional Research Service RL335434, at <http://www.fas.org/sgp/crs/row/RL335434.pdf>, (last visited 18 December 2013).

²⁰¹ The ten member states of ASEAN.

qualitative research.²⁰² This study was also concerned about description of data as opposed to numerical aspects of the data. Such description could only be possible with qualitative data. Quantitative data mainly concerns itself with numerical aspects of the data. Such ones were out of the scope of the current study.²⁰³

3.2 The Research Strategy

The strategy adopted for this study was case analysis. That is, this was a case study of the factors affecting the economy of the China-ASEAN free trade agreement. As a case study, the research's focus was on the China-ASEAN free trade agreement only. By focusing on CAFTA and no other free trade area, this study managed to retain a high level of specificity.

Usually, generalizations in research occur when too many issues are covered in one study²⁰⁴. For instance, studying two or more cases at the same time would result in such generalization. For this study, though, specificity was enhanced because only one case – CAFTA's economy – was under investigation.

The choice of the case study research strategy was informed by the need to ensure that the data collected was as specific as it possibly could get²⁰⁵. Since all the attention of the researcher was put on one single case (economy of CAFTA), it was a lot easier to ensure specificity. This in turn ensured that the validity and reliability of the results was enhanced.

The other reason why the case study approach to the research was used is that it enabled a large amount of detail and description to be collected on just one case (CAFTA). This large amount of description and detail served to add quality and value to the study. This then ensured that the reliability of the research's findings was enhanced.

²⁰² Norman K. Denzin., and Yvonna S. Lincoln, *op.cit.*, p. 44.

²⁰³ *Ibid.*

²⁰⁴ Robert K. Yin, Case Study Research: Design and Methods, 4th ed. (United Kingdom: SAGE Publications., 2009), pp. 3-94.

²⁰⁵ Norman K. Denzin., and Yvonna S. Lincoln, *op.cit.*, p. 44.

3.3 Methods of Collecting Data

Since this was a qualitative study, it was mainly concerned with qualitative data. Such data was capable of answering the ‘why’, ‘what’, and ‘how’ questions arising from and/or pertaining to the phenomena. Data for the study was collected mainly through secondary research. Here, various documents – including journal articles, books, and websites – were researched and analyzed to inform the study’s findings and conclusions.

A thorough review of different documents was undertaken with a view to coming up with documents that could provide the necessary data to test the research hypotheses formulated. To get these documents, a systematic literature review was used. Documents that were determined to offer information on or about CAFTA in general and the economy of CAFTA in particular were selected for review. These included (among others) books, journal articles, websites, internet media articles, and periodicals.

The focus was mainly on secondary sources of data as opposed to primary sources. This was because secondary sources could be easily obtained. Furthermore, secondary sources of data were determined to contain information derived from a wide range of sources. Since secondary sources of data report on other sources, they were able to bring to the study a rich variety of data and/or information regarding the phenomena under investigation.

Secondary sources of data²⁰⁶ were also preferred for this study over primary sources because they were cheaper to source or obtain. Unlike primary sources of data which in most cases required special permission to access, secondary sources could be accessed easily and without any such special permission²⁰⁷.

Finally, secondary sources of data proved to be a cheap alternative to primary sources²⁰⁸. This is because they were readily available in different forms such as the internet and libraries. Primary sources of data were more restricted.

²⁰⁶ Those sources whose information or data is not in the original form but has been passed down from the original version/form.

²⁰⁷ Norman K. Denzin., and Yvonna S. Lincoln, *op.cit.*, p. 44.

²⁰⁸ *Ibid.*

3.4 Data Analysis

The data collected was analyzed by observer impression. This is where the researcher, acting as an independent observer, examined the data and interpreted it by forming certain impressions. Subsequently, a report was prepared based on the impressions made.

Theme analysis was also used. This entailed analyzing various themes that emerged in the course of the research. Each theme that related to the economy of CAFTA was analyzed in a critical capacity to determine its possible meaning. From the analysis, different interpretations were derived.²⁰⁹



²⁰⁹ Ibid.

Chapter 4

Findings and Discussion

This chapter presents the main findings of the study. The findings are based on the hypotheses that were formulated. The chapter also discusses these findings in an in-depth manner. This is with a view to clearly pointing out the manner in which the factors actually affect the economy of the China-ASEAN free trade agreement.

The Key Factors Affecting the Economy of China-ASEAN Free Trade Agreement

This study sought to find out the key factors that affect the economy of the China-ASEAN free trade agreement. To do this, the following hypotheses were tested:

There are a lot of factors affecting China ASEAN Free Trade Area (CAFTA), both economic and political ones, including economic theories, complementarity of the economies, intra and extra political conflicts, and other related factors. However, the CAFTA shall continue to prosper despite these factors.

Hypothesis 1: China's rise to become the world's second largest economy is the major factor affecting the economy of CAFTA.

Hypothesis 2: Political issues in the eleven CAFTA member states play a very important role in shaping the economy of CAFTA.

Having carried out the study, it was found that four (4) main factors affect the economy China-ASEAN Free Trade Agreement. These are discussed here below:

1. Economic theories

- Marxism (China)
- Free trade (ASEAN)

2. Complementarity of the economies

- No complementarity because China and ASEAN Member States producing:
 - Like or directly competitive agricultural products
 - Like or directly competitive industrial products

3. Proliferation of China's and ASEAN as an International Organization and as ASEAN Member States' individually with outside states, as of now or potentially.

- ASEAN-EU
- ASEAN-USA

- ASEAN-Japan

4. Political conflicts which may have economic impacts upon CAFTA

- Extra conflicts
 - China vis a vis the four ASEAN Member States, namely Vietnam, Philippines, Brunei, and Malaysia on the issue of the Spratly Islands
 - China vis a vis Japan
 - China vis a vis USA
- Intra conflicts
 - Malaysia with Philippines
 - Thailand with Cambodia
 - Malaysia with Indonesia

Each of these key factors is discussed in detail in here below:

4.1 Economic Theories

The China-ASEAN FTA is explained by two main theories: communism for China and capitalism for ASEAN. These are two different ideologies; and it would be generally expected that the two sides would not have much in common. It comes somewhat as a surprise that China and ASEAN are working together.

According to the Merriam-Webster Online dictionary, communism is “a way of organizing a society in which the government owns the things that are used to make and transport products (such as land, oil, factories, ships, etc.) and there is no privately owned property.”

On its part, capitalism is defined by the Merriam-Webster Online dictionary as “a way of organizing an economy so that the things that are used to make and transport products (such as land, oil, factories, ships, etc.) are owned by individual people and companies rather than by the government.” Capitalism is “an economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision, and by prices, production, and the distribution of goods that are determined mainly by competition in a free market.”

Communism, the ideology adopted and pursued by China in principle, is almost the exact opposite of capitalism which is the ideology or model that is pursued by

ASEAN. This raises some interesting issues regarding the China-ASEAN relationship. Just how does it hold together and why?

For communism, the administrative system is totalitarian while democracy is the system of governance for capitalism. In capitalism, ownership of property is private while in communism it is by the state. Furthermore, free enterprise is not allowed in communism while it is the driver of capitalism. In communism, distribution of wealth is more equitable compared to capitalism where it is skewed.

These differences set communism apart from capitalism. Any two nations practicing either of these ideologies are therefore expected not to relate well – at least not on the issues mentioned above which set the two apart. On the part of CAFTA, however, the relationship has been rather unique for one main reason. This is that although China is communist in most aspects, it has been able to embrace a number of capitalist ideologies especially in the recent past.

During the country's reform agenda that saw it embarking on economic and social transformation, China has changed a lot. Among the changes are its adoption of capitalist ideologies such as liberalization of state corporation and permitting a large degree of private ownership of property. Generally, China is encouraging and more tolerant of free enterprise even though it remains politically totalitarian.

To underscore China's changing ideologies, one has to carefully examine its actions in the last thirty or so years. Among the major and radical steps taken by China was accession to the World Trade Organization (WTO). This happened in the year 2001. China's accession into the WTO is arguably the clearest indication ever of its inclination towards capitalism. Since the WTO is largely based on capitalism, China's accession shows that the country is not entirely opposed to capitalism as long as its economic interests are at stake.

For China to become a member of WTO, it had to liberalize its economy significantly. Such liberalization is in principle contrary to communist ideology that requires all property to be owned by the state. However, the fact that China so much desired to accede to the WTO means that it really was and remains keen to foster its economic growth at the expense of pursuing communist ideology to the full.

This seems to be the same reasoning behind CAFTA. China must have realized that there was more to gain economically by working closely with ASEAN than not. That is, China had to embrace the capitalist tendencies of ASEAN if it was to enjoy the benefits

that accrue from the CAFTA FTA. The fact that similar FTAs have been concluded between China and other capitalist states (Switzerland is a notable example) is further proof of China's willingness and readiness to embrace capitalism just to benefit economically.

Well, On the part of CAFTA, it was found that in spite of their ideological differences, the two need each other. China needs ASEAN just as ASEAN needs China.²¹⁰ Of course there is the possibility that one side could potentially do without the other. However, that side would still have to find another trading partner as a replacement.²¹¹

This is because the volume of trade between the two sides is high and increasing (see figure 4 below). ASEAN needs China because China has become one of its major markets. On the other hand, China needs ASEAN because ASEAN is providing China with the much-needed raw materials needed to fuel its growing industrial sector. This mutual relationship has to be sustained somewhat.

It was also established, however, that although the agreement has been lauded by both sides as a milestone in trade ties between them, some analysts are skeptical about the mutual benefits expected²¹². It is generally believed that this cooperation is largely based on competition as opposed to complementation.²¹³ That is, Chinese goods and investments pose a direct threat to those of ASEAN states. This has in turn been more destructive to ASEAN states' economies than would have been expected.

Any free trade agreement is best suited for nations with complementary cycles of trade and business. This way, the shortcomings of one side are naturally overcome by the other side. In the case of CAFTA, though, Chinese products will be in competition with ASEAN products. This is because both sides produce and export a number of similar products.

For instance, China imports a lot of energy products. ASEAN does the same. Furthermore, China produces many consumer and industrial products. ASEAN states

²¹⁰ Bondreaux. Joseph Boudreaux, op.cit., p. 30.

²¹¹ Ha-Joon Chang, op.cit., p. 28.

²¹² China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²¹³ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

have the same. This means that competition is going to be enhanced, and this could spell trouble for the less buoyant economies of a number of ASEAN states (especially the new entrants).

Indonesia, for instance, has been on record opposing the free trade agreement between ASEAN and China.²¹⁴ This has been on grounds that Chinese cheap imports will flood the domestic market in Indonesia and possibly help kill local industries.

Indonesia's concerns are a cause for concern. This is because they are in every sense true. China is currently ranked the world's largest exporter and the second largest importer. It is also the world's leading destination as far as FDI is concerned. This is because China is favorable for manufacturing and other production process. This means that the cost of production in China is far less than that anywhere in the world.

Compared to China, ASEAN will face higher costs of production²¹⁵. This will mean that Chinese exports to ASEAN will indeed be very cheap compared to products produced locally in ASEAN. Industries like electronics, steel, iron, and textiles are likely to suffer the most because China produces and exports products produced from similar industries.

