

Contemporary Chinese Political Economy and Strategic Relations: An International Journal

Volume 5 Number 3 December 2019 ISSN 2410-9681

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Contemporary Chinese Political Economy and Strategic Relations: An International Journal

Volume 5 Number 3 December 2019 ISSN 2410-9681

Contemporary Chinese Political Economy and Strategic Relations:
An International Journal

Volume 5, Number 3
December 2019



Contemporary Chinese Political Economy and Strategic Relations: An International Journal

Notes for Contributors

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Contemporary Chinese Political Economy and
Strategic Relations: An International Journal

Vol. 5, No. 3, December 2019

Contemporary Chinese Political Economy and Strategic Relations: An International Journal (CCPS)

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*Contemporary Chinese Political Economy and Strategic Relations:
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ISSN 2410-9681

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An International Journal*
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Website Administration and Maintenance: Wu Chien-yi
Copy-editing, Typesetting, Proofreading: Emile Kok-Kheng Yeoh
Publishing: Institute of China and Asia-Pacific Studies,
National Sun Yat-sen University, Taiwan, ROC
Co-Publishing: Department of Administrative Studies and Politics, Faculty of
Economics and Administration, University of Malaya, Malaysia

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FOREWORD

Under the Heaven, beyond the Sea: PRC's Twin Challenges in the 21st Century

This third and final issue of Volume 5 of *Contemporary Chinese Political Economy and Strategic Relations: An International Journal* (2019) represents a collection of research articles covering some of the most pertinent domains of the twin challenges facing China's Communist Party-State regime today. The legacy of millennia of imperial China have left its indelible mark on the concept of 天下 (*t'ien-hsia / tianxia*, "under the heaven") reflected in the worldview of "普天之下，莫非王土，率土之濱，莫非王臣" ("all land under the heaven belongs to the Emperor and all people on the land extending to the coast are subjects of the Emperor")¹.

The imperial heritage of CCP's rule is unmistakable. One of the earliest definitions of political culture is: "the system of empirical beliefs, expressive symbols, and values, which defines the situation in which political action takes place" – that given by Harvard professor Sidney Verba.² It has been observed how Marxism was transformed when it came into contact with traditional Chinese political culture and turned into the dynastic, semi-Confucian political hybrid of Maoism and other brands in Confucian East Asia (e.g., Vietnam, but especially North Korea), or in the religious domain how Buddhism was

transformed when it merged with traditional Taoist-Confucian tradition and gave rise to Mahayana Buddhism in China or how it meshed with traditional Tibetan beliefs and gave rise to Lamaism. Back to political development, it has been observed how the transplanted liberal democracy brought in and imposed by the Americans on post-World War II Japan merged with the local Confucian-Shintoist tradition and worldview and the vestiges of the former feudal class system to give rise to the distinctive deferential political culture and reverence for authority which students of the East Asian developmental State model note with theoretical enthusiasm in trying to explain the economic success of Japan and the four East Asian Tigers. Today's CCP's success in not only keeping its citizens docile but actually in convincing most of its economically contented, patriotically fulfilled deferential subjects of their fortune to finally have an enlightened ruler, 明君 (*ming-chün / mingjun*) cannot be fully grasped without looking back into the long dynastic imperial history of China that shaped the deep-rooted political culture of the country. After all, as Martin Jacques stressed, China is not a nation-state, but more than that, a civilisational state.³ It may not be too far off if we say that the People's Republic of China (PRC) embodies the real essence of the traditional Chinese civilisational state. PRC is the real inheritor of the Chinese political tradition maintained through the millennia, whether in terms of the CCP State's interaction with its citizens, its dealings with the minority-inhabited frontier regions, or its foreign policy. The Republic of China (ROC) on mainland is but an aberrational interlude whose original ideals had never been realised.

