The InsightBureau Briefings

From the Desk of...

Hans Vriens
Advisor on Asia Politics, Economics and Trade

Issue No.48 - January 2010

© copyright The Insight Bureau Pte Ltd / **Hans Vriens**

Should we celebrate the China-ASEAN FTA?

Hans Vriens, CEO of Vriens & Partners comments on why the recently announced China-ASEAN Free Trade Agreement may not necessarily be good news for Southeast Asia.

"China-ASEAN Free Trade Area (CAFTA) sets example for mutual beneficial, win-win regional co-op", writes the official Chinese news agency Xinhua. According to the official Chinese website, the agreement – which came into force on January 1st – will bring only good news to the 1.9 billion inhabitants of China as well as ASEAN's 10 member states in Southeast Asia. There is no acknowledgement in these articles that this free trade agreement will likely prove detrimental to a number of industrial sectors in Indonesia, Thailand, Vietnam, Myanmar, Cambodia and Malaysia. Indeed, there are several eminent reasons why CAFTA is unlikely to bring the usual advantages associated with free trade to ASEAN.

In record time China has become a major trade and financial power. In fact, China just surpassed Germany as the biggest exporter in the world. Although China's trade with Southeast Asia is far smaller than with the West, it has been growing rapidly. Between 2003 and 2008, it more than tripled from US$59.5 billion to US$192.5 billion. China has already overtaken the US to become ASEAN's third largest trading partner, and is expected to leap past Japan and the EU within the next couple of years. China's rise as an exporting and trading power has been meteoric.

This free trade agreement will likely prove detrimental to a number of industrial sectors in Indonesia, Thailand, Vietnam, Myanmar, Cambodia and Malaysia

Unfortunately, China doesn't act like other big economies. Instead, it follows a mercantilist policy by pegging its currency at about 6.8 yuan to the dollar. At this exchange rate, Chinese manufacturing has a large cost advantage over its rivals, leading to huge trade surpluses. The yuan has in fact depreciated by 12 per cent over the past seven months because it is pegged to a falling US dollar. China's currency is falling, even though it has the world's fastest growing economy, the largest current account surplus, and has accumulated US$2,300 billion in foreign currency reserves. This combination should have led to a sharp appreciation of the yuan under normal circumstances.

Doing the opposite is what the Nobel Prize winner Paul Krugman calls "a predatory policy of beggar-thy-neighbour". This has given Chinese exporters a growing competitive advantage over their rivals, especially producers in other developing countries. Keeping the exchange rate down is equivalent to an export subsidy. In fact it is a form of protectionism as the *Financial Times* columnist Martin Wolf argues.

The influential American economist, C. Fred Bergsten, calculates that the yuan is undervalued by up to 40 per cent. In other words, the manipulation with the yuan gives Chinese exporters a price advantage of up to 40 per cent when they compete in Southeast Asia and with exporters from Southeast Asia in the rest world. One only has to look at the furniture and shoe manufacturing sectors in Indonesia to see how devastating the effects can be. Another interesting example is

Dunia Metal Works – a nail manufacturer on Java. Its exports have been wiped out and its domestic market decimated because Chinese competitors sell nails in Indonesia below the price that Dunia pays for the steel to make nails. "We have been competing with the Japanese and the Koreans," said Juniarto Suhandinata, Dunia's director, in an interview with the New York Times, "but the Chinese? – no chance!"

Indonesia is especially vulnerable. It is the least economically developed and the most populous with a population of 235 million inhabitants among the erstwhile tigers. It will have great difficulty to accommodate a regional economic order dominated by China. Unhappiness about the prospect of job losses led to street demonstrations of 50,000 workers against CAFTA in the Indonesian industrial city of Bandung on January 6th. Indonesia is so worried that it considered asking for a delay in removing tariffs from some items like steel products, textiles, petrochemicals and electronics.

There is more bad news for ASEAN. China has created an export monster that despite the drop in demand from the U.S. is still on steroids thanks to a US$ 586 billion stimulus program by the Chinese government.