The only hope that ASEAN states have – especially those with industries similar to those of China such as Indonesia – is to renegotiate their tariff plans with China. This way, they would ensure that some tariffs remain in place until such a time as when the local industries are established enough to compete with Chinese goods²¹⁶.

Although the above argument is true, it is nonetheless worth pointing out that such concerns have been taken into consideration. There is no doubt that both sides considered the pros and cons of their free trade agreement before the agreement was implemented. Therefore, these concerns could be unfounded.²¹⁷

In fact it might be better for ASEAN states that China is included in the free trade agreement. This basically means that these states have no option but to restructure their economies so as to become more competitive.

²¹⁴ Ibid.

²¹⁵ Alexander J. Yeats, *op.cit.*, p. 42.

²¹⁶ Ibid.

²¹⁷ The free trade agreement, in my view, benefits both ASEAN and China. They need each other in more ways than just trade.

Competition has a way of helping otherwise struggling economies to get established and become more resilient. This is likely to happen to ASEAN states. As Chinese investments and exports are likely to compete with theirs, they will have to find very clear-cut ways of ensuring that they are not out-competed.

It can be clearly established that ASEAN states cooperate with China for more-or-less the same reasons. Either they cannot produce certain products at all or if they do produce them they do so at a higher opportunity cost than if they were to buy them from China. The converse is also true²¹⁸.

This, then, means that China needs ASEAN just as ASEAN needs China²¹⁹. Of course there is the possibility that one side could potentially do without the other. However, that side would still have to find another trading partner as a replacement²²⁰.

It follows then, that neither of the sides is actually willing to stick to the provisions of their key theories. China may be communist but it has not let communism affect its immediate needs regarding trade and investment. As such, it has had to embrace capitalist (free trade) ASEAN. On its part, ASEAN is not deterred by China's communism as long as it gets from China whatever goods and investments it desires. This is the reason behind the continued thriving of CAFTA in spite of the two sides' different theoretical affiliation.

4.2 Complementarity of the economies

The economy of CAFTA is affected by the complementarity of the economies of China and ASEAN. This means that either the two economies actually complement one another (both of them benefit) or the economy of one side benefits more than the other. Complementarity is mainly in terms of the following factors:

²¹⁸ Shiozawa, Yoshinori, *op.cit.*, p. 30.

²¹⁹ Dondreaux. J. Boudreaux, *op.cit.*, p. 30.

²²⁰ Ha-Joon Chang, *op.cit.*, p. 28.

4.2.1 Existence of the Bamboo Network

The bamboo network²²¹ has also accounted to a significant amount of investment in CAFTA²²². The Bamboo network consists of Chinese businesses operating mainly in Southeast Asian nations that also make up ASEAN (with the exception of the territories of China such as Taiwan, Macau, and Hong Kong).

The Bamboo network has been able to act as an alternative destination for Chinese foreign direct investment especially in the wake of increased protectionism in the US.²²³ Currently, China is restricted regarding investments in critical sectors of the US economy.²²⁴

Although in the past China has invested heavily in US Treasury Securities, China's changing investment policy has seen it reduce such investments. This has been in order to reduce overreliance on these securities²²⁵. As an alternative, China's foreign investments have been channeled mainly to the Bamboo network (especially those businesses found within ASEAN). As such, the Bamboo network is in itself a major attraction for Chinese FDI to ASEAN states.²²⁶

In the wake of the free trade agreement between China and ASEAN, the investments made by China to the Bamboo network have increased significantly²²⁷. This means that the free trade agreement between China and ASEAN has effectively served to increase the flow of foreign direct investment to the region. This, of course, has positively impacted the economy of CAFTA. It can be noted that in the past most Chinese outbound FDI used to go to other countries outside ASEAN like the US.²²⁸

²²¹ For more information about the nature and activities of the Bamboo network, see Weidenbaum Murray. L. and Samuel Hughes, The Bamboo Network: How Expatriate Chinese Entrepreneurs are Creating a New Economic Superpower in Asia, (New York: Martin Kessler Books, Free Press Co.,1996), pp. 3-23.

²²² Ibid.

²²³ Ibid.

²²⁴ Alexander J. Yeats, op.cit., p. 42.

²²⁵ Weidenbaum, Murray. L. op.cit., p. 53.

²²⁶ Asmoro, A. Ibid., p. 2.

²²⁷ Weidenbaum, Murray. L. op.cit., p. 53.

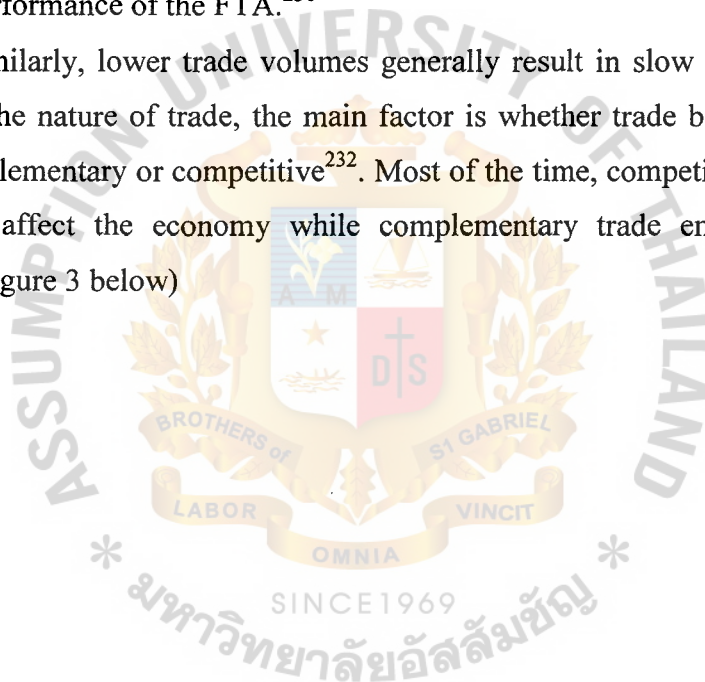
²²⁸ Ibid.

With the coming into force of the FTA, however, this FDI is now being channeled to ASEAN. Ultimately, the economy of CAFTA is largely being influenced by an increase in Chinese investments in the region. Among other recipients, the Bamboo network receives the bulk of these Chinese investments²²⁹.

4.2.2 Volume and Nature of Trade

Trade was determined to be one the most important factors affecting the economy of CAFTA. This finding is in line with theoretical findings that trade affects the economy. Generally, the higher the volume of trade²³⁰ that CAFTA deals with the better the economic performance of the FTA.²³¹

Similarly, lower trade volumes generally result in slow economic growth. With regard to the nature of trade, the main factor is whether trade between China and ASEAN is complementary or competitive²³². Most of the time, competitive trade patterns will negatively affect the economy while complementary trade enhances economic growth.²³³ (see figure 3 below)



²²⁹ Alexander J. Yeats, op.cit., p. 42.

²³⁰ The total value of exports and imports.

²³¹ Brown, K, op.cit., p. 2.

²³² Coates, S. op.cit., p. 4.

²³³ China Daily “China-ASEAN FTA pact set to boost trade volume,” China Daily (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18.January 2012).

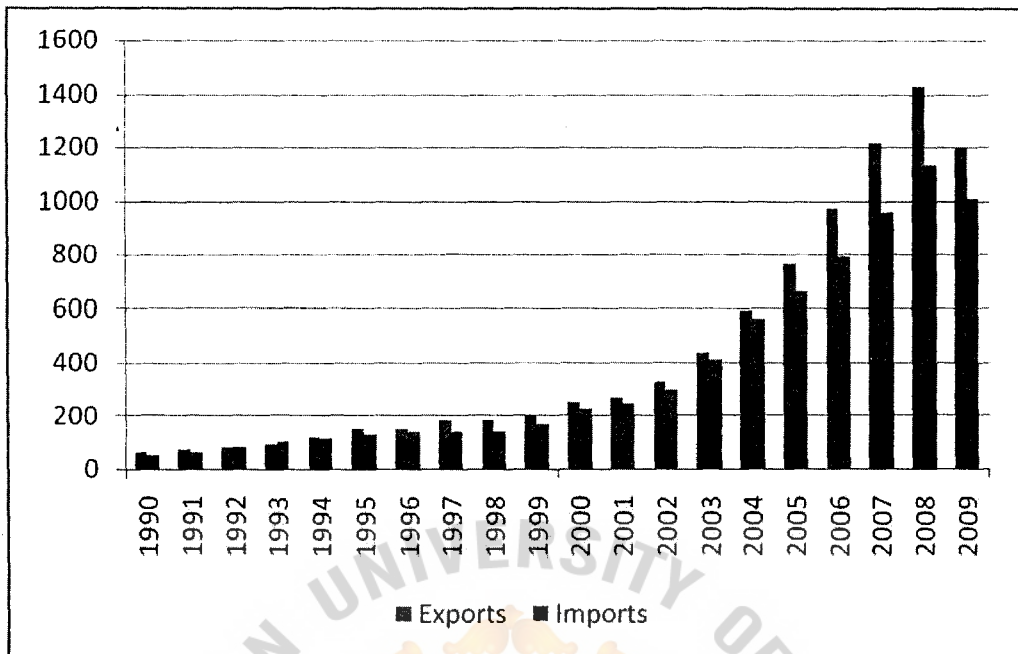


Figure 3: Growth (\$ millions) in external growth for China (1990 to 2009).

Source: Asian Development Bank

Currently, China is the world's largest exporter of goods and services. It is the world's second largest importer²³⁴. Both of these issues have significant implications for the economy of China and by extension that of CAFTA²³⁵.

First of all, that China is the largest exporter in the world means that it has a lot of products to sell not just to the ASEAN states but to the whole world. However, the ASEAN states are more directly affected by China's export potential because they have a free trade agreement with China²³⁶.

The free trade agreement that China has with ASEAN has, among other effects, effectively opened up the borders of the ASEAN nations to Chinese exports to the region. This means that unless otherwise stated, Chinese exports are finding its way into ASEAN more easily than before. This is because of the elimination of a number of trade tariffs and

²³⁴ Coates, S. op.cit., p. 4.

²³⁵ Brown, K, op.cit., p. 2.

²³⁶ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009).; at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

quotas that previously existed between China and ASEAN²³⁷.

Except for the new ASEAN member states which still have a few tariffs in place with respect to their trade with China, all the other states have moved towards eliminating all tariffs. This has generally seen an influx of cheap Chinese exports to the region²³⁸. This, of course, has had very dire economic implications²³⁹. One of them is competition.

