

# COMPETING WITH CHINA IN SOUTHEAST ASIA: THE ECONOMIC IMPERATIVE

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## EXECUTIVE SUMMARY

As great power rivalry intensifies in Southeast Asia, China is increasingly achieving its strategic goals in the region through economic statecraft — illustrated most vividly in its signature Belt and Road Initiative (BRI) — and economic factors are playing a prominent role in shaping the choices of Southeast Asian leaders on policy issues that divide Washington and Beijing. Security concerns will continue to resonate within this decision-making calculus, of course. Southeast Asian countries can be expected to push back against Beijing (and be more open to U.S. policy positions) when they feel threatened by China, especially where territorial integrity is concerned. These concerns will provide a continuing opening for Washington in the security domain. Yet, the security-centric paradigm that has long guided American thinking is an insufficient lens through which to view and understand the region. As Southeast Asia begins to recover from the COVID-19 pandemic, the United States must also improve its economic game in a region where China has come to dominate trade and tourism and is matching if not exceeding Japan in infrastructure investment. The objective shouldn't be to confront BRI and create a bifurcated region, imposing choices that could end up marginalizing the United States over time, but to develop compelling alternatives and then reengage China from a position of strength.

To compete with China and sustain American power and influence effectively, Washington should take the following steps to improve its economic standing in the region:

- **Operationalize infrastructure coordination in Southeast Asia with allies and partners:** The U.S. should operationalize existing multi-country platforms to facilitate infrastructure investments in the region. Washington shouldn't miss this opportunity to compete with China, produce benefits for American investors, and demonstrate high standards and best practices in collaboration with key regional partners.
- **Establish a regional center for strategic economic engagement:** To galvanize cooperation with allies and partners, Washington should appoint a special infrastructure envoy to lead a new regional center at the U.S. embassy in Singapore. The center should be staffed by representatives of the U.S. International Development Finance Corporation, U.S. Agency for International Development, U.S. EXIM Bank, and U.S. Department of State.
- **Explore the costs and benefits of joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP):** When the Trump administration withdrew from TPP negotiations in January 2017, the United States effectively ceded economic leadership to China in the Asia-Pacific. The U.S. should explore returning to the TPP family, starting with Congressional hearings that examine the costs and benefits, assess the impact on the American workforce and middle class, and identify possible areas for renegotiation.
- **Deepen bilateral ties with emerging partners like Vietnam:** Washington should establish a “strategic partnership” with Hanoi before the end of 2021. This would signal that U.S. relationships are innovative and growing in Asia and could facilitate broader development cooperation in mainland Southeast Asia. A central component of the partnership should be expanding economic ties with a country expected to be the world's fastest growing economy this year, having controlled COVID-19 with remarkable success.
- **Revitalize and reframe foreign aid cooperation with the region:** The Trump administration presented foreign aid and development as

a “Journey to Self-Reliance,” but today’s development needs increasingly emanate from global governance challenges like pandemics and climate change — challenges that require multilateral solutions. Going forward, in part to protect America’s economic future, the United States should expand support for regional efforts addressing these urgent global challenges.

- **Reengage China on select issues like climate change:** Washington should coordinate with China to combat climate change in Southeast Asia, a maritime region that is particularly vulnerable to global warming. The U.S. could work with Beijing to establish a multi-donor trust fund at the World Bank, to which third countries could apply for climate support, or simply encourage co-financing from regional development banks to address this issue.

## THE PROBLEM

The U.S.-led security system has underpinned regional peace and stability in East Asia for decades. China is now challenging this system as it woos American allies like Thailand and the Philippines, seeks to reorient Asia’s security architecture in its favor, and takes aggressive steps to enforce its far-reaching territorial claims in the South China Sea. At the same time, China is increasingly achieving its strategic goals in Southeast Asia through economic statecraft or the use of economic tools to achieve foreign policy goals. Starting in 2018, the Trump administration launched some new economic initiatives with allies and partners under its Free and Open Indo-Pacific (FOIP) strategy, but so far these efforts pale in comparison to China’s financial might and growing economic integration with the region. Meanwhile, U.S. efforts to brand BRI as “predatory economics” or “debt-trap diplomacy” have failed to resonate with Southeast Asian countries. The COVID-19 pandemic has only increased the policy challenges for Washington as China recovers faster from the outbreak, reinforcing its already advantaged economic position and advancing its strategic goals as a result.

