

William Bratton

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CHINA'S RISE ASIA'S DECLINE

Marshall Cavendish Editions



# CHINA'S RISE ASIA'S DECLINE

Asia's difficult outlook under China's shadow

China's rise will be long-term punitive for the rest of Asia. Across all aspects of Asian geopolitics and economics, China's ascendancy to regional hegemonic status will result in the decline of its neighbours' political independence, economic dynamism and future growth potential. Any short-term benefits of China's growth, such as increased trade, will be transitory. The longer-term implications of its emergence as the regional hegemon will be greater economic and financial dependencies and vulnerabilities, the large-scale shift of business activity to within its boundaries and its increasing geopolitical influence across the region.

The challenge for China's neighbours is how to respond to these evolving dynamics, especially as their strategic options are increasingly limited and few of the potential future scenarios are long-term positive. China's rise, therefore, will be Asia's decline.

"Bratton overturns the narrative of Asia rising as he convincingly argues that China's rise will create long-term headwinds for its neighbours which will constrain their future development."

Peter Milliken

Head of Asia-Pacific Company Research, Deutsche Bank

"One of the few pieces of genuinely objective analysis of a country which consistently confounded the sceptics. Bratton's work removes emotion and presents a persuasive account of why China will continue to dominate Asia."

Jim McCafferty

Joint Head of Asia Pacific Equity Research, Nomura

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For Review only

William Bratton



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under China's shadow



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Editions

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*For Charles, Claire, James and Luke*

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## **National Library Board, Singapore Cataloguing-in-Publication Data**

Name(s): Bratton, William.

Title: China's rise, Asia's decline : Asia's difficult outlook under China's shadow / William Bratton.

Description: Singapore : Marshall Cavendish Editions, [2021] | Includes bibliographical references and index.

Identifier(s): OCN 1202590288 | ISBN 978-981-49-2826-7 (paperback)

Subject(s): LCSH: China--Foreign relations--Asia. | Asia--Foreign relations--China. | China--Foreign economic relations--Asia. | Asia--Foreign economic relations--China.

Classification: DDC 327.5105--dc23

Printed in Singapore

# For Review only

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## Preface

When I first arrived in Asia 20 years ago, China was not considered particularly important. The US and its regional allies dominated all aspects of the region while China was seen as an almost curious economic experiment. I remember having discussions as to whether it would be able to sustain its post-1978 growth or whether the country's internal contradictions would result in its eventual collapse. Multiple arguments were advanced as to why the regional giant would not be able to maintain its growth trajectory, ranging from the economic (the country suffers from excessive capital misallocation or the banking system has substantial exposure to bad debt), to the geopolitical (the increasing wealth gap between the coastal and inland provinces will result in political fragmentation), to the social (the country's deteriorating demographic situation will place an excessive and unsustainable strain on government spending and public finances).

Many of these arguments continue to circulate. There is substantial literature as to why China's development model is fundamentally flawed and its economic growth unsustainable. But all this criticism and cynicism looks increasingly hollow as China's economy has wilfully refused to collapse. China has proved its doubters wrong, as it has instead gone from strength to strength. It is true that I describe myself as a "China bull" and have spent much of my working life arguing against those who appear to be almost fundamentally opposed to its ascendancy (a view which is surprisingly common across the financial industry). But I firmly believe that China's success at transforming itself from a communist state-and-control economy to a dynamic mixed economy—and in the process, elevating hundreds of millions out of poverty—is to be commended, not criticised.

There are underlying structural and fundamental problems within China that may constrain its long-term potential; but that

is no different from any other economy and the country's ability to recognise, address and resolve such problems is significantly greater than for many of its neighbours. One of China's core strengths is its relatively high degree of ideological and policy flexibility in its pursuit of long-term objectives, whether political or economic. But I have always believed that China is held to higher standards than those achieved by other developed countries at a comparable stage of economic development. I have, therefore, viewed many of the criticisms of the country as both unfair and not reflective of history. It seems to me that much of the Western world's response to China's rise is primarily driven by American and European reluctance to incorporate the new global superpower into the existing Western-defined international frameworks, structures and relationships, and to give the country the status, recognition and global role its size implies.

This is clearly unsustainable, especially as many of the American and European criticisms are hypocritical. China's behaviour and actions are in many aspects comparable to those of the European powers and the US during their various ascents. But as a result of these similarities, I have, however, always been convinced that China's size represented a substantial risk for its neighbours. I am often reminded by my family of a television appearance many years ago when I told the programme's host, "You must remember that China is big." This resulted in a degree of mirth that I could state such a truism. But I am surprised by how rarely the geopolitical and economic implications of China's relative size versus its regional neighbours are discussed.

In part this is because China's newfound scale is often not appreciated. One of the frequent comments provided by those I asked to review this book prior to publication was that they had not realised how large China now is versus the rest of the region across so many metrics. Even when China's relative size is recognised, the general optimistic presumption within the financial and business

world is that it will be an incremental and long-term source of wealth for the rest of Asia. It is true that over the last few decades, there has been a positive impact with substantial increases in intra-regional trade and service flows, and increased financial linkages. But China's ascendancy has created substantial asymmetries across the region's geopolitical, trade, financial and industrial dynamics, and the thesis advanced in this book is that these asymmetries will be longer-term negative for the rest of Asia. China's rise will create dependencies and vulnerabilities across its smaller neighbours, the large-scale geographic shift of economic activity to the regional hegemon, and result in its increasing geopolitical influence across the region as it displaces the US from its historic stabilising role.