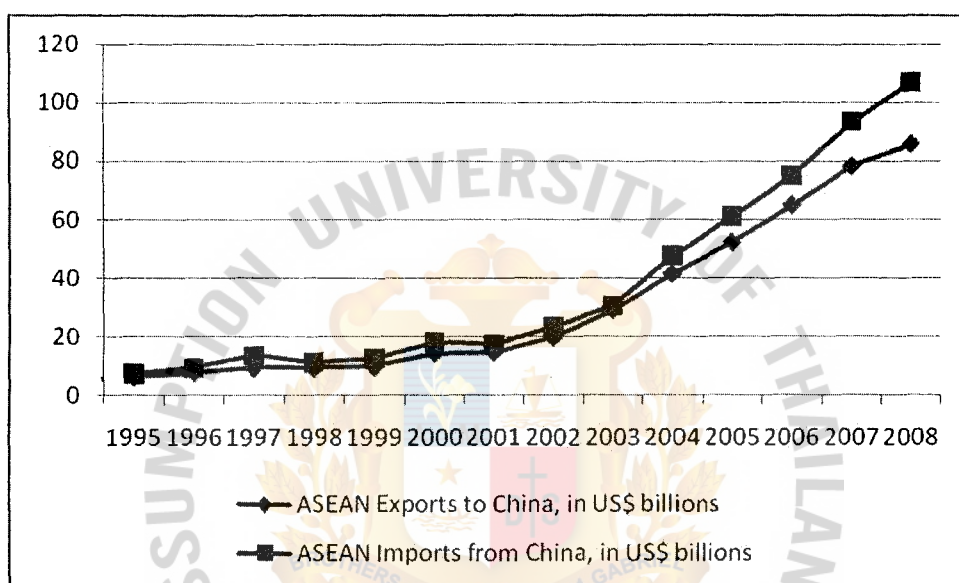


Figure 4: The external trade (\$ billions) that ASEAN had with China between 1995 and 2008. **Source:** ASEAN Statistical Yearbook

Industries in ASEAN states are faced with increasing competition from Chinese goods. As the market gets flooded with cheap Chinese exports, it has been difficult for local industries to keep up with the competition. This has been made worse by the fact that China and most ASEAN states have similar trade patterns such that the two sides'

²³⁷ Ibid

²³⁸ Coates, S. op.cit, p. 4.

²³⁹ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

products compete with each other instead of complementing each other.²⁴⁰

For instance, both ASEAN and China produce and sell electronic goods. This means that the CAFTA market is full of electronic goods competing for the same consumers. The winner, ultimately, is the side that is able to produce and export its products at a comparative advantage. In this case, China is the winner.²⁴¹

Chinese exports are generally cheaper in ASEAN compared to ASEAN local products. This situation has seen ASEAN industries face an increasing risk of being competed out of business. This is unless they can restructure themselves and compete with Chinese products. However, restructuring might not happen in the short run.²⁴²

This means that the ASEAN side of CAFTA will most likely continue incurring economic losses. As more Chinese exports get to the market in ASEAN states, the economies of the individual states – especially those that rely heavily on exports of similar products – will start shrinking.²⁴³

As the largest manufacturing economy in the world, China is also likely to add significantly to the amount of processed or manufactured products that it sells to ASEAN. This means that as a leading manufacturer, China has been able to export a lot of manufactured products to ASEAN²⁴⁴. This has had the same effect of posing a direct threat to the local manufacturing industries in ASEAN. Ultimately, a decline²⁴⁵ in the economies of a number of ASEAN states has occurred²⁴⁶.

4.2.3 Level of Foreign Direct Investment

Like with many other free trade agreements, the level of foreign direct investment is a key determinant of the economic performance of CAFTA²⁴⁷. This finding

²⁴⁰ Ibid.

²⁴¹ Coates, S, op.cit., p. 4.

²⁴² Brown, K, op.cit., p. 2.

²⁴³ Ibid.

²⁴⁴ Ibid

²⁴⁵ ‘Decline’ here is used to refer to a general slackening in the economy. A period when the economic growth rate is stagnant or negative.

²⁴⁶ Brown, K. op.cit., p. 2.

²⁴⁷ Alexander J. Yeats, op.cit., p. 42.

supports theoretical findings that the level of FDI inflows into a region determines to a very large extent the performance of the economy of the region. As a rule, the more FDI a free trade area receives the better its economy will perform.²⁴⁸

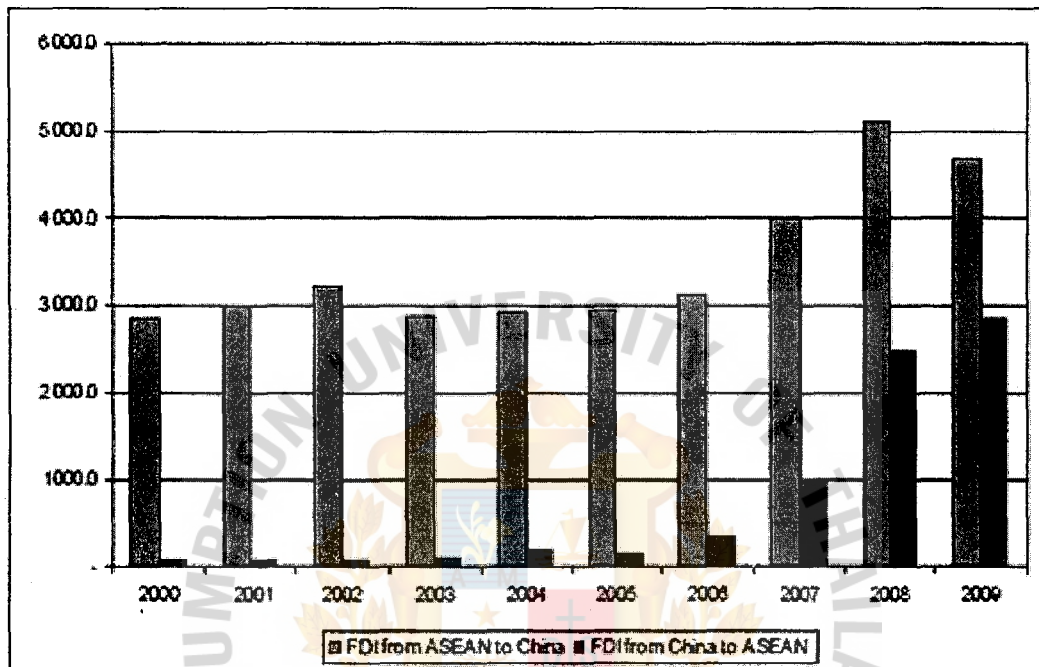


Figure 5: The flow of FDI (\$ millions) between China and ASEAN from 2000 to 2009.

Source: United Nations Conference on Trade and Development, World Investment Report.

Foreign direct investment in CAFTA has largely flowed from a number of regions in the world. The notable ones have been the US, the EU, Japan, South Korea, and a number of the Gulf States. Since the advent of the economic cooperation between China and ASEAN, both sides have been competing on an equal platform for foreign direct investment.²⁴⁹

As would have been expected, though, China has emerged as the preferred destination for inbound FDI. This is because of a number of factors which make China generally more attractive to foreign capital investments than most other states in CAFTA (Lee, 2011).

²⁴⁸ Li, M., and Kwa, C. G, op.cit., p. 2.

²⁴⁹ Brown, K, op.cit., p. 2.

China’s economic prosperity that has been realized after nearly three decades of economic reform has made it to stand out as leading source of FDI (Brown, 2010). China’s economy has recently become the second largest in the world after that of the US. This means that China has overtaken Japan²⁵⁰ to become the second largest economy in the world by nominal GDP and by purchasing power parity²⁵¹.

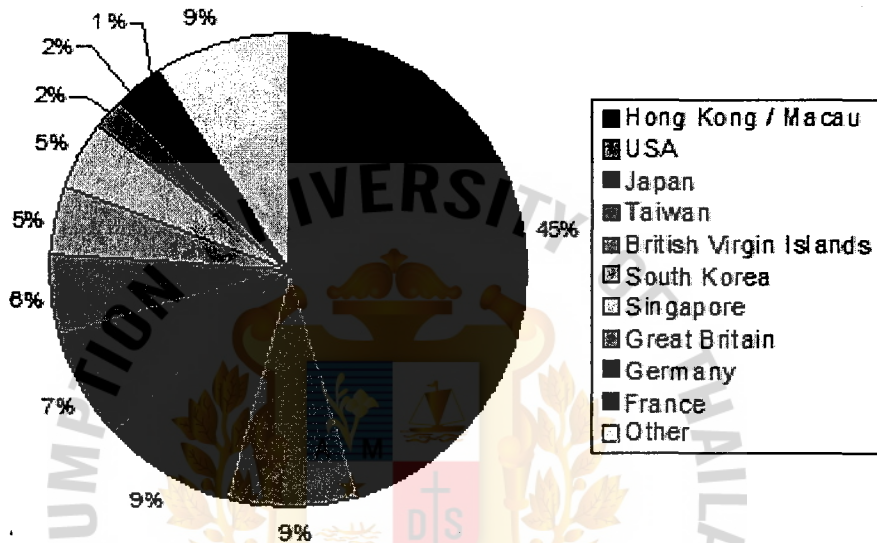


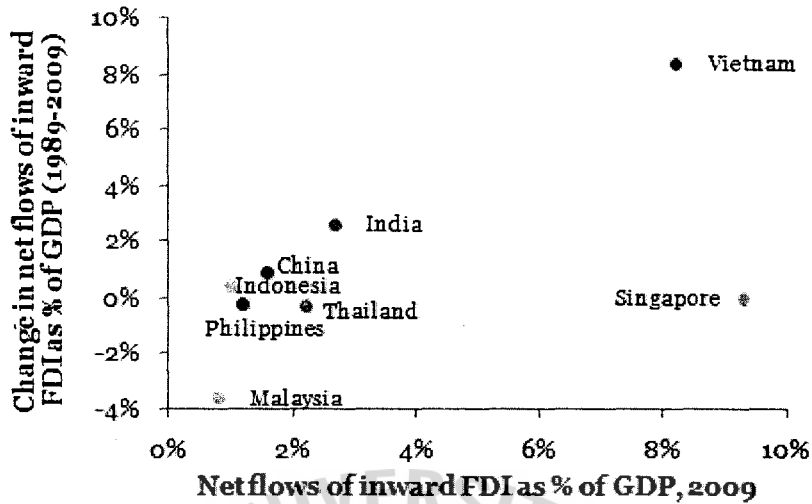
Figure 6: (FDI to China by Country of Origin (1990-2004).

Source: Statistical Office of the European Communities (Eurostat)

²⁵⁰ Before China became the second largest economy in the world, that position had been held by Japan.

²⁵¹ Lee, Y. Yoong, ASEAN Matters! Reflecting on the Association of Southeast Asian Nations, (Singapore: World Scientific Publishing Co., 2011), pp. 23-33.

Openness to Foreign Investment



Source: Economic Intelligence Unit 2010, calculation by ACI

Figure 7: ASEAN's openness to FDI.

Source: Economic Intelligence Unit

4.2.4 CAFTA's Growth Prospects

Like any other free trade area, CAFTA's economy has been affected by its growth prospects. This basically means that the economy of CAFTA is affected by the growth prospects of CAFTA's member states. This is a very important factor in the determination of the economy of CAFTA.²⁵²

Generally, nations within CAFTA that have shown great growth potential have tended to register better economic performance than those nations with limited growth prospects. For instance, Singapore, Malaysia, and Thailand have generally recorded better economic performance because of their higher growth potential when compared to nations like Vietnam, Burma, and Cambodia.²⁵³

The main reason why nations with higher growth prospects experience better economic growth is that they attract the most FDI. Since investors look to invest in nations where they are likely to get higher returns on investments (ROI), they generally prefer more prosperous nations than those that are less prosperous.²⁵⁴

²⁵² Alexander J. Yeats, op.cit., p. 42.