### *America’s economic challenge*

Much is at stake for U.S. foreign policy and American interests in the region. Southeast Asia not only includes two U.S. allies, but also important security

partners like Singapore and key emerging partners such as Vietnam and Indonesia. Taken together, the 10 countries that make up the Association of Southeast Asian Nations (ASEAN) boast the third largest population in the world at 650 million. In addition, ASEAN is the fifth largest economy in the world with a gross domestic product (GDP) of \$2.8 trillion and the top destination for U.S. investment in the Indo-Pacific at \$329 billion (more than the United States has directed to China, Japan, South Korea, and India combined). Almost 42,000 U.S. companies export to ASEAN countries, supporting about 600,000 jobs in the United States.<sup>1</sup>

Yet, while the stakes are high, the region is confused about the objectives and focus of U.S. policy. At a trilateral dialogue organized by Brookings in Singapore in late October 2019, just before COVID-19 emerged in Wuhan, experts from Southeast Asia asked tough and probing questions about U.S. Asia strategy in the context of escalating U.S.-China rivalry. Southeast Asian participants said the United States should better define the goal of U.S. Asia policy today: Is it to reestablish preeminence, construct a new balance of power, preserve the rules-based order, or some combination of these elements? They said strategic competition should be a means to an end, not an end in itself. They also felt U.S. policy was too concentrated on defense and security, to the detriment of diplomacy and development, allowing China to fill the soft power vacuum and capture the narrative through BRI.<sup>2</sup>

U.S. economic engagement with the 10 ASEAN countries remains substantial. The United States exports about \$75 billion in goods and \$31 billion in services to ASEAN on an annual basis. Washington disburses over \$800 million annually in foreign assistance to ASEAN countries, as well.<sup>3</sup> This includes support for the new Mekong-U.S. Partnership, successor to the Lower Mekong Initiative (LMI) that lasted from 2009 to 2020. Under the new partnership, launched in September 2020, the U.S. will contribute about \$150 million to support the autonomy, economic independence, and sustainable growth of Mekong partner countries, with \$33 million of this total coming from the existing Asia Enhancing Development Growth through Energy (EDGE) initiative.<sup>4</sup>

Under FOIP, the Trump administration also took steps to expand its efforts in the infrastructure domain. In late 2018, it joined Japan and Australia to form the Trilateral Partnership for Infrastructure Investment in the Indo-Pacific to promote sustainable infrastructure based on high standards. Subsequently, it partnered with Tokyo in launching the Japan-U.S. Mekong Power Partnership, or JUMPP, with an initial U.S. commitment of \$29.5 million, and created the Blue Dot Network with Japan and Australia, a multi-stakeholder initiative designed to evaluate and certify nominated infrastructure projects based on high quality standards and principles.<sup>5</sup> Yet, few concrete projects have resulted from these initiatives apart from an electrification project in Papua New Guinea and recently-announced plans to finance an undersea telecommunications cable for the Pacific Island of Palau, although the three countries also sent a joint delegation to Indonesia in 2019 to explore potential projects there.<sup>6</sup>

### ***China's growing economic influence***

Meanwhile, Chinese economic engagement has grown dramatically and surpassed U.S. levels in most areas. China has been ASEAN's largest trading partner for over a decade. ASEAN's total annual bilateral trade with China is currently valued at \$642 billion, compared to about \$291 billion with the United States.<sup>7</sup> China ranks third in annual foreign direct investment in ASEAN, behind the United States and Japan, but Chinese investment is quickly approaching U.S. levels if foreign direct investment (FDI) from mainland China is combined with FDI from Hong Kong. In addition, Chinese FDI does not include the billions of dollars Beijing is lending to the region through its powerful development banks under the Belt and Road Initiative (BRI).