It is my view that the implications of these asymmetries have not been widely considered nor assessed, partly because there is a reluctance to consider the consequences of China's relative scale within the region or to recognise its accelerating international ascendancy after the 2008 Global Financial Crisis and the arrival of the Xi Jinping era post-2012. The finance industry, for example, still refers to "Asia ex Japan", despite the fact that China's financial markets now dwarf those of Japan. I also remember how some colleagues and investors would use free-float metrics instead of absolute market capitalisations to deliberately reduce the relative size of Chinese listed companies. At the same time, emerging market desks across many investment banks are still centred in London instead of Hong Kong or Shanghai, even though Asia now accounts for the vast majority of the emerging world, with China the single largest component. And at the more macro level, China remains under-represented in numerous international organisations, including the Bretton Woods financial institutions, despite its relative economic size. While just a few examples from a specific industry, they are all reflective of a seeming reluctance to address the new global geography and its associated consequences.

Another reason why the long-term implications of China's rise on the rest of Asia are often not considered is the sheer volume of noise the country creates. Every new piece of information is pounced upon by analysts, commentators and the press to determine whether annual government targets will be met or whether the economy is just a heartbeat away from a "hard landing". Even if the data suggests that targets will be met or exceeded, the debate simply transitions on to whether the information can be trusted. When I started my career as a research analyst, one of my mentors urged me to always "ignore the noise and focus on the longer-term trend". As such, I was always surprised by investors who would seemingly spend most of their time and resources worrying if China's next quarter GDP would disappoint, instead of focusing on the long-term trends that are completely reshaping Asia's geopolitics, trade flows, financial inter-dependencies and industrial landscapes. And as I argue in this book, if you step back from the short-term noise and consider the impact of China's increasingly hegemonic position within the region, especially when overlaid with its geopolitical objectives and the behavioural precedent set by other comparable large powers surrounded by much smaller neighbours (including, for example, the US), it is difficult to feel positive about the rest of Asia long-term, at least on a relative basis.

There are a number of potential criticisms of this book's thesis. One is that I have underestimated the longer-term permanence of the region's increased trade flows and China's continued dependency on imports from its neighbours. It has also been suggested that my concerns over the US's willingness to remain a regional counterweight to China are misplaced and as such, Asian countries will be able to maintain a longer-term balance between the two global superpowers. I have sought to address both these potential criticisms throughout the book, since my views that (a) the majority of any economic benefits resulting from China's growth will be

transitory in nature, and (b) that the US's longer-term commitment to the smaller Asian countries is highly uncertain, are both core components of the overall argument. It is possible that changing regional and global dynamics may result in a different outcome than the generally pessimistic scenario presented in the following chapters; but I do believe that given current regional trends, global precedent and Asia's geography, the argument advanced in this book is the most probable longer-term outcome.

The rest of this book, therefore, presents the argument that China's rise is Asia's decline. Chapter 1 introduces and summarises the argument with the geopolitical, military, trade, financial and industrial components discussed separately in the following chapters. Chapter 2 addresses China's increasingly strident geopolitical approach towards the region and the resultant pressure that its neighbours will face to align themselves more closely with it, especially given increasing uncertainty over future US commitment to Asia. Chapter 3 develops this by highlighting China's disproportionate hard power capabilities versus the rest of the region. This is especially the case, as many of its neighbours appear either unwilling or unable to match its rapid advances in military capability, even those with most to fear from China's more aggressive international posturing. Chapter 4 then details the region's increasing economic dependency on China as a trading partner, while Chapter 5 highlights the country's expanding role as a source of capital for its neighbours. Both these dependencies create substantial geopolitical vulnerabilities across the region. Chapter 6 highlights China's aggressive industrial development policies and their alignment with the country's broader geopolitical objectives. This leads into Chapter 7, which argues that China's rapid industrialisation represents a major long-term economic trap for all its neighbours, both developed and emerging. Chapter 8 concludes by assessing how the rest of Asia could respond to its rise and increasing regional hegemony, especially as the US's historical regional role is

eroded. The argument is that the available responses are increasingly limited, with some no longer possible; while others carry significant longer-term economic and geopolitical risks.

The problem with writing on this topic is that there will always be a continual flow of new events and information. Although I have sought to use the most recent information available at time of writing, it is possible that some of the facts presented to support the argument may become dated. It is also possible that some of the new information may appear to undermine the validity of the book's central argument. As I was writing in early 2020, for example, the world was being convulsed by the COVID-19 pandemic. Alongside the natural concern over the virus's spread and mortality rate, the disease has also sparked further discussions about the world's increasing economic dependency on China and the need to modify global supply chains to reduce this vulnerability. But in many ways, China's response to the COVID-19 outbreak highlights the substantial progress it has made over the last two decades, especially relative to other countries, including Europe. It is true that the pandemic will create a substantial shock for the economies of China, Asia and the broader world, but it is unlikely that the shock will be lasting nor will it fundamentally change the direction and scale of the longer-term dynamics. If anything, it could be argued that such events are more likely to accelerate the impact of the trajectories presented in this book.