China watchers in the West love to comment that despite admitting the horrors of the Cultural Revolution and the failure of Mao's radical collectivist economic policy today's new leaders of the CCP would not discredit Mao because to do so would be shaking the foundation of the CCP's legitimacy. The implication is: what Mao represents is in all

practicality dead. In reality, is this really so? This is among the issues explored in the first paper under the first section of this journal issue, *Taking the Pulse*, “Mapping Political Views in Chinese Cyberspace” by Shan Wei and Gu Yongxin. Despite tight government control over political dissent, Shan and Gu’s study reveals that Chinese online ideologies still show a “left” and “right” cleavage along three dimensions in terms of their different views on political development, economic reform and nationalism. Nevertheless, owing to the State’s authoritarian control, this left-right division does not suggest a pro- and anti-government cleavage, for the simple reason that views crossing the line of government tolerance would invite repression, though there is still a certain degree of government tolerance as the debates among online ideological clusters rarely involve offline mobilisation or collective actions and hence do not represent a direct threat to the Party-State regime.

If tracking netizens’ online debates represents a way to take the politico-ideological pulse of the nation, reading into the nuances of the State’s discourse is another. Alex Payette, in his policy commentary on the recently held fourth plenary session of CCP’s 19 central committee, “Reviewing the Fourth Plenum: Governance and Morality in the Era of Xi Jinping”, points out the multiple-layered meaning of the Party’s discourse – for “harmonious society” read rising social tensions, for “Chinese dream” read unfulfilled promises and growing socioeconomic nightmare, for “political security”, “governance”, and “Party’s leadership” read a lack of control and a feeling of uncertainty in governing capabilities and legitimacy in times of testing situations such as the trade war and the Hong Kong protests. On the latter Payette sees Beijing going for the long-haul solution waiting for insurrection, which is resource-disadvantaged vis-à-vis the ruling regime, to crumble, but the continued contention is most likely to result in a financially costly

stalemate for Hong Kong.

More detailed analysis specifically on the Hong Kong crisis is provided by Matthew Harrison in his paper “Does Hong Kong Have a Future?” If the political pulse is not clear enough to raise alarm in Beijing for policy reassessment, then perhaps taking the economic pulse would serve to strengthen the signal. If it is indeed Beijing’s plan to sit out patiently, as Payette perceives, Hong Kong’s “Revolution of Our Times” towards an inevitable denouement, Harrison urges for a realistic take on the part of Beijing for, given that nationwide opening-up is incompatible with its state-permeated system, Hong Kong as the enclave model *par excellence* still plays the “doubly-assured role as China’s gateway to the world and China’s gateway to its own future”.

This section closes with Manganelly Sumesh’s analysing the pulse of demographic mobility in China and its socioeconomic factors and impacts, “The Dynamics of Migration within China: A Study on Socio-Economic Aspects”, focusing on the phenomenal rural-urban labour migration.

If taking the pulse of the body politic is vital in assessing the short- and long-term viability CCP Party-State’s governance model and regime maintenance within PRC’s territory where Beijing claims sovereignty, riding the waves into the four seas (the ancient metaphorical four bodies of water making up the boundaries of China: East China Sea on the east, South China Sea on the south, Koko Nur⁴ on the west, Lake Baikal⁵ on the north), representing a re-invention of imperial China’s extension of the Middle Kingdom’s awe-inspiring sovereign power with the new manifestation today in the form of the PRC’s assertive military gestures in the East and South China Sea and Xi Jinping’s grandeur signature Belt and Road Initiative project, is another utmost important subject of study for China-watchers and policy-makers around the world today.