²⁵³ Coates, S. op.cit., p. 4.

²⁵⁴ Gerald W. Fry, *The Association of Southeast Asian Nations*, (New York: Chelsea House Co., 2008), pp. 77-105.

On the side of China, there is no doubt whatsoever regarding its growth potential. China has been growing constantly in the last 30 years²⁵⁵. This has seen it average a 10% annual growth in this period of time²⁵⁶. This has elevated China to the position of the fastest growing economy in the world.

If these past statistics are anything to go by, then China is likely to continue growing at least in the near future²⁵⁷. This growth potential partly explains why investors have been flocking to China. This has in turn seen China fare much better as far as economic growth is concerned.

4.2.5 Cost of production within CAFTA

China's attractiveness as a foreign investment destination has also had very far-reaching implications for the whole economy of CAFTA²⁵⁸. First of all, China has been able to attract to its territory a host of foreign investments in the recent past. International businesses from across the world are finding it irresistible to move to China. Most have directly invested there while others have plans to do so in the future.²⁵⁹

The reason for this mass transfer of businesses and capital to China is simple – lower costs of production²⁶⁰. China is rated the cheapest country in the whole world in the area of manufacturing. So nations from the world over – especially those in the developed world where the cost of labor and raw materials is relatively high – have come to China to make use of its cheap resources.

The high population of China makes it one of the cheapest nations when it comes to labor.²⁶¹ With no or minimal industrial disputes, international firms find China

²⁵⁵ China Daily "China-ASEAN FTA pact set to boost trade volume," China Daily (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁵⁶ Lee, Y. Yoong, *op.cit.*, p. 59.

²⁵⁷ Asmoro, A. *op.cit.*, p. 2.

²⁵⁸ *Ibid.*

²⁵⁹ Gerald W. Fry, *op.cit.*, p. 60.

²⁶⁰ The cost of production is basically the amount of factors of production (land, labor, capital, entrepreneurship) needed to produce a certain amount of output.

²⁶¹ Coates, S. *op.cit.*, p. 4.

their destination of choice. They prefer to produce from China and export their products to other parts of the world. So basically China's economic growth has helped contribute positively to the economic growth of CAFTA.²⁶²

On an individual basis, though, it is clear that the attractiveness of China as a foreign investment destination has negatively affected the economies of other ASEAN states. This is because the free trade agreement between ASEAN and ASEAN covers investments as well. As such, smaller, less attractive ASEAN states are being forced to compete for investments with China on an equal platform.²⁶³

Since China is more attractive by virtue of being the cheapest place for manufacturing, ASEAN states are losing foreign investments to China. In a way, China is reaping the most benefits from the free trade agreement²⁶⁴. In essence, China benefits at the expense of the other ASEAN states. In a way, therefore, China's membership in the free trade agreement could in effect work to hamper the economic fortunes of a number of ASEAN member states.

4.2.6 CAFTA's Strategic Location

The other factor that was found to have an impact on the economy of CAFTA is the location of China and ASEAN²⁶⁵. That CAFTA is located in an economically prosperous region of the world and brings together a number of global economic powers such as India and China means that CAFTA's economic future is secure.²⁶⁶

Trade and foreign direct investment (which are the two main factors upon which the economy of CAFTA is dependent) are largely determined by issues of location. The place where a nation is located will determine how much foreign investment it is going to attract.

Investors often choose to invest in places or regions of the world where they are assured of higher returns on their investments. As such, they will invest only in places

²⁶² Weidenbaum, Murray. L. *Ibid.*, p. 53.

²⁶³ Lee, Y. Yoong, *Ibid.*, p. 59.

²⁶⁴ Coates, S, *op.cit.*, p. 4.

²⁶⁵ Henry Wai-chung Yeung, Handbook of Research on Asian Business, (United Kingdom: Edward Elgar Publishing Co., 2007), pp.19-99.

²⁶⁶ Lee, Y. Yoong, *op.cit.*, p. 59.

where there are strategic interests that suit them.²⁶⁷

Both China and ASEAN are strategically located not only geographically but also with regard to special investment and trade interests. With regard to location, the two (China and ASEAN) are found in Asia. Asia is one of the world's most developing region with a lot of growth potential.²⁶⁸

Furthermore, China and ASEAN are located either in the middle of or in close proximity to some of the world's most economically developed nations. These include India, Japan, South Korea, Singapore, and China itself. Other emerging economies in the world such as Thailand, Australia, and the Gulf states are also close by. This makes CAFTA a very strategic location for not only foreign investments but also trade.

Seaports are major factors to consider in the location advantages of CAFTA. Within ASEAN, it is known that most of the region occupied by its ten member states has seaports. This means that trade and investment can be facilitated through easy transport infrastructure. Actually, the sea area held by ASEAN is three times more than the land area. This means that ASEAN is easily accessible from any part of the world.

More specifically, a number of ASEAN nations have some of the best harbors in the world. For instance, both Singapore and Malaysia enjoy close proximity to the Malacca Strait.²⁶⁹ This proximity, coupled with their extensive and modern seaport infrastructure, makes them and the whole ASEAN an attractive destination for trade and investment. Investment comes in here because no investor wants to invest in places which are inaccessible through major international sea routes.²⁷⁰

With regard to strategic advantages, China and ASEAN have what it takes to attract foreign investors. Much has been said about China and how its economic rise makes it an unequalled destination for FDI²⁷¹. ASEAN is also among the leading FDI destinations in the world. Nations like Thailand, Singapore, and Malaysia have emerged as competent enough in the global economic order. Their economic performance has been

²⁶⁷ Asmoro, A. *op.cit.*, p. 2.

²⁶⁸ Henry Wai-chung Yeung, *op.cit.*, p. 62.

²⁶⁹ The Malacca Strait is a major sea route whose presence has greatly enhanced trade in the area.

²⁷⁰ Asmoro; A. *op.cit.*, p. 2.

²⁷¹ Gerald W. Fry, *op.cit.*, p. 60.

unequaled in many senses.

Many nations around the world have been competing to invest in ASEAN. This is because of the general attractiveness of the region as well its capacity to offer investors high returns on their investments.²⁷²

That ASEAN has in place its own free trade agreement means that intra-ASEAN trade and investment has also been on the increase. As a free trade area, ASEAN has been open to investors from all over the world.²⁷³

The internal competition among the various member states of ASEAN has also meant that they have been able to restructure their own economies to make them more attractive to foreign investors. Nations previously regarded as not being economically prosperous such as Burma and Laos have now firmly embarked on the path towards development as a result of their decision to open up their economies.²⁷⁴

Others like Cambodia and Vietnam which used to be torn apart by conflicts have now changed to become major economies with high growth potential. Such strategic issues have been appealing to foreign investors. These investments have contributed immensely to the economic growth of ASEAN (and by extension that of CAFTA).²⁷⁵

The mere fact that ASEAN states have been acting together as a group as opposed to as individuals has given them great bargaining power especially in the face of or while negotiating deals with great world powers. In fact the very free trade agreement that ASEAN has signed with China stemmed from the fact that ASEAN was acting as a block as opposed to each member state acting alone.²⁷⁶ This multilateral approach to global economic issues has in itself enhanced the attractiveness of ASEAN and made it a strategic location relative to the rest of the world.²⁷⁷

Actually, the formation of the ASEAN free trade agreement (AFTA) was in

²⁷² Lee, Y. Yoong, op.cit., p. 59.

²⁷³ Henry Wai-chung Yeung, op.cit., p. 62.

²⁷⁴ China Daily "China-ASEAN FTA pact set to boost trade volume," China Daily (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁷⁵ Lee, Y. Yoong, op.cit., p. 59.

²⁷⁶ Asmorø, A. op.cit., p. 2.

²⁷⁷ Coates, S. op.cit., p. 4.

order to achieve two main goals. The first was to enhance the attractiveness of the region as a foreign direct investment destination and so attract more FDI to the region.²⁷⁸

The second was to enhance the region's competitive ability in the region and the whole world especially in terms of trade and investment. These two have since been accomplished; and they have made ASEAN a very attractive region indeed.

Finally, plans to extend the economic cooperation within ASEAN from a simple economic union to a fully-fledged monetary union has given ASEAN a leading role in the world – at least among free trade areas. If it materializes, the ASEAN monetary union will only be the second in the world after that of the eurozone. This will mark a significant step forward for ASEAN. It is such growth prospects that have placed ASEAN on a high pedestal as regards its economic future.²⁷⁹

4.2.7 High Population of CAFTA

Another major factor that impacts the economy of CAFTA is high population. CAFTA is the world's most populated free trade area with a total population of about 1.8 billion people. This large population has had many impacts on the economy of CAFTA.²⁸⁰

First and foremost, it has acted as a key determinant of the level of foreign investments that are channeled to the region²⁸¹. This is because the population ultimately determines the availability of labor (and so the cost of that labor).

In CAFTA, the high population has effectively pushed the cost of labor down. This has in turn made it a more attractive destination for foreign firms seeking to invest in low-cost production regions of the world.²⁸²

²⁷⁸ Ibid.

²⁷⁹ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁸⁰ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁸¹ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁸² Henry Wai-chung Yeung, *op.cit.*, p. 62.

Although China's labor costs have been among the lowest throughout CAFTA, other nations within the free trade agreement have equally or only slightly higher labor costs. All these have been directly attributed to the FTA's high population which is unequalled in the world.²⁸³

Secondly, the high population has served as a ready market for the products produced in the region. In the past, there have been concerns from economists that that some nations in CAFTA (notably China) would not experience sustainable economic growth because they have been too reliant on exports to grow economically. This prompted these nations to reform their economies so as to make them more consumer-based.²⁸⁴

China has been leading the other CAFTA nations in this endeavor by successfully transforming itself from a nation that exported virtually everything it produced to one that now consumes a significant proportion of whatever it produces.²⁸⁵ Although China is the world's leading exporter, it is nonetheless the second largest importer. This shows just how consumer-based its economy has become.²⁸⁶

Therefore, CAFTA is a large consumer economy. This means it is a major market for products from across the world. As a ready market for not only its own products but also imported products, CAFTA has been able to grow economically²⁸⁷.

4.3 Proliferation of China's and ASEAN as an International Organization and as ASEAN Member States' individually with outside states, as of now or potentially.

The economy of CAFTA is also affected to a large extent by the regional economy in the wider Asian continent. This stability has enabled both China and ASEAN

²⁸³ Coates, S. op.cit., p. 4.

²⁸⁴ Gerald W. Fry, op.cit., p. 60.

²⁸⁵ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁸⁶ Asmoro, A. op.cit., p. 2.