BRI is China's most visible platform for advancing its influence and diplomatic goals in Southeast Asia. Projects include hydropower dams, oil and gas pipelines, and Beijing's extensive railway plans to connect the southwestern city of Kunming not just to Laos and Thailand, but eventually to Singapore through Malaysia.<sup>8</sup> Although exact figures are difficult to pin down, Indonesia, Vietnam, and Malaysia consistently rank as the top recipients of Chinese capital for infrastructure development in Southeast Asia. In terms of projects that are at

the stage of planning, feasibility study, tender, or currently under construction, Indonesia currently leads the list at \$93 billion, followed by Vietnam and Malaysia at \$70 billion and \$34 billion, respectively.<sup>9</sup>

China is also developing new sub-regional initiatives, such as the Lancang-Mekong Cooperation (LMC) mechanism, to coordinate BRI projects and advance its economic and political ambitions in mainland Southeast Asia. Established in 2015 among the six countries that comprise the Greater Mekong Subregion (Cambodia, China, Laos, Myanmar, Thailand, and Vietnam), the LMC promotes cooperation across a range of economic and cultural domains, but the driving force is infrastructure.<sup>10</sup> Beijing has set aside over \$22 billion under the mechanism to support projects focusing on technological connectivity and industrial development as well as trade, agriculture, and poverty alleviation.

The strategic implications of China's dam building along the Mekong are particularly daunting. China has built 11 mega-dams along the upper Mekong within China, apart from the hydropower dams it is financing in Laos and Cambodia, effectively giving it the power to "turn off the tap" for the five ASEAN countries that rely on the river for economic stability and security in the Lower Mekong Subregion. A recent study from U.S.-based climate consultant Eyes on Earth has offered evidence that Chinese dams held back water in 2019 — exacerbating drought in Vietnam, Laos, Cambodia, and Thailand.<sup>11</sup>

Although the Trump administration has accused China of practicing "debt-trap diplomacy" in the region, almost all ASEAN countries are in good shape according to pre-pandemic data on their external debt relative to gross national income. The exceptions are Laos and to a lesser extent Cambodia. Laos highlights the risk of taking on too much debt too quickly, especially non-concessional debt, a problem exacerbated by the economic challenges brought on by COVID-19. Although Laos is eligible for the Debt Service Suspension Initiative promoted by the G20, it recently chose instead to negotiate directly with China, its main creditor, including a debt-for-equity swap in which the China Southern Power Grid Co. is taking a direct stake in Laos's power transmission company.<sup>12</sup>

China's rising economic influence has generated some unease and pushback in Southeast Asia over contract terms, corruption, and lack of transparency. However, as reflected in Malaysia's successful renegotiation of the Chinese-financed East Coast Rail Link project in 2019, most ASEAN countries appear to be getting smarter in the way they are managing BRI and negotiating with China.<sup>13</sup> Beijing is also showing a capacity to learn from its implementation mistakes, make adjustments, and preempt criticism from the region going forward. In sum, there appears to be a mutual learning dynamic at play that could make BRI more resilient and enduring in Southeast Asia over time.<sup>14</sup>

### ***The accelerating effects of COVID-19***

Meanwhile, the COVID-19 pandemic is only reinforcing China's economic position as it recovers faster from the pandemic. While the U.S. economy remains mired in recession, the Chinese economy is rebounding and surged by 4.9% in the third quarter of 2020 compared to the same period last year. Chinese exports and imports are growing as well, showing a recovery in trade. In fact, ASEAN has recently become China's largest trading partner — not just the other way around — eclipsing the European Union and the United States for the first time.<sup>15</sup> Furthermore, China is building new supply chains in Southeast Asia as tensions with Washington are resulting in reduced access to U.S. technology.<sup>16</sup>