Renato Cruz De Castro, in the first paper under the section of *Beyond the Sea* in this journal issue, “The Philippines and the Maritime Security Order in Southeast Asia: The Risks of an Appeasement Policy on an Expansionist China”, takes a critical look at President Rodrigo Duterte’s foreign policy that is undoing the former president Benigno Aquino III’s geopolitical agenda of thwarting China’s expansive design in the West Philippine Sea by casting aside The Hague’s Permanent Court of Arbitration the July 2016 ruling in favour of the Philippines (that China has no legal standing to claim rights to most of the South China Sea and it has “no historical rights” based on its “nine-dash line” map), distancing the Philippines from its long-standing treaty ally the U.S. and gravitating toward China in order to avail itself of Chinese aids and loans through Xi Jinping’s Belt and Road Initiative (BRI). While beyond the ancient West Sea and North Sea goes the land-based Silk Road Economic Belt (SREB, the “Belt” in BRI), into and beyond the East Sea and South Sea the Chinese economic and geopolitical power flexes its formidable muscle through the 21st-Century New Maritime Silk Road (MSR, the BRI’s “Road”) – the “Belt” and “Road” that together would form an ambitious loop linking the three continents of Asia, Europe and Africa through six economic corridors, i.e. the New Eurasia Land Bridge, China-Mongolia-Russia, China-Central Asia-West Asia, China-Indochina Peninsula, China-Pakistan, and Bangladesh-China-India-Myanmar Economic Corridor, supported by infrastructural project funded by Chinese investment, loan and aid. As can be seen in these economic corridors, South Asia is a main target of the BRI, and given the political tension and rivalry between India and China and the geopolitical imbroglio that the South Asian nations have long been entangled in, BRI’s inroads upon the subcontinent have become a cause for much concern. The next paper under this section, Amit Ranjan’s “China’s infrastructure Development Projects in South Asia under the

BRI: An Appraisal”, sets out to assess BRI projects in the nations of South Asia, notably infrastructural and water-related projects, look at how India and Bhutan have stayed out of BRI, and evaluate the validity of the BRI-critics’ “debt-trap diplomacy” argument.

While South Asia becomes the arena of competition for influence by the world’s two most populous nation, China, now the world’s second largest economy and an aspiring world superpower, has entered a global contest for political and economic influence with the world’s largest economy and the sole superpower post-Cold War, the United States of America. Under the next section of this journal issue, *Rivalry for Global Dominance*, Fu-Lai Tony Yu in his article “Toward an Explanation of U.S.-China Trade Disputes: Entrepreneurial Innovation, Protectionism and the Struggle for Hegemony in the Global Economy” explains the origin of the U.S.-China competition over the past decades and in particular their current trade war by using an international development model which incorporates entrepreneurial innovation, protectionism and world politics.

How this arena of rivalry for global dominance could take on a glistening twist is the subject of enquiry in the next article by Elizabeth Marsha and Michael A. Soedrajat, “The Influence of China in Hollywood Environment”, in which the authors explore, by focusing on China’s multinational conglomerate the Dalian Wanda (大連萬達) group founded by Wang Jianlin (王健林, a former regimental commander in the People’s Liberation Army, today one of the richest men in China), how the China’s Party-State has sought to expand its global influence through inroads into Hollywood film production which it then uses as a conduit for extending its global “soft power”. This has just become such a pertinent subject in the wake of the most recent controversy surrounding the animation movie *Abominable*, a joint production by Shanghai-based Pearl Studio (which is also the film’s

distributor in China) and Hollywood's DreamWorks Animation (a subsidiary of Universal Pictures), at one point in which is shown a map of the South China Sea bearing the U-shape "nine-dash line" that covers an estimated 80 per cent or more of the whole sea and cuts deep into the exclusive economic zones (EEZs) declared by several ASEAN claimant states that were created by drawing straight baselines around their coasts that extend 200 nautical miles seaward in accord with the United Nations Convention on the Law of the Sea (UNCLOS). The refusal by Universal Studios, the film's distributor in countries other than China, to remove the map from the film has led to Malaysia banning the movie in October 2019, following similar actions by Vietnam and the Philippines earlier in the same month.⁶ Adding to this latest controversy is the removal of the Republic of China (Taiwanese) and Japanese flags from the flight jacket of Tom Cruise in the upcoming *Top Gun* film, *Top Gun: Maverick* (2020) that film fans quickly noticed in the film's trailer this July, showing explicitly the heavy influence of China in Hollywood including through the East Asian giant's huge box office takings for Hollywood blockbusters.⁷