²⁸⁷ China Daily, op.cit., p. 11.

to forge stronger and prosperous economic cooperation (including FTAs) with other nations from across the world. If events of the past are anything to go by, then it can be concluded that economic stability of any one nation or group of nations is dependent on the stability of other nations around it (and possibly across the world).²⁸⁸

To this end, economic crises have in the past negatively impacted the economies of not just ASEAN but also of China. The Asian crisis and the more recent global financial crisis are notable examples. To stay clear from such crises in the future, CAFTA has been cooperating with other nations in the region.²⁸⁹ Such cooperation has largely been aimed at ensuring that economic stability in general and financial stability in particular is guaranteed in the whole region.²⁹⁰

The ASEAN+3 agreement that brings together ASEAN and three other nations in the region (China, Japan, and South Korea) is a typical example of the economic cooperation in the region. By working together on a number of issues of mutual interest to them, the members of ASEAN+3 have been able to reduce the incidence of financial and economic crises.²⁹¹

This has in turn helped foster greater economic growth throughout ASEAN+3. This means that economic stability in the region has had a great bearing on the economy of CAFTA²⁹². Actually, it was due to the absence of such economic stability that the Asian financial crisis resulted. The crisis had far-reaching consequences for the nations of the region most of which experienced economic recessions²⁹³.

4.3.1 ASEAN-Japan

ASEAN and Japan continues to be important trading partners is regarded as a major factor that will affect the economy of CAFTA. Trade between ASEAN and Japan

²⁸⁸ Henry Wai-chung Yeung, *op.cit.*, p. 62.

²⁸⁹ Gerald W. Fry, *op.cit.*, p. 60.

²⁹⁰ Coates, S. *op.cit.*, p. 4.

²⁹¹ Henry Wai-chung Yeung, *op.cit.*, p. 62.

²⁹² China Daily "China-ASEAN FTA pact set to boost trade volume," China Daily (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁹³ Henry Wai-chung Yeung, *Ibid.*, p. 62.

continued on an upward trend. Total trade increased by 28.4 percent from 2009 to 2010, amounting to US\$206.6 billion in 2010. In 2011, the total trade was US\$273.35 billion, an increase of 32.3 per cent from 2010. Japan also moved up from being ASEAN's third largest export destination in 2010 to the region's top export destination in 2011. ASEAN's exports to Japan increased by 43.3 percent amounting to US\$147.4 billion while imports from Japan grew by 21.4 per cent totalling US\$125.9 billion. Japan maintained its position as ASEAN's second largest trading partner after China.²⁹⁴

Foreign direct investment from Japan to ASEAN increased significantly by 39 per cent from US\$11.0 billion in 2010 to US\$15.3 billion in 2011. Japan remained an important source of foreign direct investment with a share of 17.1 per cent of total inward investment to ASEAN in 2011. Japan stepped up from the third to become the second largest source of FDI for ASEAN.²⁹⁵

4.3.2 ASEAN-USA

The possibility of ASEAN-USA is regarded as a major factor that will affect the economy of CAFTA²⁹⁶. ASEAN is the focus of increased attention on the global stage. Gatherings such as the ASEAN Regional Forum and the East Asia Summit draw leaders and senior officials from across the world. The country is being courted by the US, China, India, Australia and Japan as well as the EU. The EU and ASEAN have been close partners for 35 years. Both the US and the EU are major markets for products as well as major sources of raw materials needed in CAFTA. ASEAN is the fifth largest trading partner and fourth largest export market for US with two-way ASEAN-US trade reaching US\$200 billion in 2012.²⁹⁷ US direct investment in ASEAN reached stands at

²⁹⁴ Joint Media Statement of the 18th AEM-METI Consultations, 30 August 2012, Siem Reap, Cambodia.

²⁹⁵ Ibid.

²⁹⁶ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

²⁹⁷ US-ASEAN Business Council, INC. Why is ASEAN important to the United States. *US-ASEAN Business Council* (19 November, 2012). at <http://www.usasean.org/regions/asean/about>, (last visited 6 June 2013).

\$157 billion, and is the largest in Asia, nearly three times more than China and ten times more than India²⁹⁸. US-ASEAN bilateral goods trade grew by \$18.5 billion, or 10.4%, in 2011, with growth in all ten bilateral relationships.²⁹⁹ The average ASEAN consumer purchases nearly 1.75 times as many US goods per capita as the average Chinese consumer, and nearly nine times as many as the average Indian consumer³⁰⁰. Thus, the importance of trade is vital in the context of both parties. With the growing importance of the ASEAN region, the U.S. role in this region is poised to increase in the future. Any such bilateral relationships and FTAs would greatly improve the economy of CAFTA³⁰¹.

ASEAN-US: Key Statistics (2012)	
GDP	\$ 2.2 trillion
GDP Growth	4.7%
GDP per capita	\$ 3,601
Population	620 million
U.S. Exports to ASEAN	\$ 75.5 billion
U.S. Imports from ASEAN	\$ 122.9 billion

Figure 8: ASEAN-US key Statistics (2012)

Source: ASEAN Statistics

4.3.3 ASEAN-EU

The relationship between ASEAN-EU is also regarded as a major factor that will affect the economy of CAFTA. The EU is ASEAN's third largest trading partner (after the US and China), while ASEAN is the EU's 5th largest trading partner. Total trade

²⁹⁸ Ibid.

²⁹⁹ Ibid.

³⁰⁰ Ibid.

³⁰¹ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

in 2011 in goods and services amounted to \$265 billion³⁰². ASEAN had a surplus of \$25 billion in its trade with the EU. The EU is the biggest provider of Foreign Direct Investment into ASEAN, 24% of the total. The EU is by far the largest investor in ASEAN countries. EU companies have invested around €9.1 billion annually on average (2000-2009). The EU's main exports to ASEAN are chemical products, machinery and transport equipment. The main imports from ASEAN to the EU are machinery and transport equipment, agricultural products as well as textiles and clothing³⁰³. (See the below figures)

European Union, Trade with ASEAN: Trade flows by HS section 2008 – 2012

European Union, Trade with ASEAN										
Trade flows by HS section 2008 – 2012										
HS Sections	Imports(Mio €)					Exports (Mio €)				
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
TOTAL	79,743	68,000	87,282	95,506	100,077	55,701	50,060	61,609	69,066	81,317
Live animals; animal products	1,334	1,243	1,391	1,485	1,358	589	615	936	1,261	1,357
Vegetable products	2,298	1,903	2,048	2,577	2,933	355	333	542	457	482
Animal or vegetable fats and oils	3,662	2,973	3,679	4,283	4,975	53	44	56	71	90
Foodstuffs, beverages, tobacco	2,918	2,755	2,913	3,432	3,515	1,983	1,931	2,369	2,887	3,567
Mineral products	3,890	3,074	2,516	3,356	2,974	1,340	1,201	1,628	2,278	3,747
Products of the chemical or allied industries	7,167	6,179	8,888	10,915	13,054	6,635	6,254	7,892	8,755	9,320
Plastics, rubber and articles thereof	4,981	3,586	5,989	7,387	5,935	1,903	1,602	2,165	2,292	2,546
Raw hides and skins, and saddlery	485	428	556	675	771	439	406	516	631	737
Wood, charcoal and cork and articles thereof	1,453	1,069	1,186	1,118	1,057	97	81	111	112	128
Pulp of wood, paper and paperboard	633	563	566	558	487	1,275	1,169	1,355	1,518	1,627
Textiles and textile articles	5,281	4,897	5,413	6,337	6,433	783	658	807	963	1,084
Footwear, hats and other headgear	3,506	3,202	3,615	3,499	3,953	63	55	70	96	117
Articles of stone, glass and ceramics	543	398	491	575	551	484	470	577	606	590
Pearls, precious metals and articles thereof	1,290	1,178	1,839	2,731	1,561	694	569	1,434	1,852	2,385
Base metals and articles thereof	2,101	1,279	2,063	2,501	2,111	4,033	3,371	3,898	4,852	5,421
Machinery and appliances	30,257	25,193	35,255	35,348	38,549	25,159	20,265	23,898	25,131	28,637
Transport equipment	2,436	2,690	2,859	2,304	2,904	5,995	6,973	8,617	9,654	13,590
Optical and photographic instruments, etc.	2,370	2,206	2,760	3,186	3,637	2,392	2,243	2,653	2,939	3,473

³⁰² ASEAN-AU Business Summit, "The EU-ASEAN relationship in twenty facts and figures," *Journal of Jakarta*, (October 2013): at http://eeas.europa.eu/asean/docs/key_facts_figures_eu_asean_en.pdf. (last visited 25 December 2013).

³⁰³ European Commission, "EU Trade with ASEAN," *European Commission* (19 November, 2013): at <http://ec.europa.eu/trade/policy/countries-and-regions/regions/asean/>. (last visited February 2014).

Arms and ammunition	28	7	20	18	15	51	85	92	43	41
Miscellaneous manufactured articles	2,811	2,317	2,618	2,391	2,506	490	468	519	551	679
Works of art and antiques	14	23	12	10	19	20	12	45	54	84
Not classified	288	836	607	821	780	868	1,255	1,427	2,064	1,613
AMA / NAMA Product Groups	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
TOTAL	79,743	68,000	87,282	95,506	100,077	55,701	50,060	61,609	69,066	81,317
Agricultural products (WTO AoA)	8,880	7,416	8,573	10,400	11,610	3,239	2,950	3,968	4,685	5,607
Fishery products	1,947	1,916	2,071	2,268	2,125	98	114	138	225	225
Industrial products	68,916	58,668	76,638	82,838	86,341	52,364	46,996	57,502	64,155	75,485

Figure 9: European Union, Trade with ASEAN: Trade flowa by Hs section 2008-2012

Source: Eurostat Comext Statistical regime 4

EU-ASEAN: "Trade in Services" Statistics			
Trade in Services 2009-2011, € Billions			
Year	EU imports	EU exports	Balance
2009	18.2	21.9	3.7
2010	21.0	24.9	3.9
2011	23.8	27.9	3.5

Figure 10: EU-ASEAN: "Trade in Services" Statistics

Source: Eurostat Comext Statistical regime 4

EU-ASEAN: "Trade in goods" Statistics			
Trade in Goods 2010-2012, € Billions			
Year	EU imports	EU exports	Balance
2010	87.3	61.6	-25.7
2011	95.5	69.1	-26.4
2012	100.1	81.3	-18.8

Figure 11: EU-ASEAN: "Trade in goods" Statistics

Source: Eurostat Comext Statistical regime 4

EU-ASEAN: Foreign Direct Investment			
Foreign Direct Investment 2011, € Billions			
Year	Inward Stocks	Outward Stocks	Balance
2011	71.5	199.6	128.1

Figure 12: EU-ASEAN: Foreign Direct Investment

Source: Eurostat Comext Statistical regime 4

Having argued that way, though, it is worth adding that a few challenges remain. These could hinder the ultimate formation of such FTAs. For instance, Burma's human rights issues could potentially impact the whole region³⁰⁴. Recently, attempts by ASEAN states to fast-track talks with the EU³⁰⁵ (with a view to forming an ASEAN-EU free trade agreement) have failed.³⁰⁶

The failure, according to analysts, has been occasioned by unwillingness or inability of ASEAN to prevail upon Burma to end its human rights abuses. Therefore, the domestic problems affecting individual nations are undoubtedly impacting negatively on the entire economy of the region.³⁰⁷

Clearly, everyone was keen to have in place a free trade agreement between ASEAN and the EU. This would have seen an increase in bilateral trade between the two sides. However, the Burma problem is now hindering this noble endeavor.³⁰⁸

However, ASEAN cooperate with Japan, US and EU will improve economic cooperation between the two sides and to speed up ASEAN's economic integration. And Japan, EU and US has FTA with other countries will bring the benefits to CAFTA. It has also encouraged other players outside China and ASEAN to invest in the region. This has contributed to improve economic growth in CAFTA.