In addition, the pandemic has further enhanced U.S.-China tensions as seen in the ongoing “tech war” surrounding the use of Huawei technology. In Southeast Asia today, Vietnam appears to be siding with Washington in barring Huawei (albeit for its own reasons), whereas countries like Malaysia, Thailand, and the Philippines are open to deploying Huawei's 5G technology into their domestic networks.<sup>17</sup> The pandemic has also deepened American interest in a broader-gauged decoupling of the U.S. and Chinese economies. Decoupling is a nightmare scenario for ASEAN countries because it could impose a wider choice, preventing them from navigating U.S.-China competition issue by issue. It could also increase the region's economic interdependence with China if supply chains fragment and then realign in China's favor — potentially boxing out American businesses, increasing China's soft power, and inadvertently contributing to a Chinese sphere of influence over the long run.

The Chinese economy also faces serious domestic challenges, of course, and could well stumble.<sup>18</sup> Yet, as ASEAN governments try to recover from the pandemic, they are watching the Chinese economy closely for signs of a sustained recovery and possible knock-on effects. Even before COVID-19 hit, 79.2% of Southeast Asian policy elites viewed China as the most influential economic power in the region, compared to just 7.9% for the United States and 3.9% for Japan, although they remain distrustful of China's long-term strategic intentions, according to a respected regional survey.<sup>19</sup> ASEAN policymakers will be clear-eyed about these economic realities as they look to the future, estimate China's economic footprint, and calculate their likely interdependencies and opportunities with Beijing. These interdependencies are expected to deepen further with the completion this month of the Regional Comprehensive Economic Partnership (RCEP), a free trade agreement involving the 10 ASEAN countries, China, Japan, Korea, Australia, and New Zealand.

National University of Singapore Professor Khong Yuen Foong has aptly framed the strategic implications for ASEAN as the recovery unfolds: “I will not underestimate the U.S.'s economic resilience and technological ingenuity, but if China were to do better on the economic front, its narrative about being the wave of the future will fall on receptive ears in Southeast Asia.”<sup>20</sup>

## **OBJECTIVES**

An enduring goal of U.S. Asia strategy has been to prevent the emergence of a hostile hegemon, thereby sustaining America's role as a Pacific power and making the region safe for American pursuits like trade and investment and democracy support.<sup>21</sup> To achieve this goal, the United States has cultivated and sustained a regional security order through a network of alliances and strategic partnerships with countries as far flung as Japan, Australia, the Philippines, and Singapore. What was not anticipated, however, was how a rising power like China could begin to undermine this U.S.-led security order by using economic tools to achieve its foreign policy goals in the region. To meet this challenge and sustain U.S. power and influence in Asia, the United States needs to rapidly improve its own economic game in coordination with key allies and partners like Japan, Australia, Singapore,

and Vietnam. Washington should also take steps to engage China in the region, rather than forcing choices that could redound to China's benefit over the long term.

## RECOMMENDATIONS

China's emerging economic dominance in Southeast Asia begs the question of what Washington can realistically do to compete with Beijing economically in its own backyard. Yet, concrete policy options are available to the United States in the region. Below are series of steps that could be taken to develop a more effective economic strategy in 2021.

**Operationalize infrastructure coordination in Southeast Asia with allies and partners:** The United States should increase cooperation with longstanding partners to support sustainable infrastructure development based on high governance and environmental standards. As discussed above, the Trump administration signed an infrastructure memorandum of understanding (MOU) with Japan and Australia and announced a U.S.-Japanese partnership to support energy development in the Mekong. It also inked an agreement to work with Singapore's Infrastructure Asia initiative to promote infrastructure development in the region.<sup>22</sup> Washington should now operationalize these platforms to facilitate investments and loans, especially in mainland Southeast Asian countries like Cambodia, Laos, and Vietnam. Partnerships are difficult to implement, and MOUs often languish with little activity or output. The United States shouldn't miss this opportunity to compete with China, produce benefits for American investors, and demonstrate high standards and best practices in collaboration with key regional partners.