This journal issue ends the section *Money and Finance* that features a paper by Lin Yao, Wee-Yeap Lau and Tien-Ming Yip, "Dynamic Relationship between Yuan-Dollar Exchange Rate and Malaysian Macroeconomic Variables in Pre- and Post-Exchange Rate Reform Periods in China", investigating the impact of changes in the yuan-dollar exchange rate on Malaysia's macroeconomic variables during China's pre- and post-exchange rate reform periods, and that by Xiao Fu and Tuck Cheong Tang, "You've Got Money Left Over: Twin Surpluses of Balance of Payments Accounts in China", exploring the sustainability and macroeconomic determinants of China's twin surpluses of balance of payments (in its current account and financial account) as well as the possible transmission channels between the two surpluses, followed by a

book review article by Chang Le on Peter Baláž, Stanislav Zábajník and Lukáš Harvánek's *China's Expansion in International Business: The Geopolitical Impact on the World Economy* (2020 edition, published in September 2019).

The present issue of *Contemporary Chinese Political Economy and Strategic Relations: An International Journal*, the third and final issue (December) of this year thus significantly completes the 2019 volume beginning with the regular issue of Vol. 5, No. 1 (April/May), followed by the Vol. 5, No. 2 (June/August) special focus issue of *Upon the Thirtieth Anniversary of Tiananmen Protests and June Fourth Massacre: Value Renewal and Path Finding for China's Pro-democracy Movement*, covering the 30-year legacy of the Tiananmen demonstrations of 1989 which spread to some 400 cities and culminated in the 3rd-4th June massacre, mainly in Beijing – a June/August issue as the usual August publication date was brought forward to June to commemorate the thirtieth anniversary of a momentous, tragic event of June 1989 that tremendously shaped and altered China's trajectory of development whether in terms of her internal political economy or her foreign relations and diplomacy in the subsequent decades. The impacts, overt or subtle, are undoubtedly still strongly felt today.

The present issue, Vol. 5, No. 3, thus brings the 2019 volume to a close by revisiting some of the most critical areas of the state and changes in the political economy and strategic relations of contemporary China which the journal has explored through the two issues of April and June/August, in particular the twin challenges that the CCP Party-State regime, non-electoral and authoritarian, is facing today, i.e. in domestic governance and foreign relation, as reflected most shapely in the current anti-extradition bill protests in Hong Kong, PRC's continuing conflict with the ASEAN claimant states in the South China Sea, and international backlashes against Xi Jinping's grandeur signature

BRI projects.

Before ending this foreword, we would like to thank all the contributing authors and the anonymous reviewers for their invaluable efforts in making the publication of the three issues of this 2019 volume possible. We are also grateful to Miss Wu Chien-yi (吳千宜) for the journal's website construction and maintenance. The responsibility for any errors and inadequacies that remain is of course fully mine.

*Dr Emile Kok-Kheng Yeoh**

Chief Editor

*Contemporary Chinese Political Economy and
Strategic Relations: An International Journal*

Notes

1. From the classic 左傳 (*Tso Chuan / Zuo Zhuan*), compiled ca. 389 BC.
2. Sidney Verba (1965). Comparative political culture (pp. 529-542). In: Lucian W. Pye and Sidney Verba (eds.), *Political culture and political development*. Princeton: Princeton University Press. (See: p. 513.)
3. Martin Jacques (2009). *When China rules the world: The rise of the Middle Kingdom and the end of the Western world*. London: Allen Lane. / See also: Martin Jacques (2011). Civilization state versus nation-state. *Süddeutsche Zeitung*, 15 January 2011. Available at: Martin Jacques - Official Site <<http://www.martinjacques.com/articles/civilization-state-versus-nation-state-2/>>.
4. Former Mongolian name of Ch'ing-hai/Qinghai Lake (青海湖), located in today's Qinghai Province, China.
5. "Baikal Nur" (Baigal Nuur) in Buryat and Mongolian, located in southern Siberia, Russia, between Irkutsk Oblast to the northwest and the Buryat

Republic to the southeast.