To repeat my mentor's earlier message: do not be distracted by the short-term noise, but always focus on the long-term trends. I hope this book convincingly makes the case that these long-term trends are not positive for the Asia beyond China's boundaries.

This work is the result of numerous discussions over the last two decades with colleagues, investors, executives and academics. I have been very fortunate to have met so many insightful, engaging and helpful people during my time in Asia, and my conversations and arguments with them have helped to frame the thesis presented in this

book. I am especially grateful to Yogesh Aggarwal, Alf Chin, Brian Cho, John Chung, David Clark, Jim Clarke, Prashant Gokarn, Nigel Kiernan, Herald van der Linde, Paul Mackel, Jim McCafferty, Peter Milliken, Piyush Mubayi, Dilip Shahani and Stuart Walker. Not only did many of these close friends read and review earlier drafts, but they all helped me refine the argument by providing critiques, new insights and alternative views over the last few years. None of the above, however, should be held responsible for the arguments and opinions developed in this book, nor for any omissions and errors contained within. Finally, I am forever thankful to Li Eng, who persuaded me to move to Singapore all those years ago and without whom my life would have been very different.

**William Bratton**

*January 2021*



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## Glossary

<b>ABC</b>	Agricultural Bank of China
<b>ADB</b>	Asian Development Bank
<b>AIIB</b>	Asian Infrastructure Investment Bank
<b>ASEAN</b>	Association of Southeast Asian Nations
<b>BOC</b>	Bank of China
<b>BRI</b>	Belt and Road Initiative
<b>CCB</b>	China Construction Bank
<b>CCCC</b>	China Communications Construction Company
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>FTA</b>	Free Trade Agreement
<b>GDP</b>	Gross Domestic Product
<b>ICBC</b>	Industrial and Commercial Bank of China
<b>IMF</b>	International Monetary Fund
<b>M&amp;A</b>	Mergers and Acquisitions
<b>MiC2025</b>	Made in China 2025
<b>NATO</b>	North Atlantic Treaty Organisation
<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>PLA</b>	People's Liberation Army, of which: <b>PLAA</b> PLA Army, <b>PLAAF</b> PLA Air Force, <b>PLARF</b> PLA Rocket Force, and <b>PLAN</b> PLA Navy
<b>PRC</b>	People's Republic of China, the official title of China
<b>R&amp;D</b>	Research and Development
<b>RCEP</b>	Regional Comprehensive Economic Partnership
<b>SAR</b>	Special Administrative Region, specific to Hong Kong and Macau
<b>SCO</b>	Shanghai Cooperation Organisation
<b>SEATO</b>	Southeast Asia Treaty Organisation
<b>SOE</b>	State-Owned Enterprise

<b>THAAD</b>	Terminal High Altitude Area Defence
<b>TPP</b>	Trans-Pacific Partnership
<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>USSR</b>	Union of Soviet Socialist Republics
<b>WIPO</b>	World Intellectual Property Organisation
<b>WTO</b>	World Trade Organisation

## *Chapter 1*

### **Introduction**

China's emergence as an international great power, an economic giant and the region's undisputed hegemon will result in the gradual but unstoppable suppression of its neighbours' geopolitical independence, economic dynamism and future growth potential. As China grows, the rest of Asia will decline. This dynamic is simply unavoidable—the sheer scale of China versus the other Asian countries, in terms of international power, military capabilities and economic strength, will result in a degree of asymmetry unparalleled in modern history.

China will be able to use its substantial size to achieve overwhelming advantages versus the other regional countries in terms of geopolitics as well as economic superiority, especially as its relative size will only continue to increase on the back of its continued economic outperformance.

Optimists argue that China's growth offers the region economic upside from its substantial new wealth generation. They claim that China's economic expansion will create new trade opportunities for the whole of Asia, across both goods and services. These new trade flows will enhance the region's overall prosperity while outbound investments from China in new infrastructure and businesses will support broader economic growth. Greater regional economic integration, especially in terms of supply chains, will create a virtuous cycle of higher exports to China, while Chinese tourists will flood

across Asia spreading its wealth to neighbours. To such optimists, all this will be positive for the region. At the same time, it is argued that China is not a belligerent country and that unlike most of history's great powers and hegemonies, its peaceful rise will not be particularly disruptive to regional geopolitics—nor will it be as interventionist as the Western great power precedents.

But such arguments ignore China's aspirations as well as history. For in many ways, the script has already been written. History provides us with numerous examples that being a small country next to a significantly larger one is a perilous place to be, both in terms of geopolitics as well as economics. Whether it be the US with Latin America or Russia with Central Asia and Eastern Europe, big countries, especially regional hegemonies, have demonstrated an inherent tendency to achieve their own objectives and priorities by intervening directly and indirectly in the internal politics, economics and international relations of smaller countries, usually to the lesser country's detriment. Furthermore, smaller countries are always at an inherent economic disadvantage to a bigger neighbour, especially when the larger country is aggressively pursuing an agenda of nationalistic self-interest and has the capabilities to achieve its objectives, whether through military strength or economic leverage. History also shows that an emerging hegemon generally wants to redefine and replace legacy frameworks, institutions and rules with those that reflect its beliefs, importance and interests—a process which is inevitably disruptive for the region it dominates.