³⁰⁴ Gerald W. Fry, *op.cit.*, p. 60.

³⁰⁵ The European Union, currently made up of 27 member states.

³⁰⁶ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

³⁰⁷ Gerald W. Fry, *op.cit.*, p. 60.

³⁰⁸ Asmoro, A. *op.cit.*, p. 2.

4.4 Political conflicts which may have economic impacts upon CAFTA

The issue of security has also impacted the economy of CAFTA. The security issue has been a major challenge for CAFTA.³⁰⁹ Not that it is a totally new issue that has just come up recently. Instead, it is a challenge that has been there for a long time now. Fortunately for CAFTA, there has been no major conflict involving a member state of CAFTA in the recent past. This has seen the region remain fairly calm.³¹⁰

As a result, investors have been drawn there. Although China is sometimes faced with frequent security issues, this has not been able to affect the stability of CAFTA because China's approach to conflicts has changed in the recent past. No longer does China use forceful means to resolve its conflicts. Instead, it actually prefers and emphasizes the use of diplomacy.³¹¹

On its part, ASEAN has been relatively calm and stable for many years now. In the last two decades, for instance, no notable conflict has been reported there³¹². The only exception could be the political challenges in nations like Thailand and Burma. However, these are considered as internal conflicts and have not been able to affect the whole region.³¹³

Generally, the security of the whole region is a major determinant of how the region performs economically. The economy will only thrive if there are guarantees of security from both sides³¹⁴. China will especially be required or expected to demonstrate

³⁰⁹ Ibid.

³¹⁰ Henry Wai-chung Yeung, *op.cit.*, p. 62.

³¹¹ China Daily "China-ASEAN FTA pact set to boost trade volume," *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

³¹² Coates, S. *op.cit.*, p. 4.

³¹³ Lee, Y. Yoong, *op.cit.*, p. 59.

³¹⁴ Coates, S. *op.cit.*, p. 4.

to the ASEAN states that it does not in any way seek to use its might to bully the other CAFTA member states³¹⁵.

4.4.1 Political issues in the eleven (ASEAN + China) member states (Extra conflicts)

4.4.1.1 China vis-a-vis the four ASEAN Member States, namely Vietnam, Philippines, Brunei, and Malaysia on the issue of the Spratly Islands.

A major factor affecting the economy of CAFTA is the conflict pitting China and the four ASEAN member states namely Vietnam, Philippines, Brunei, and Malaysia. The conflict is largely about territory³¹⁶. That is, it is a territorial dispute mainly in the South China Sea. The territory disputed is both maritime and land (island).³¹⁷

One of the disputes is about a maritime boundary located in the Gulf of Tonkin. The other disputes are about maritime territories located off the coasts of four nations: Brunei, Malaysia, Vietnam, and the Philippines.³¹⁸

In the South China Sea, the conflicts are mainly about the Spratly Islands and the Paracel Islands. Each of the involved nations has different interests in claiming the territories. These interests include the need to acquire fishing areas located around these two islands (archipelagos), the likelihood that the disputed territories could be rich in oil and gas, and the need to control strategic international shipping lanes.³¹⁹

³¹⁵ China Daily “China-ASEAN FTA pact set to boost trade volume,” *China Daily* (December 30, 2009), at http://www.chinadaily.com.cn/china/2009-12/30/content_9244077.htm, (last visited 18 January 2012).

³¹⁶ Carlyle A. Thuy, Recent Developments in the South China Sea: From Declaration to Code of Conduct. In T. T. Thuy, (ed.), The South China Sea: Towards a Region of Peace, Security and Cooperation. (Hanoi: The Gioi Publishers., 2011), p. 1-19.

³¹⁷ Ibid.

³¹⁸ Coates, S. op.cit., p. 4.

³¹⁹ Carlyle A. Thuy, op.cit., p. 72.

More specifically, China is involved in a conflict with Vietnam over the maritime boundary located along the coast between the two countries³²⁰. China and Indonesia are engaged in a conflict over the maritime boundary in the waters north of the Natuna Islands located between Indonesia and China. Another dispute is about the maritime boundary located north of Borneo and that separates China and Brunei, Malaysia, and Vietnam.³²¹

Then there is a dispute over the Spratly Islands (South China Sea) pitting China and Vietnam, the Philippines, and Malaysia. Between China and the Philippines, the main dispute is over the maritime boundary located off the coast of central Philippines and Luzon. Vietnam and China are in conflict over the Paracel Islands in the South China Sea. Finally, China claims ownership of the nine-dash area in the South China Sea, bringing into dispute with Brunei, Vietnam, the Philippines, and Malaysia.³²²

Impacts of the Conflict

The conflict has had various impacts, the most notable one being the Declaration on South China Sea by China and ASEAN. The declaration was about the manner in which the South China Sea – including the disputed territories, were to be used. It specifically provided for the amicable and peaceful resolution of the conflicts in the South China Sea. The use of force was ruled out. The declaration was signed in Phnom Penh between China and the 10 foreign ministers of ASEAN in 2002.³²³

The declaration has basically helped reduce hostilities and enhanced mutual cooperation between the two sides. It has also encouraged other players outside China and ASEAN to invest in the region. This has contributed to economic growth in CAFTA.³²⁴

The coming into force of the ASEAN Treaty of Amity and Cooperation in Southeast Asia (TAC) was also a key step in fostering peace in the region. TAC provides for – among other things – the formation of an ASEAN High Council at the ministerial level. The ASEAN High Council has immense powers regarding

³²⁰ Ibid.

³²¹ Coates, S. op.cit., p. 4.

³²² Carlyle A. Thuy, op.cit., p. 72.

³²³ Coates, S. op.cit., p. 4.

³²⁴ Carlyle A. Thuy, op.cit., p. 72.

recommending to nations how to deal with disputes. It can also recommend measures for prevention of disputes from deterioration.³²⁵

That both China and ASEAN have acceded to this important legal instruments means that the risk of the conflict escalating is minimal³²⁶. Actually, it is more likely that the disputes between China and the four ASEAN states will be solved amicably sooner rather than later.

Possible Solution

The most challenging security issue in CAFTA is therefore that between China and the four ASEAN states concerning disputed territories. This issue is threatening the very existence of CAFTA – not just its economy.³²⁷

China, whenever its territorial integrity is in question, has historically not tolerated any malicious actions of the kind being exhibited by the four ASEAN nations. As such, it has been largely expected that actions by the four ASEAN nations to claim that some territories in the South China Sea belong to them would be met with force.³²⁸

However, China has chosen to approach the issue more cautiously, preferring to use diplomacy instead of force. Yet there is no telling how this conflict will exactly play out in future given the high stakes involved.³²⁹

The worst would be if China takes action against the four ASEAN nations. This would have immediate economic ramifications for CAFTA because the other ASEAN member states would interpret China's actions as equivalent to bullying smaller nations. This might change the nature of the relations between the two sides.³³⁰

One way to solve the dispute would be if China and the four ASEAN nations would enter bilateral negotiations. The key here is for the four to

³²⁵ Ibid..

³²⁶ Ibid.

³²⁷ Henry Wai-chung Yeung, *op.cit.*, p. 62.

³²⁸ Lee, Y. Yoong, *op.cit.*, p. 59.

³²⁹ Asmoro, A. *op.cit.*, p. 2.

³³⁰ Lee, Y. Yoong, *op.cit.*, p. 59.

negotiate together as entity and not separately as individual states³³¹. This will give them higher chances of getting justice from China.³³²

In the past, the conflict has been complicated by the fact that each of the four ASEAN nations has approached the problem differently and unilaterally³³³. Some (the Philippines) have resorted to using international arbitration while others have tried to use the UN Convention on the Law of the Sea (UNLOS). This has not worked. They need to adopt a bilateral approach to the problem.³³⁴

However, any peaceful resolution of the conflict might have to involve other players such as the UN.³³⁵ It stands now, interested parties are the only ones involved. That the US is involved is just making the problem worse. Indian participation should also be stopped.³³⁶

Finally, any attempts to make the dispute a multilateral one as opposed to a bilateral one are dangerous. Although China wields immense power in the region and so has an upper hand in the conflict, the fact that the four ASEAN nations might work together and not individually could reduce China's bargaining power.³³⁷

4.4.1.2 China vis-a-vis Japan

China is also involved in a conflict with Japan over the Senkaku/Diaoyu islands³³⁸. Both countries claim that the tiny islands form part of their land territory. The struggle for the islands is largely because of their large deposits of fossil fuels which are in high demand both in Japan and China.³³⁹

³³¹ Carlyle A. Thuy, *op.cit.*, p. 72.

³³² *Ibid.*

³³³ Quoted Weatherbee et. al., International relations in Southeast Asia. (Rowman and Littlefield Co., 2005), p. 237.

³³⁴ Carlyle A. Thuy, *op.cit.*, p. 72.

³³⁵ Quoted Weatherbee et. al., *op.cit.*, p.75.

³³⁶ Carlyle A. Thuy, *op.cit.*, p. 72.

³³⁷ *Ibid.*

³³⁸ *Ibid.*

³³⁹ *Ibid.*

The conflict has greatly impacted not just China but the whole CAFTA region. The major impact has been the escalation of tensions in the region³⁴⁰. Since China and Japan are virtually opposed to each other, they have been trying to advance this conflict within ASEAN³⁴¹. On one part, China has been opposed to an ASEAN-Japan FTA while Japan has been opposed to CAFTA. The result has been that not all the economic potential of the region has been fully exploited.³⁴²

The main goal of Japan has been to try as much as possible to reduce the influence and possible dominance of China in the region. By doing so, Japan hopes to emerge as the undisputed power in Asia-Pacific and specifically in Southeast Asia. However, China also seeks to do just the same – reduce Japan's dominance in the region³⁴³. That Japan is a key ally of the US has often enraged China. If Japan's position in the region can be weakened, China hopes that the US's influence there would also be reduced.³⁴⁴

The solution to this problem could be both legal and political. A legal solution will have to entail recourse to United Nations conference on the Law of the Sea³⁴⁵ (UNCLOS) as both nations are party to it. This way, it will be a lot easier for both sides to abide to the ruling of the UN. However, a political solution could also be necessary. If both nations could agree not to escalate tensions, then the problem could be solved. That is, the two need to agree on sharing the islands between them or having the resources there shared equally upon extraction.

³⁴⁰ Quoted Weatherbee et. al., op.cit., p.75.

³⁴¹ Carlyle A. Thuy, op.cit., p. 72.

³⁴² Quoted Weatherbee, et. al., op.cit., p. 75.

³⁴³ Thuy, T. op.cit., p. 72.

³⁴⁴ Quoted Weatherbee, et. al., op.cit., p. 75.

³⁴⁵ United Nations Convention on the Law of the Sea Agreement relating to the implementation of part XI of the convention. at http://www.un.org/depts/los/convention_agreements/texts/unclos/closindx.htm. United Nations Convention on the Law of Sea of 10 December 1982. (last visited 18 December 2013).