6. “Malaysia the latest country to ban *Abominable* over controversial map of South China Sea”, *Vulture*, 20th October 2019 <<https://www.vulture.com/2019/10/malaysia-bans-abominable-over-chinas-nine-dash-line-map.html>>; “‘Abominable’ won’t be screened in Malaysia after South China Sea map uproar”, *South China Morning Post* (Hong Kong), 20th October 2019 <<https://www.scmp.com/news/asia/southeast-asia/article/3033750/abominable-wont-be-screened-malaysia-after-south-china-sea>>; “‘Abominable’ film banned in several Asian countries over controversial map of South China Sea”, *Matador Network*, 21st October 2019 <<https://matadornetwork.com/read/abominable-film-banned-south-china-sea/>>.
7. “Nine films that show how China influences Hollywood, from Iron Man 3 to Top Gun 2”, *South China Morning Post*, 20th August 2019 <<https://www.scmp.com/lifestyle/entertainment/article/3023568/nine-films-show-how-china-influences-hollywood-iron-man-3>>.

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Taking the Pulse

Mapping Political Views in Chinese Cyberspace

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Abstract

Existing research on online public opinion in China has focused on how Internet empowers and helps netizens to politically express themselves or how the state controls their opinions, but few have examined the general ideological landscape and its underlying structures. This study attempts to outline ten clusters of political views popular in Chinese cyberspace, finding that Chinese online ideologies have a “left” and “right” cleavage and these clusters group along three dimensions in terms of their different views on political development, economic reform and nationalism. We argue that this left-right division does not suggest a pro- and anti-government cleavage and provide an analysis of factors that may contribute to the plurality of ideologies in Chinese Internet.

Keywords: *ideology, cyberpolitics, public opinion, authoritarianism, China*

1. Introduction

Ideology plays a crucial role in the Chinese Communist Party's (CCP) endeavour to garner legitimacy. Since President Xi Jinping came to office, the party has taken great effort to unify ideology among party members and the general public. Through the quest for the "China Dream", the CCP shows its determination to achieve broad social consensus on the country's path to the future.

Yet Chinese citizen's ideologies are far from unified. In Chinese cyberspace, there have been heatedly debated on various issues. For instance, should the state intervene in housing prices, should the government limit or encourage the development of state-owned enterprises, is Western multi-party politics suitable for China, or are national sovereignty and territorial integrity superior to all other values? These discussions are reflections of divergent ideological positions in the society.

Previous studies of online public opinion in China either emphasize how Internet empowers netizens and helps them to voice their opinions (e.g. Yang, 2009), or focus on how their views have been controlled or manipulated by the state (e.g. King *et al.*, 2014, 2017). Few studies have examined the details of these opinions and views, and how they are different when in comparison with each other. Although there are some researches probing into individual netizen clusters with common political views, such as Voluntary Fifty-cent Army or Little Pinks (Fang and Repnikova, 2018; Han, 2015), the general configuration and underlying structures of all the clusters remain unexplored.

It is the purpose of this article to present the general landscape of ideological diversity in Chinese cyberspace and explore the underlying structures. We find that a variety of ideologies actively debate on the Internet and have formed the camps of "left" and "right". No matter they are left or right, these ideologies tend to group along three dimensions

according to their different views on political development, economic reform and nationalism. We argue that the division between the left and the right does not indicate a pro- and anti-government cleavage. For the left-wing ideologies, their positive views about authoritarian regime and nationalism are well aligned with the party-state, but it is not the case for their demands for socioeconomic equality. For the right-wing ideologies, although their pro-democracy and pro-Western orientations do not get along with the authorities, the government would not necessarily object market reform or economic globalisation advocated by the rightists. These findings suggest that a consolidated opposition to the regime may not emerge in the near future.