China's relationships with its significantly smaller Asian neighbours will be no different. Its rapidly growing size relative to other Asian countries will result in an unprecedented asymmetric balance of power that will become ever more entrenched and difficult to offset. Even if China did pose no explicit threats to achieve its foreign policy objectives, its sheer economic and political size relative to its neighbours will provide it with an unparalleled ability to achieve regional superiority. With the

possible exceptions of India and Japan, no Asian country has the ability by itself to effectively respond to this threat—and even India cannot be seen as a regional competitor, given its substantial developmental and capability gaps with China, while Japan is a declining power constrained by history. Nor has there been any real attempt to create an anti-China regional bloc to provide a collective and coordinated response to its rise. In part, this is because no country has advanced itself as the basis for such an organisation due to a fear of being punished by China. But this is also because the US has to date been very willing to be the regional counterweight to China's expanding influence—something which many Asian countries have eagerly embraced, especially given their unwillingness to invest in and develop their military capabilities. But as the US slowly detaches itself from the region, and in the absence of any regionally coordinated response to its emergence, China will be able to use its substantial scale advantage in any bilateral, or even multilateral, relationship to achieve its own geopolitical and economic purposes almost completely at will.<sup>1</sup>

### **Neighbourly dependency**

China's neighbours are actively complicit in this dynamic through their desire to have access to its emerging prosperity. As China becomes increasingly wealthier, its importance as a trading partner and export destination for its Asian neighbours has surged. In 1990, for example, the 10 ASEAN countries exported just \$3 billion of merchandise to China, in contrast to the near \$30 billion sent to the US. But China displaced the US as ASEAN's primary export destination in 2010 and by 2019, the region's total exports to the country reached nearly \$190 billion (down slightly on the \$200 billion recorded in 2018).<sup>2</sup> China's importance as the end destination for ASEAN products increased from just 2% of the region's total exports in 1990 to 14% in 2019. In contrast, the share of the region's exports going to the US declined from 19% to 12% over the same period.<sup>3</sup>

But this trend is not unique to the ASEAN countries. It is also impacting long-standing US allies in the region, which find themselves increasingly dependent on China as an export market. South Korea exported just \$1 billion of goods to China in 1991, which increased to \$160 billion in 2018 and \$140 billion in 2019. China is now the end market for more than a quarter of South Korea's exports, with volumes dwarfing the \$70 billion of merchandise sent to the US in both years.<sup>4</sup> Similarly, China displaced the US as Japan's single largest market in 2018, and although it lost that position in 2019, nearly 20% of all Japan's merchandise exports are now sent across the East China Sea to the mainland.<sup>5</sup>

Australia is even more dependent than both South Korea and Japan on China as an export destination. Less than 3% of Australia's exports in 1990 went to China compared to the 11% dispatched to the US. By 2019, however, more than 38% of Australia's exports went to China versus just 4% to the US.<sup>6</sup> In value terms, Australia now exports more than 10 times as much to China as to the US; and if imports are considered, then the country is Australia's largest trading partner, accounting for a third of all its 2019 merchandise trade—substantially more than the 7% accounted for by its US ally.<sup>7</sup> Admittedly, Australian exports to China are dominated by raw materials, in particular iron ore and its associated products; but this gives Australia a substantial and growing trade surplus and makes the economic linkages with China much more important than with its older US partner. And given trade flows and economic dynamics often drive geopolitical realities, it is no surprise that the relationship between Australia and China resulted in a “comprehensive strategic partnership” underpinned by the 2015 China–Australia Free Trade Agreement (although this agreement does seem to have marked a recent high in bilateral relations).<sup>8</sup>

China clearly sees trade as a mechanism to build and strengthen its primacy within the region by creating substantial economic

dependencies. It has strong geopolitical motivations to link neighbouring economies to its own through trade, as reflected through its emphasis on securing bilateral free trade agreements (FTA). Along with the Australian FTA, it has already entered into 16 such agreements with, *inter alia*, ASEAN, New Zealand, Pakistan, South Korea, Singapore and Switzerland, and is in the process of negotiating further such deals, including a planned ambitious trilateral FTA with Japan and South Korea.

As a result of these efforts, the last few years have seen the rather unexpected situation whereby China has effectively superseded the US within Asia as the leading proponent of free trade. While the US is now viewed within the region as increasingly isolationist and transactional in its approach to foreign relations and trade, China presents itself as an open and fair trading partner. This stance includes its leadership role in the development of the pan-Asian Regional Comprehensive Economic Partnership (RCEP), a trade agreement that it sought to define as its own construct, despite being initially proposed by the ASEAN bloc.<sup>9</sup> But however its motivations are interpreted, the summary effect of these actions is to significantly reduce the importance of US–Asian trade, increase its own economic leverage over its regional neighbours and establish China—not the US nor its regional allies—as the primary definer of the region's trade rules and frameworks.