4.4.1.3 China vis-a-vis USA

The conflict between China and the US in the region centers on three main issues. The first one is the USA's adherence to rules of law, especially UNCLOS. To this end, China is not happy that the US tries to force it to follow UNCLOS when the US is not a signatory to the law.³⁴⁶

The second is the USA's dissatisfaction with the China's policy in air and sea control in South China Sea. China has been insisting on strictly controlling both air and sea routes this has been in an attempt to safeguard Chinese interests and exert power and control.³⁴⁷ The US, on its part, insists that as per the UNCLOS, it has the right to use sea and air spaces in the region without restriction. This includes using them for militarized activities.³⁴⁸

Finally, the third issue is the USA's attempt to regain its influence in Southeast Asia (SEA) after its withdrawal a decade ago. The US has been trying to make a comeback in the region, and it has used conflicts such as that between China and Japan, China and Taiwan, and China and the four ASEAN states as the excuse for its increased participation in the activities of the region³⁴⁹. China wants none of this as it regards it as an affront on the sovereignty of China and the other nations in the region. The US wants to contain China not just in the region but also globally. By setting up nations in the region against China, the US hops to accomplish this goal³⁵⁰.

The impacts of this conflict on the economy of CAFTA have been minor. This is because ASEAN states find China indispensable as a trading partner. However, they also recognize that they need the US to help contain China. The main impact has been that the ASEAN states have been cautious when dealing with China³⁵¹.

The solution to this conflict is also both legal and political. The US needs to choose between accepting China as a rising power in the region and the world and agree to share with it the influence and hegemony. The US might also have to accede

³⁴⁶ Carlyle A. Thuy, op.cit., p. 72.

³⁴⁷ Ibid.

³⁴⁸ Quoted Weatherbee et. al., op.cit., p.75.

³⁴⁹ Carlyle A. Thuy, op.cit., p. 72.

³⁵⁰ Ibid.

³⁵¹ Quoted Weatherbee et. al., op.cit., p.75.

to UNCLOS. China, on its part, needs to adhere to the rule of law especially with regard to UNCLOS. This will ensure that both sides adhere to the rule of law.

4.4.2 Political issues in the eleven (ASEAN + China) member states (Intra conflicts)

When the Association of Southeast Asian Nations (ASEAN) was first established, the internal political instability between ASEAN member states. Many of the ASEAN countries are facing internal strife whereas some countries are dominated by the military government and some countries the cabinet changes frequently. In addition to that in some countries there are rebels and rampant terrorist activities, plus in recent years, tied with the US led western countries and the counterterrorism and hostility to Islam and Muslim tradition has expanded hence causing national sentiment in ASEAN countries. Such Unstable directly affects the political situation in foreign investment, therefore hindering the normal development of economic trade, objectively in the region economic development and the future of the whole development of free trade area has a negative impact. ASEAN's historical grievances and the many territorial disputes reflect the internal instability of the association of Southeast Asian nations (ASEAN).

For example, Vietnam invaded Cambodia and this has put a permanent damage to their relation, and sovereignty disputes over Pulau Sipadan and Pulau Ligitan Island between Malaysia and Indonesia. Between Malaysia and Singapore are Disputes to outdo each other in Pedra Brance³⁵², the concierge in Indonesia islands sovereignty dispute with Philippines, Sovereignty dispute between Philippines and Malaysia in Sabah. Also the frequent disagreement over the maritime disputes and sovereignty of the Spratly islands between Malaysia, Vietnam and Philippines³⁵³, will be affect to bilateral or multilateral relations. In recently, sovereignty dispute between Cambodia and Thailand in Preah Vihear Temple. All these reflect the internal instability in the situation of the association of Southeast Asian nations (ASEAN). There are a number of conflicts within ASEAN could be summarized as the following:

³⁵² Malaysia called Pulau Batu Puteh island, Singapore called Pedra Brance Island.

³⁵³ Dosch John, "Vietnam's ASEAN Membership Revisited: Golden opportunity or Golden cage Contemporary Southeast Asia." Institute of Southeast Asian., 2006, vol 28, No.2,: 234-258.

4.4.2.1 Malaysia with Philippines

The Malaysia-Philippines conflict is about territory. Specifically, it is about Sulu's claim of the territory in Sabah. The conflict dates back in time to the early 1960s long before the two countries even had any formal relations.³⁵⁴

Although this conflict is likely to affect the cohesion within ASEAN, it has very minor impacts on CAFTA. The main impact is that investors seeking to invest in the two countries might shy away as a result of the tensions between the two. However, the investors could then still channel the investments in other ASEAN states that are peaceful such as Singapore.³⁵⁵

The solution to the conflict should be political. This is because the two nations have in the past shown little regard for the rule of law; and are such less likely to adhere to a legal solution. In this respect, referring the matter to the ICJ might be counterproductive. A political solution could involve mediation by ASEAN.

4.4.2.2 Thailand with Cambodia

Thailand and Cambodia are in a conflict over a disputed border region. This is the area where the 11th-century Preah Vihear Temple is located. For many over 100 years now, the conflict has been ongoing and all efforts to resolve it (including use of international law) have failed. However, the latest round of the conflict began only in 2008. Each side lays claim to the Temple area.³⁵⁶

Since this is a long-running conflict, it has not had major impacts on the economy of CAFTA. However, it has also discouraged investments in the two countries. This is would-be investors are concerned about the security of the two nations and so of their investments.³⁵⁷

Since the conflict has been ongoing for a long time, it is less likely that a legal solution would be found. This leaves room for a political solution. That the two nations are now member states of ASEAN means that an ASEAN-led dispute resolution mechanism (such as arbitration or mediation) should be pursued. Having noted

³⁵⁴ Quoted Weatherbee et. al., op.cit., p.75.

³⁵⁵ Ibid.

³⁵⁶ Ibid.

³⁵⁷ Ibid.

that, though, it would also be important for the matter to be referred to the ICJ for further interpretation. It is to be noted that the ICJ has handled the issue before. However, more clarifications might be need. The decision of the ICJ, however, can only be implemented when there is a political solution as well.

4.4.2.3 Malaysia with Indonesia

The conflict between Malaysia and Indonesia has been mainly confrontational. This confrontation was caused by the formation of Malaysia³⁵⁸. However, the confrontations as a result of this are now slowly dying down. In recent times, the conflict between the two is about the island of Borneo which is a disputed border region. Each side (as well as Brunei) has been claiming control over the island. There is another current conflict over the islands of Ambalat which are rich in oil.³⁵⁹

This conflict, like many other historical conflicts in the region has not impacted CAFTA in any way. That this was a historical confrontation taking place over half a century ago means that its effects have not been felt today. The only impacts present are those stemming from the conflict over the islands of Ambalat.³⁶⁰

To resolve the current conflict, there is need for the matter to be referred to the ICJ because the dispute is largely over the exact location of boundaries³⁶¹. This will help located and demarcate the boundaries between the two nations.

³⁵⁸ Ibid.

³⁵⁹ Ibid.

³⁶⁰ Ibid.

³⁶¹ Ibid.

Chapter 5

Summary and Conclusion

This chapter is the conclusion of the study. It is basically a summary of the entire study. In this summary, the chapter lays out the main research methodology adopted and the key research findings. The chapter also presents the implications of the findings and the possible way forward for CAFTA. Finally, the chapter lays out the limitations of the study.

5.1 Summary of the Study

This study explored the main factors that affect the economy of the China-ASEAN free trade area. In essence, it was a case study of the factors that affect the China-ASEAN free trade agreement. The study sought to achieve three main objectives. These are exploring the economy of CAFTA, ascertaining the causes of CAFTA's good economic performance in the region and across the whole world, and gauging the viability of CAFTA as free trade agreement.

There are a lot of factors affecting China ASEAN Free Trade Area (CAFTA), both economic and political ones, including economic theories, complementarity of the economies, intra and extra political conflicts, and other related factors. However, the CAFTA shall continue to prosper despite these factors. The two hypotheses were tested. The first hypothesis was that China's rise to become the world's second largest economy is a major factor affecting the economy of CAFTA. The second one was that political issues in the eleven CAFTA member states (ASEAN 10 + China) play a very important role in shaping the economy of CAFTA.

In order to test the hypotheses, qualitative research design was used. Here, secondary research was conducted with a view to examining the factors that actually affect the economy of CAFTA. It was from these factors that it was determined that the hypotheses were true.

That is, after the data had been collected and analyzed, it was found that four key factors affect the economy of CAFTA. The four factors that were actually determined as

affecting the economy of CAFTA economic theories, complementarity of the economies, proliferation of China's and ASEAN as an International Organization and as ASEAN Member States' individually with outside states, and political conflicts which may have economic impacts upon CAFTA.

5.2 The Future of CAFTA

These findings have various implications for the future of CAFTA. First of all, the continued integration into CAFTA will largely depend on how well the member states approach and deal with the critical factors affecting the economies of each individual state. While it is true that the overall outlook of the whole China-ASEAN free trade agreement looks great, individual nations could be struggling with a number of issues. Therefore, how well these issues are addressed will ultimately determine the future economic performance of the entire free trade area.

Secondly, the economic performance of CAFTA will in future be heavily dependent on the decisions made by both ASEAN and China regarding opening up the free trade agreement to more members. For instance, more trade would be realized if ASEAN succeeds to form a free trade agreement with the EU.

Similar results would be realized if China manages to sign a free trade agreement with nations like Japan, South Korea, and India. Bottom-line is that increased integration into the existing free trade agreement is likely to enhance economic growth in CAFTA.

Having noted that, however, it is also imperative to add that countries that have less stable economies (new members of ASEAN) such as Vietnam, Burma, and Cambodia will need to be helped to establish their domestic economies before allowing any free trade agreements with the more powerful and economically established nations such as India, China, and even the EU. This way, these nations will be protected from harmful economic impacts of free trade agreements such as dumping.

Thirdly, China's rise to power has brought both benefits and concerns to the ASEAN members. In the short term, ASEAN hopes to benefit from China's modernization program by taking advantage of economic opportunities. However, as the reform process continues, China is able to augment its political, economic and military influence in the region. ASEAN supports the policy of engagement with China, hoping that the economic

interdependence, and China's participation in the embryonic regional security architecture, will mitigate their security concerns.

Another implication of the findings is that political issues will inevitably continue to play a very critical role in shaping not just the fortunes but also the destiny of CAFTA. Chinese politics are particularly important in this respect. If CAFTA is to continue thriving, it will have to respond to emerging security concerns especially those pitting China and other ASEAN states such as the Philippines.

There is no denying that there are still disturbing factors in the region that affects stability and development, but they do not represent the mainstream. On the disputes in the South China Sea, China maintains that consultations should be held by the parties directly concerned on the basis of respecting historical facts and international law. The Chinese government is committed to fulfilling its responsibilities and is ready to seek a proper settlement through friendly consultations. China believes that the disputes in the South China Sea are not an issue between China and ASEAN, nor should or can they affect the overall China-ASEAN cooperation in the future.