Our findings also shed light on how political cleavages emerge. The diversified ideologies in the Chinese Internet are a product of increasing heterogeneity of Chinese society. Rising middle class and private entrepreneurs have brought about new political preferences in the public sphere. Winners and losers during the market reform have developed divergent attitudes towards reform policies. Globalisation and the rise of the Internet economy have also contributed to the plurality of ideologies. China's vibrant pop culture and fan culture have facilitated netizens in the organisation and mobilisation of their political expressions in online debates.

The empirical analysis of this study is based on existing literature and the authors' observation on the discussions and debates in Chinese cyberspace. The focus of the analysis is identifying the "labels" of distinct political views or ideologies, and examining their major propositions. The labels are tagged by netizens onto different clusters of opinion, for instance, "Mao Fans" or "US-cent Party". While the different clusters may overlap in certain aspects, such as support towards their government, they do differ in the main thrust of their stance.

This article is organised as follow. We first discuss ideological dimensions and the “left” and “right” in Chinese Internet, and provide a working definition of labelled ideological cluster. Then we go through the individual ideological clusters, presenting their major arguments and government’s attitudes towards them. Followed there is an analysis of factors contributing to the plurality of ideologies in Internet. Finally, we conclude that these ideological clusters do not suggest a pro- and anti-government cleavage, and whether the CCP can unify the diversified ideologies needs further observation.

2. Left, Right and Ideological Labels in Chinese Cyberspace

Scholars on ideologies have found that individuals tend to position their views on one or more dimensions of political spectrum, such as “left-right” or “liberal-conservative” (Campbell *et al.*, 1980). These positions show that people are pursuing “consistency” in their ideas across various issues. For instance, individuals who favour market economy are inclined to hold a favourable view of democracy. Likewise, individuals who advocate authoritarianism are more likely to support state intervention. In societies with multiple party competition, different political parties offer different policy packages labelled as “conservative” or “left”. By choosing among different packages, citizens are pushed to position themselves on one or more ideological dimensions.

Conventional wisdom believes that in authoritarian regimes citizens tend not to group along a certain political spectrum because of ideological control and lack of electoral competition.¹ However, scholars have found this may not be true in China after the country started its economic reform. Chinese society has become increasingly diverse and

different social actors have formed divergent political views. In Chinese cyberspace, clusters of Internet users with different political ideas are frequently labelled as “New Left”, “Liberals” or others, showing that netizens are aware that there are certain political spectrums in form. Therefore, in contemporary Chinese society, different ideologies are likely to have been structured along certain dimensions.

Some China observers argued that ideology in China could be simply explained by one-dimension with “pro-government” on the one end and “pro-Western” on the other (Mulvad, 2018). Others, however, find that there may be two dimensions underlying Chinese citizens’ political views – an economically left-right and politically authoritarian-democratic axis, or a capitalism-socialism and paternalism-fraternalism axis (Mulvad, 2018; Shi-Kupfer *et al.*, 2017; Wu and Meng, 2017). Pan and Xu’s study on China’s online ideologies finds that public preferences currently showed three dimensions: (1) a political dimension differentiating authoritarian conservatives from democratic liberals; (2) an economic/social dimension distinguishing economically pro-market and socially non-traditional individuals from those in favour of state intervention and traditional values; (3) the nationalism dimension dividing respondents between nationalists and those with a globalised view (Pan and Xu, 2017: 254-272).