Not only is China Asia's primary trading partner, it is also an increasingly important source of capital for the region. Multiple factors are driving this trend, including ever-more acquisitive Chinese companies, the increasing involvement of China's banks in offshore funding, specific government policies, including the Belt & Road Initiative (BRI), and the longer-term policy objective of easing the country's relatively tight capital controls. Given how quickly China's financial activities are increasing, it is highly likely that it will soon become the region's biggest source of investment capital.

This trend is already reflected in China's transition from a net recipient of foreign direct investment (FDI) to a net provider. Its outbound FDI has surged over the last decade from just \$12 billion in 2005 to \$117 billion in 2019, having peaked at nearly \$200 billion in 2016.<sup>10</sup> China was the source of a cumulative \$760 billion in outbound FDI between 2015 and 2019—more than every other country over the period, apart from Japan and the US.<sup>11</sup> These outgoing flows were significantly larger than the \$685 billion in net inflows to China over the same five years.<sup>12</sup> As a result of these surging outbound flows, the country's FDI outward stock, its cumulative equity and net loans to enterprises outside China, has increased from just \$4 billion in 1990 to \$2.1 trillion in 2019.<sup>13</sup> While this is still substantially less than the corresponding total for the US, which accounted for 22% of the 2019 global outward stock versus China's 6%, it is now significantly more than the levels attained by the UK, Japan, Germany and France—highlighting the growing importance of Chinese corporates as a source of investment flows within the global economy.<sup>14</sup>

Driving these outward investment flows have been increasingly acquisitive Chinese companies. While there is always a degree of year-on-year volatility in such activities and the use of Hong Kong-based subsidiaries for some acquisitions also complicates, Chinese companies' involvement in international mergers and acquisitions (M&A) has been growing rapidly since 2007, when they undertook cross-border acquisitions with a total net value of less than \$2 billion (which was even lower than what Icelandic companies undertook in that year). By 2017, however, Chinese corporates were the most active globally; and although this activity has eased in recent years, their \$350 billion in cumulative M&A between 2015 and 2019 was only exceeded by the US's \$680 billion over the same period.<sup>15</sup>

Consequently, Chinese companies are increasingly visible across the region. When Malaysia needed funding in 2016 to rescue the scandal-hit 1Malaysia Development Berhad (1MDB) state investment

fund, China General Nuclear Corp acquired the distressed entity's power assets.<sup>16</sup> Similarly, when Malaysia needed a new strategic partner for Proton, its financially troubled national car manufacturer, Zhejiang Geely, one of the China's largest auto makers, rode to the rescue.<sup>17</sup> Outside Malaysia, China Telecommunications Corp agreed in 2019 to lead a \$5.4 billion investment commitment in a Philippines telecommunications operator; and when Singapore-based Global Logistic Properties, one of Asia's largest logistic companies, put itself up for sale in 2017, the winner was a consortium of Chinese private equity firms.

China's acquisitions of foreign assets are not just limited to the larger and higher-profile transactions, especially as its venture capital companies are increasingly active in Southeast Asia, with a particular focus on technology start-ups.<sup>18</sup> China is also vying with Japan to be Asia's main provider of infrastructure investment funds, primarily through the BRI. This initiative is an enormous undertaking and there is widespread enthusiasm across the region to be involved in it, despite concerns over the potential sustainability of the associated debt and the extent to which China is using the initiative to secure geopolitical advantages (the BRI is discussed in more detail in Chapters 2 and 5).<sup>19</sup> But as a ready source of much-needed capital, many Asian countries and corporates are already eagerly embracing Chinese financing, regardless of the subsequent geopolitical implications.

### **Economic leverage**

This growing reliance on China as a funding source and end-market for the region's exports comes with increasing geopolitical vulnerability. China fully understands the attractiveness of its domestic markets to foreign firms and is all too willing to control access or threaten exclusion to achieve its broader economic and geopolitical objectives, as convincingly demonstrated by its 2017 spat with South Korea. When its East Asian neighbour deployed a US anti-missile platform—

the Terminal High Altitude Area Defence (THAAD) system—to protect itself from the threat of North Korean missiles, China reacted angrily.<sup>20</sup> It limited the number of Chinese tourists travelling to South Korea and through various measures complicated the operating environment for South Korean companies within China. These actions resulted in significant costs for the South Korean economy through lost sales—both domestically from inbound tourists, and within China as Korean products were boycotted. South Korea subsequently agreed a number of concessions to limit the economic pain and appease the regional hegemon. These were the “three nos”: no additional anti-ballistic missile systems beyond the THAAD system already installed; no participation in a US-led regional missile-defence system; and no trilateral military alliance with Japan and the US. Apologists for these concessions argue that they are meaningless gestures, as South Korea has no need for a further THAAD system—it is developing its own missile-defence capabilities and a tripartite alliance with Japan and the US has never been a realistic option, given the ongoing tensions with Japan. But from China’s perspective, South Korea’s haste to appease it clearly shows its ability to influence the international relations and behaviour of its neighbours, even historically strong US allies.