China appears to have adopted a more accommodating attitude towards these disputes. China has demonstrated the willingness for dialogue. On the positive side, China has engaged in both bilateral and multilateral negotiations with ASEAN. China and ASEAN future will be a mixture of cooperation on some fronts and unresolved issues conducive to tension on the other fronts. These are the future challenges and opportunity for China and ASEAN. A stabilized China-ASEAN should help stabilize the Asia-Pacific region, which is what both China and ASEAN seek to develop and prosper together. In summary, the relations between China and ASEAN clearly reflect the dictum 'there is no permanent enemies or friends only permanent interests'.

5.3 Limitations of the Study

This study experienced various limitations. The first and most important was the lack of recent data on the subject matter. To this end, it was difficult finding accurate data about CAFTA as a combined entity. Although there was a lot of data pertaining to ASEAN and China as separate entities, very limited data was available for the combined China-ASEAN free trade agreement. This was attributed to the fact that the agreement

has only been launched recently (less than three years ago).

The second limitation was with regard to identifying the best secondary sources for review. This was a purely qualitative research that relied on secondary research. Since there was a large number of secondary sources of data, it was difficult to determine which ones were credible and worth using.

Generally, peer reviewed sources were scant owing to the fact that this research area is relatively new. To overcome this challenge, as minimal media and internet articles as possible were used. Instead, more scholarly sources (books, journal articles, and credible internet sources) were used more extensively.

5.4 Conclusion

In view of the findings of the study, it can be concluded that political factors play the greatest role in shaping the economy of CAFTA. This is because economic factors are largely dependent on political factors. Although economic factors are no less important, their importance has been dwarfed by political factors. Going forward, therefore, the economy of CAFTA will continue being largely dependent on political factors in the region. More specifically, it is how the various disputes and conflicts (intra and extra) will be resolved that will determine the economic performance of CAFTA.

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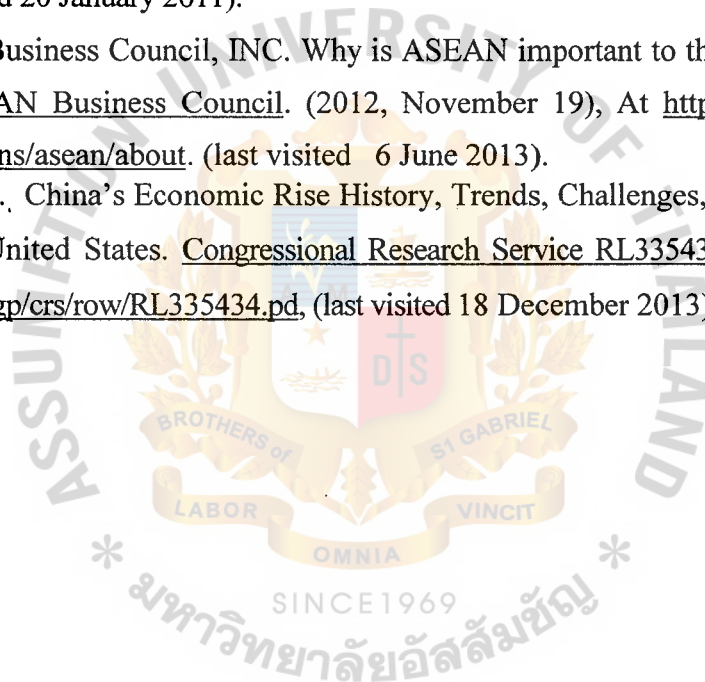
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Appendix A

Tariff rate schedule between China and ASEAN+6.

Source: ASEAN

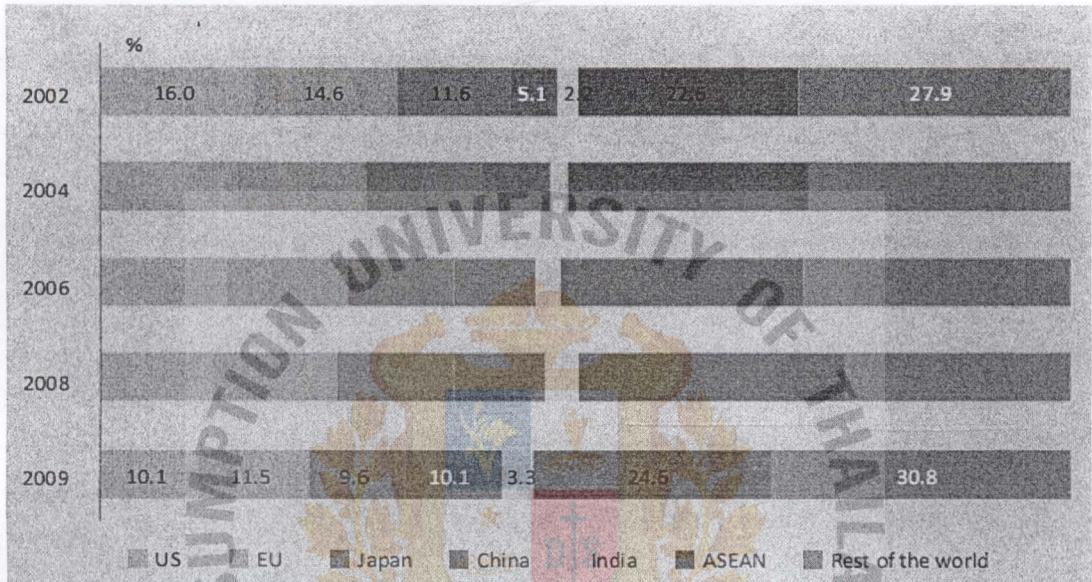
Schedule	Commitments			
Jan 2010	<ul style="list-style-type: none"> • Eliminate all tariff lines 			
Jan 2007	<ul style="list-style-type: none"> • At least 60% of its tariff lines reduced to 0-5%. 			
Jul 2005	<ul style="list-style-type: none"> • At least 40% of its tariff lines reduced to 0-5%. 			
Applicable Tariff Rates	CAFTA Preferential Tariff Rate			
	2005	2007	2009	2010
20% and above	20	12	5	0
15% (inclusive) – 19.99%	15	8	5	0
10% (inclusive) – 14.99%	10	8	5	0
5% – 9.99%	5	5	0	0
4.99% and below	Standstill		0	0

Appendix B

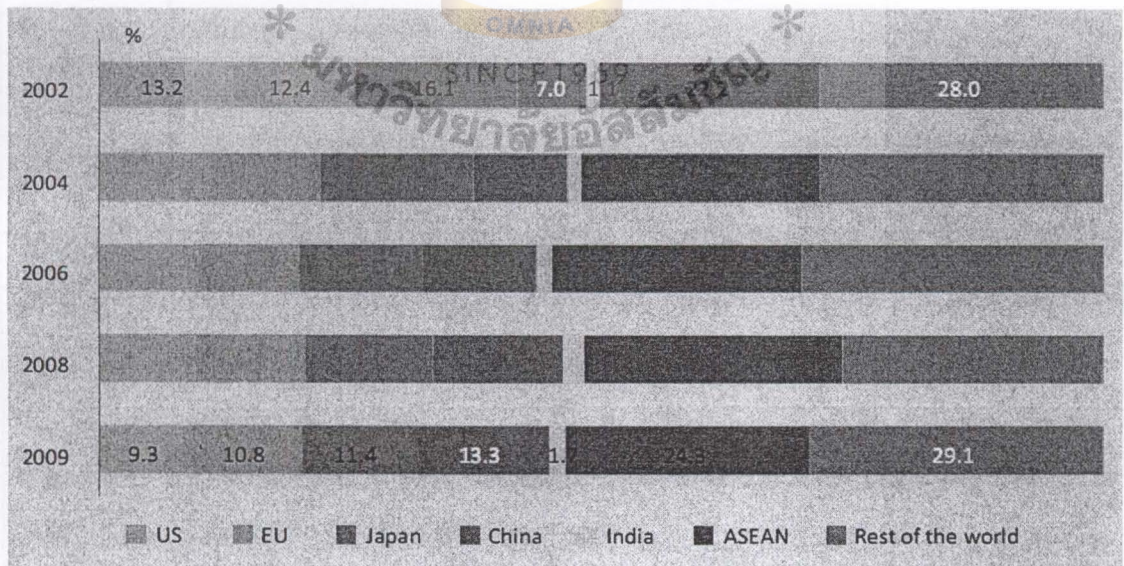
ASEAN Export statistics (2002-2009).

Source: China Custom Figures.

ASEAN Export statistics (2002-2009). Source: China Custom Figures.



ASEAN Import statistics (2002-2009). Source: China Custom Figures.



Appendix C

Timeline for the China and ASEAN FTA Implementation.

Source: Official website of the Association of Southeast Asian Nations, <http://www.aseansec.org/index2008.html>, accessed 12th May 2010.

Timeline for the China and ASEAN FTA Implementation	
July 1991	Chinese Foreign Minister Qian Qichen attended the opening session of the 24 th ASEAN Ministerial Meeting in Kuala Lumpur, Malaysia. China expressed its keen interest to forge cooperation with ASEAN for mutual benefit.
1995	China and ASEAN established the China and ASEAN Joint Science and Technology to plan, approve, coordinate, monitor and evaluate joint cooperative programmes and activities. Since then, there have been many joint programmes and activities convened.
1996	China was accorded full Dialogue Partner status at the 29 th ASEAN Ministerial Meeting in Jakarta, Indonesia.
1997	Chinese President Jiang Zeming and ASEAN leaders had their first informal summit and issued a joint statement to establish a partnership of good neighborliness and mutual trust oriented towards the 21 st century.
2000	Chinese Premier Zhu Rongji proposed setting up an FTA with ASEAN
November 2001	China and the ten members Association of South East Asia Nations (ASEAN) began negotiations to set up an China-ASEAN Free Trade Agreement in 10 years.
November 2002	The “China and ASEAN Framework Agreement on Comprehensive Economic Cooperation” was signed.
2003	Signing of Joint Declaration of State/Government of the ASEAN Nations and China on Strategic Partnership for Peace and Prosperity at the 7 th ASEAN and China Summit.
1 January 2004	Implementation of the Early Harvest Program (EHP); tariffs on certain products were reduced over a period of three years, and zero tariff no later

	than 1 January 2006. The Early Harvest Program (EHP) covers over 130 agricultural and manufacturing products. In return ASEAN countries agree to give tariff concessions to China under the Harmonized System(HS) for agricultural products, including meat, fish, fruits, vegetables, and milk.
November 2004	The China and ASEAN Protocol on Enhanced Dispute Settlement Mechanism (DSM) and the Agreement on Trade in Goods were signed at the Tenth China and ASEAN Summit.
July 2005	Agreement on Trade in Goods under Framework Agreement on ASEAN and China Comprehensive Economic Cooperation became effective. The gradual lowering and removal of the trade threshold encourage new industrial structural adjustment and offer new choices for market development of enterprises.
January 2007	Agreement on Trade in Services between China and ASEAN countries was signed.
August 2009	On August 15, 2009, the China and ASEAN Investment Agreement was signed during the 41 st ASEAN Economic Ministers Meeting. This completes the China and ASEAN negotiation processes on FTA as set in the Framework Agreement on Comprehensive Economic Cooperation between China and ASEAN, marking the successful of main CAFTA negotiations.
January 2010	Full implementation of the CAFTA.
Source: Official website of the Association of Southeast Asian Nations, < http://www.aseansec.org/index2008.html >, accessed 12th May 2010.	