China is doing the opposite of what it did during the financial crisis of 1998; when most countries in the region saw their currencies sharply depreciate, China held the value of the renmenbi stable. By doing this it prevented a race to the bottom of currency devaluations. This time it is the other way round. On top of that the Chinese leaders seem tone-deaf to the problem they have created.

In an attempt to keep up with the Chinese, Vietnam just devalued its currency by 5 per cent. In 2008, Vietnam exported worth US$4.5 billion to China, but imported about US$15.7 billion worth of Chinese goods.

A lot of this money is being lent by state-owned banks to state-owned companies at rates so cheap that the credit is almost free, holding down operating costs. This has created the mother-of-all overcapacities.

Take steel, for example. China's excess steelmaking capacity equals the entire annual production of the world's number two steelmaker, Japan. Every Chinese province wants a steel industry, because it conveys prestige, creates jobs and attracts other business. A recent study by the European Union Chamber of Commerce in China entitled *Overcapacity in China; Causes, Impacts and Recommendations,* argues that overcapacity is one of the drivers of the current rise in trade tensions and anti-dumping cases between China and its trading partners.

The well-known US hedge fund investor James S. Chanos warned in a recent interview with Politico.com: "The Chinese are in danger of producing huge quantities of goods and products that they will be unable to sell". This is not all. CAFTA could lead to a fall in FDI in Southeast Asia. Why build a car factory in Thailand or Indonesia if you can import the cars from China with its discounted currency? This will make it even more difficult for countries like Malaysia, Thailand, Vietnam and Indonesia to modernise their economies and upgrade their industries. Many factories have moved from Southeast Asia to China as it became the preferred destination for FDI in the last ten years. Cities like Penang – the centre of Malaysia's high-tech industry – have suffered as a result. Despite all these dangers there is also some good news; ASEAN is expected to benefit from increased exports of fruits and raw materials to China like pineapples, coal, palm oil and some oil.

The FTA does not allow the free trade of goods (let alone services) like the European common market; individual member states within ASEAN have exempted quite a few sectors. Less-developed countries like Laos, Vietnam, Cambodia and Myanmar have until 2015 to see their tariffs being lowered to zero.

After seven years of gradually lowering their tariffs after CAFTA was signed in 2002, Indonesia and the Philippines panicked at the eleventh hour when they realised the extent to which their industrial sectors might be affected. In fact, in most sectors, tariffs between China and ASEAN are already low, often as low as 5 per cent. Irvan K. Hakim, co-chairman of the Indonesian Iron and Steel Industry Association, told the *New York Times* he had aired complaints to the Chinese officials for many years. He doesn't appear to be optimistic. "China is China, you know?" he said, shrugging, "Even the U.S. cannot talk to China."

About Hans Vriens and The Insight Bureau

Hans Vriens is one of the leading independent advisors on public policy in the Asia Pacific region, with almost 20 years of experience following the political shifts taking place across a number of key countries. Based in Singapore, he has been counsel to chief executives and board members on market entry strategy, regulatory affairs and managing sensitive issues across Asia. He has particularly strong experience in Southeast Asia, China and India. Hans frequently provides background briefings to visiting executives to help them understand political, economic, cultural and business developments in the region. He is able to provide unique and frank analysis thanks to the many research and consultancy projects he has led for leading multinationals and governments around Asia over recent years.

The Insight Bureau provides speaker placements and briefings as a service that helps achieve a better understanding of the world in which we do business and to ultimately help senior executives to make better business decisions. The Insight Bureau represents Hans Vriens globally for speeches and briefings.

www.insightbureau.com +65-6300-2495 engage_us@insightbureau.com

Disclaimer: The Insight Bureau Pte Ltd accepts no liability for the content of this document or for the consequences of any actions taken on the basis of the information provided. Any views or opinions presented herein are solely those of the author(s) and do not represent those of The Insight Bureau.