South Korea is not alone in suffering from China’s willingness to use its scale to achieve its international geopolitical objectives. Singapore’s attempts to balance its relationships with both global superpowers, while demonstrating its own geopolitical independence, led to tensions with China, exacerbated by the city-state’s initial position with respect to China’s land reclamation efforts in the South China Sea. Similarly, the rise of increasingly provocative anti-China rhetoric in Australia has resulted in China imposing higher tariffs on non-essential imports from the smaller partner. In particular, the hegemon appeared to respond to Australia’s calls in early 2020 for an independent international investigation into the origins of COVID-19 by imposing higher tariffs and selective import bans on Australian

barley and beef.<sup>21</sup> It also urged its tourists and students considering visiting or studying in Australia to “evaluate the risks involved and exercise caution”.<sup>22</sup> China may claim that its actions against Australia were based on technical justifications, including breaches of agreed regulatory requirements and anti-dumping controls. But the timing of these moves so soon after Australia had called for an independent COVID-19 investigation can only really be seen as an attempt by China to use trade as a mechanism to signal its displeasure and to assert its power over its smaller neighbour.

China has also used its scale and increasing economic influence to further isolate Taiwan within the international community. The number of countries that recognise Taiwan as a separate sovereign state is already pitifully small, and yet China continues to work hard to erode this number further with the promise of stronger economic ties and support, especially in terms of infrastructure and other investments. Even corporates are now subject to coercion to advance China’s Taiwan strategy. Companies that previously identified the island as a separate entity, as many airlines used to do as well as several consumer and hotel chains, have all come under sustained pressure to explicitly define Taiwan as an integral part of China.<sup>23</sup> However it be defined, China’s willingness to use “chequebook diplomacy” or “economic coercion” against both countries and corporates to advance its long-term geopolitical goals, especially with respect to Taiwan, is all too apparent.

For China’s regional neighbours, its actions and intent are increasingly very clear: do what we want or there will be punitive economic consequences. But these recent developments are only the beginning of this trend. Over the coming decades, China’s ability to bully its smaller neighbours into effective subservience will only grow as its relative economic scale increases, its markets become ever more important as an export destination and as it invests substantial sums in its military capabilities. These economic

and financial trends are now so inevitable that it is perhaps unsurprising that multiple countries have sought to strengthen their relationships with China. Several of its neighbours have already willingly courted and permitted an expansion of its regional influence, driven by a desire to be seen as more closely aligned with the regional hegemon. China's relationships with Cambodia and Laos are particularly strong, a consequence of history; but even the Philippines, a US treaty partner and one of China's main adversaries in the recent South China Sea diplomatic dispute, has significantly softened its stance towards the regional hegemon at the relative expense of its long-standing relationship with the US. It is true that all these countries may have their own motivations for such a realignment, but the regional trend is very apparent: in an evolving asymmetric relationship, it is better to be friends with the dominant country than rely on rapidly waning and increasingly uncertain historic friendships.

China's ability to use its economic power for its broader strategic objectives is not limited to its regional neighbours. Its growing international confidence means that it has already indicated a willingness to use its expanding scale and power in the international community to achieve broader geopolitical targets—especially as smaller Asian countries align themselves to China's wishes. It has used its increasing power to influence international agreements or to simply ignore any such arrangements if they do not align with its objectives. The final wording of the 2015 Paris Climate Change Accord, for example, was to a large extent driven by China's leadership role in ensuring that measures to limit climate change did not punitively impact economic growth for developing countries.<sup>24</sup> At the other extreme, it simply ignored the 2016 ruling by the Permanent Court of Arbitration that China's claims in the South China Sea are without legal foundation. China has also moved to establish new international institutions and frameworks, for example the Asian Infrastructure

Investment Bank (AIIB), the New Development Bank (NDB) and the RCEP, to ensure a leadership position—especially when it believes the existing, often Western-defined, multilateral structures do not appropriately reflect its relative global importance.

Reflecting this new status, China is also becoming more assertive with countries outside Asia, as the UK discovered in 2019 when it announced plans to send an aircraft carrier into the South China Sea and establish a new military base in Southeast Asia. Similarly, France was the recipient of Beijing's displeasure when it sent two warships through the Taiwan Strait in April 2019. Given these developments, any support the smaller Asian countries may have expected to receive from the non-Asian powers in a potential dispute with China is clearly at risk. It is, for example, increasingly unrealistic for Singapore and Malaysia to expect support from the UK and/or Australia under the Five Powers Defence Arrangements, when both the UK and Australia are increasingly influenced by their relationships with China. Australia, for example, now sends nearly 40% of its exports to China, while the UK has identified the country as an important economic partner in its post-European Union future.

It can, of course, be argued that all the other non-US international powers are becoming irrelevant at the global level. The "old" European powers can make agreements and commitments, but they are as vulnerable to China's pressure and influence as the countries they pledge to support. Long gone are the days when European countries had any real influence over China, either through economic power or military threats. The only country representing a real strategic counterweight is the US. But the additional complication for Asia is the increasing uncertainty as to US strategy, intent and commitment in the face of an influential and interventionist China. This may seem somewhat at odds given the anti-China rhetoric over recent years from the Trump administration, but the current and increasingly

embedded “America First” foreign policy doctrine poses significant long-term risks for the entire region.