**Establish a regional center for strategic economic engagement:** To galvanize cooperation with allies and partners in Southeast Asia, Washington should appoint a special infrastructure envoy to head up a new regional center at the U.S. embassy in Singapore focusing on strategic economic engagement. The new center should be staffed by representatives of the U.S. International Development Finance Corporation, U.S. Agency for International Development, U.S. EXIM Bank, and U.S. Department of State, with the special envoy helping to triangulate efforts and improve intra-agency coordination.

**Explore costs and benefits of joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP):** When the Trump administration withdrew from TPP negotiations in January 2017, the United States effectively ceded economic leadership to China in the Asia-Pacific. Today, American companies are disadvantaged because the United States isn't part of the CPTPP, the free trade agreement with 11 parties without the U.S., under which signatories can trade with each other at preferential rates that U.S. exporters don't enjoy. The CPTPP also makes it more cost effective to situate supply chains within participating countries rather than outside of them. Conversely, U.S. participation in the CPTPP could potentially facilitate supply chain integration between the United States and key allies and like-minded partners in Asia — building resilience in critical sectors like medical equipment, semiconductors, and telecommunications infrastructure. Returning to the TPP family would not be an easy lift from a domestic political perspective. The option should be explored, however, starting with Congressional hearings that examine the costs and benefits, assess the impact on the American workforce and middle class, and identify possible areas for renegotiation, including provisions related to labor and environmental standards.<sup>23</sup>

**Deepen bilateral ties with emerging partners like Vietnam:** In addition to supporting regional initiatives, the United States should deepen relations with emerging country partners. In recent years, U.S. relations with Vietnam have expanded considerably owing to growing trade ties, strong people-to-people relations, and a common concern over China's actions in the South China Sea and growing economic influence in mainland Southeast Asia. Highlights include the establishment of a "comprehensive partnership" in 2013 and the dramatic visit of a U.S. aircraft carrier to Danang in 2018. In September 2020, the U.S. Centers for Disease Control and Prevention also announced plans to open a regional office in Hanoi to increase public health engagement in Southeast Asia.<sup>24</sup> As a next step, Washington should establish a "strategic partnership" with Hanoi before the end of 2021. This would signal that U.S. relationships are innovative and growing in Asia, and it could facilitate broader development cooperation in the Lower Mekong subregion. A central component of the partnership should be expanding economic ties

with a country expected to be the world's fastest growing economy this year, having controlled COVID-19 with remarkable success.<sup>25</sup>

Revitalize and reframe foreign aid cooperation with the region: Inspired by escalating rivalry with China, the Trump administration presented foreign aid and development as a “clear choice” between China’s authoritarian and predatory approach, on the one hand, and U.S. efforts to support a “Journey to Self-Reliance” for developing countries, on the other.<sup>26</sup> The U.S. approach not only put regional countries in an uncomfortable position, since they prefer to have constructive relations with both Washington and Beijing, but it failed to recognize that today’s development needs increasingly emanate from global governance challenges like pandemics and climate change — challenges that require multilateral solutions and regional cooperation. Going forward, in part to protect America’s economic future, the United States should support regional efforts to address these urgent global challenges. It should also support homegrown initiatives such as the ASEAN Institute for Green Economy and the Ayeyawady-Chao Phraya-Mekong Economic Cooperation Strategy (ACMECS), enhancing ASEAN’s capacity to develop viable economic strategies for the region.

Reengage China on select issues like climate change: Finally, the United States should consider engaging Beijing to help combat climate change in Southeast Asia, a maritime region that is particularly vulnerable to global warming. For instance, Washington could work with Beijing to establish a multi-donor trust fund at the World Bank, to which third countries could apply for climate support or simply encourage co-financing from regional development banks to address this issue. Such initiatives would not only send a reassuring signal that U.S.-China cooperation is possible but would combine the substantial resources of the world’s two largest powers to address a global challenge that threatens both the region and the American homeland.

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