### **America’s counterweight**

Since the accession of the Trump administration, some of America’s strongest allies in the region have found themselves on the wrong side of its increasingly nationalistic approach towards international relations. The last few years, for example, have been particularly difficult for South Korea–US relations: Trump viewed the previously agreed South Korea–US Free Trade Agreement as unfair and drove a renegotiation of the terms under threat of termination; forced a significant cut in South Korea’s steel exports to the US; replaced the annual South Korea–US large-scale military exercises with a far smaller undertaking; left the US ambassador to South Korea post unfilled for nearly 18 months from early 2017; and complained about the costs of maintaining the US military in the country. An additional twist to an already difficult relationship was Trump’s criticism of South Korea for not paying for the THAAD system, despite the economic costs the country incurred as a result of its deployment.<sup>25</sup>

South Korea is not alone in having to redefine its relationship with its historical ally. The entire region is adjusting to the new American foreign policy approach. Lee Hsien Loong, the Singapore prime minister, highlighted this challenge in 2018 when he warned at the 21<sup>st</sup> ASEAN Plus Three Summit (ASEAN plus China, Japan and South Korea) that the region may need to choose at some stage between China and the US.<sup>26</sup> Similarly, Jacinda Ardern, the New Zealand prime minister, expressed concerns in July 2019 about the US’s “declining interest in the Pacific”.<sup>27</sup> Rodrigo Duterte, the president of the Philippines, went even as far as to suggest in April 2019 that his country could no longer rely on its ally to come to its aid in any dispute with China, despite the Mutual Defence Treaty between the two countries.<sup>28</sup>

These concerns are not just a function of an ascendent China but also growing fears across Asia that either the US will become more inward looking, given its current policy framework and slowly withdraw support, allowing China to more quickly achieve regional dominance; or that the US will prioritise its longer-term relationship with China over existing historic partnerships. This emerging sense of insecurity reflects fears that the importance of the US–China relationship, however it develops, along with the region’s geographical realities and evolving balances of power, will result in the erosion of the US’s willingness or ability to be the regional counterweight to China. In fact, while more hawkish American commentators talk about the need for the US to respond more forcefully to China’s rise, as reflected in Obama’s “Pivot to Asia” and Trump’s National Security Strategy, it appears to many observers that the US’s transactional and antagonistic approach towards its bilateral relations will undermine the degree to which it is prepared and able to act as a counterweight to China’s growing influence.

To a very large extent, these concerns are understandable. The economic costs, or perhaps more appropriately, the economic risks incurred by the US in supporting smaller Asian countries, will become ever larger over the long-term, especially as they embark on their period of relative economic decline versus China. Given these risks and costs, it is naïve to believe that the US will always prioritise Asia’s smaller economies over its broader longer-term relationship with China or its own self-interest. For all the discussion about increased tensions between the two superpowers, the US’s relationship with China is far more important to it economically than its relationships with the smaller Asian countries. This is reflected in Asia’s trade flows with the US. Although there is substantial focus on the US’s trade deficit with China, the Asian superpower is the third largest end-market for American goods after Canada and Mexico, and is



now substantially more important to US exporters than Japan, South Korea or the entire ASEAN region.<sup>29</sup>

It is true the current US–China tensions have impacted the two countries' bilateral trade flows. US imports from China fell 11% between 2017 and 2019, while US exports to China compressed an even larger 18% over the same period.<sup>30</sup> As a result, China accounted for just 10% of total 2019 US trade compared to 12% in 2017. Despite this decline, however, China is far more important to American traders than Japan, the US's second largest trading partner in the region, which accounted for just 4% of total US trade in 2019.<sup>31</sup> Furthermore, it is entirely possible that this decline is just a temporary blip in the two countries' longer-term trade relationship. As China maintains its growth trajectory and transitions to a greater emphasis on domestic consumption as a driver of economic growth, it has to be presumed that trade between the two countries will grow over the longer-term. The current US-initiated trade disputes may be creating some near-term instability, but they appear to be driven more by a desire to balance the nature of the trading relationship by increasing American access to China's markets rather than as part of a broader anti-China containment strategy.

The problem for the rest of Asia is that the US's attempts to persuade China to buy more American products reflected the Trump administration's animosity towards any country running a bilateral trade surplus with it.<sup>32</sup> Both Japan and South Korea have already agreed to new trade deals under threat of more punitive tariff regimes, while the US has also selectively increased tariffs on Indian products in an attempt to improve market access and reduce the trade deficit it runs with the South Asian country. Even Vietnam, which has been widely cited as a potential winner of the China–US trade tensions, attracted Trump's ire with his June 2019 comment that, "A lot of companies are moving to Vietnam but Vietnam takes advantage of us even worse than China."<sup>33</sup>

This level of US animosity towards any country running a trade surplus with it has profound long-term implications for the region. It fundamentally undermines the export-led development strategies so widely adopted across Asia and risks embedding the current economic hierarchies. The US's focus on balancing its trading relationship with China also presents a longer-term problem for the smaller Asian countries, lest it results in their exports to China being replaced by US substitutes. But more fundamentally, the US's current transactional and "America First" approach to trade and foreign policy substantially erodes the region's trust in the future sustainability of long-standing partnerships and frameworks. This is especially so, as it is unclear that a change in the colour of US administration will significantly alter the overall direction of American policy. Future rhetoric may be less strident, but the use of trade policies to advance and achieve domestic outcomes is likely to become a more entrenched component of US foreign policy, to the long-term detriment of Asia.

At the same time, the US's ability to use its military superiority to over-awe China on behalf of its Asian allies is rapidly fading, given the substantial improvements in Chinese hard power capabilities over the last two decades. The People's Liberation Army (PLA) now represents a potent competitive risk to the US military in the region. Consequently, the days of US gunboat diplomacy to keep China in check, or in more practical terms, sailing aircraft carriers through the Taiwan Strait or in the South China Sea with apparent impunity, have either already disappeared or will soon be gone.<sup>34</sup> China's rapid expansion of its military capabilities has been pursued with the sole objective of significantly eroding and displacing the US presence across East Asia. This is particularly important for China, as the vast majority of Asian countries are nothing more than military minnows without the defensive cloak provided by the US. After decades of chronic underinvestment in their militaries, many Asian countries are now effectively unable to defend their territorial boundaries, or

even counter internal insurgencies, without American assistance.

While the Western powers may protest at China's assertive military posturing, the hegemon's objective of displacing geopolitical competitors from the west Pacific is comparable to the US's Monroe Doctrine, which sought to exclude the European powers from the Americas.<sup>35</sup> From the Chinese standpoint, therefore, such protests are hypocritical. But from its neighbours' perspective, should China successfully reduce the US's ability to exert force in East and Southeast Asia or should the US simply decide the potential cost of meeting China's military expansion is simply too great, then they will lose this protective shield and be fully exposed to the region's changing balance of power. Any residual notion of independence from China's encroaching influence will be lost, especially as many Asian countries have entered a period of relative military stagnation, even while China's offensive capabilities have been developed.

The rapidly evolving China-US dynamic and the risk that either China displaces its geostrategic competitor from the west Pacific or the US decides to focus primarily on its China relationship at the expense of historic partnerships, create a substantial strategic dilemma for countries which are reliant on US support to counter China. They can either continue to rely on a long-standing partner whose apparent commitment to the relationship is weakening, and risk antagonising the regional hegemon; or choose to realign towards China and its rapidly increasing wealth, but risk becoming nothing more than geopolitical and economic puppets. Consequently, many Asian countries are caught in a world of geopolitical uncertainty: unsure as to how they should respond to China, and meandering between a desire to be a closer partner to Asia's economic powerhouse and a fear of the regional hegemon's potential behaviour.

### **Super-scale competitor**

But there is an additional economic dynamic developing which is problematic for China's neighbours. Even if China was non-belligerent, non-interventionist and sought to develop economic linkages for the mutual benefit of the entire region, its scale threatens the future outlook for its neighbours' companies, industries and, therefore, economies. The region is seeing the emergence of an economic asymmetry which, though already enormous, will only continue to widen. At more than \$14 trillion, China's Gross Domestic Product (GDP) is already almost as large as the rest of East and Southeast Asia combined, and this asymmetry will only continue to grow. Prior to the COVID-19 pandemic, for example, the International Monetary Fund (IMF) forecasted that China would continue to increase its share of total Asian GDP as it added another \$7 trillion to its economy over the next five years.<sup>36</sup> While COVID-19 has complicated forward economic assessments, the IMF still expects China to grow faster than its East and Southeast Asian neighbours over 2020 and 2021, and this outperformance will further entrench its relative economic regional might.<sup>37</sup>

The problem for the rest of Asia is that China's economic scale will give its industries and companies substantial competitive advantages in terms of capital availability, research and development (R&D) potential and outcomes, unit cost efficiencies, technological innovation and the domestic demand to support all sectors and sub-sectors, no matter how niche or specialised. These are advantages that competing non-Chinese companies will simply never have, especially when overlaid with China's pro-nationalist industrial policies. As a result, the region's industrial sectors will become dominated by Chinese corporations, simply as a result of their inherent competitive advantages. This in turn will threaten the large-scale geographic transfer of economic activity across Asia as Chinese firms displace their regional competitors. This process

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## About the Author



William Bratton has 20 years' experience in Asia in both management consultancy and investment banking. He was initially based in Singapore, where he worked as a strategy consultant specialising in the telecom and media sectors. He then joined Deutsche Bank in Hong Kong, where he quickly became a top-ranked equity analyst. He most recently ran HSBC's Asian equity research department between 2014 and 2019, where he oversaw a significant improvement in product quality and client traction. He has extensive networks across Asia, especially within financial institutions, and has seen first-hand many of the region's evolving geopolitical, financial and economic dynamics.

He was trained as an economic geographer with a PhD from the University of Cambridge and a first-class degree from the London School of Economics. He is studying for his second doctorate at the University of Oxford on the geography of finance.