These three dimensions, though statistically distinctive, are highly correlated. That is, those who favour authoritarian systems in politics are inclined to support state intervention in economy and hold sceptical attitudes towards the West; individuals who show preference for Western democratic systems are more likely to approve free market economy and tend to be more open-minded to the Western world. According to the tradition in Chinese public debates, the former group of people, we may label them as “left”; for the latter group, we can label them as “right”. In this sense, the left-right dichotomy may represent one

of the most profound divides in Chinese society. However, this left-right division should not be simplified into a pro- or anti-government cleavage. As we will see in the next section, the ideological clusters on the “left” are not necessarily well aligned with the regime, while the rightist clusters do not necessarily go against the government.

Chinese netizens with different political ideas are now active on the Internet, which have formed multiple clusters in recent years. During online debates, the netizens tend to give their opponents demeaning nicknames. For instance, the Little Pinks were labelled by their rivals, and they retaliated with nicknames like “US-cent Party” (Fang and Repnikova, 2018). When these names become more widely used, they eventually turn into the “labels” representing the different political views and ideologies. In this article, we define an ideological cluster as a labelled opinion group with common political stance and propositions. Based on our online observation, we identify ten major ideological clusters currently active in Chinese cyberspace, namely, Voluntary Fifty-cent Army, the Industrial Party, Mao Fans, New Left, Young Marxists, the Little Pinks and Imperial Han at the left side of political spectrums, and Liberals, Neo-liberals and US-cent Party at the right side.

The identification is based on two standards: first, the label of the cluster must be widely used online for over one year; second, the cluster of opinions should generally share the same “organisation of preference across a variety of different issues” (Pan and Xu, 2017: 257).² For instance, the Little Pinks would hold relatively consistent nationalist attitudes towards South China Sea disputes or South Korea’s deployment of American anti-missile defence system; Neo-liberals would consistently have non-interventionist views on stock market governance or reform of the state-owned enterprises.

However, due to the fluid nature of online discussions, the clusters do not have clear-cut membership. It is possible that an individual

belongs to one ideological cluster when debating on one issue but another cluster on another issue. For example, one netizen may be labelled as “Voluntary Fifty-cent Army” when he or she defends the government in domestic issues, while labelled as the “Little Pinks” when it comes to foreign affairs discussions. On the other hand, the use of the labels in online environment can be rather casual. In their usage, the above two labels can be used interchangeably in labelling all opinions standing up for the government, no matter whether the issue is domestic or foreign-related. Consequently, some of these different clusters may have significant overlaps. It is difficult to draw a clear boundary between each cluster and estimate their membership size, let alone to quantify the relative influence of the clusters in the Chinese Internet. What is clear is that there are more numbers of leftist clusters than those on the right. This may be the product of government censorship and public opinion guidance online.

Each cluster may discuss various issues, involving politics, economy and foreign relations, but each of them generally has its own topics of focus. We will see in the next section that these topics are roughly centred on three lines of issues: attitudes towards the authoritarian regime, the role of the state in economy, and nationalism in foreign issues, which is consistent with the three dimensions revealed in Pan and Xu’s research (Pan and Xu, 2017).

3. Ideologies on the Left

There are seven ideological clusters belonging to the “left” camp. In political dimension, the leftist clusters tend to support the authoritarian regime and tend not to favour Western-style democracy. Economically, these clusters see importance in social equality. Some of them pay great attention to people who are underprivileged; others even wish to revert

to the planned economy. In the dimension regarding foreign affairs, they tend to be nationalistic and defensive of the government.

Voluntary Fifty-cent Army (自乾五)

The Voluntary Fifty-cent Army³ is a group that tends to produce commentaries in favour of the Chinese government and the CCP. Unlike the “Fifty-cent Army” (五毛黨),⁴ the Voluntary Fifty-cent Army is not hired by the authorities. They voluntarily defend the CCP’s policies online. The term “Voluntary Fifty-cent Army” first appeared sporadically in 2005 and has spread to become the label of a netizen cluster since 2008 (Pan, 2015: 91). The year 2008 witnessed a series of natural calamities and tragedies like the Tibet riots and Sichuan Earthquake and protests against the Olympic torch relay. The Voluntary Fifty-cent Army widely participated in online discussions about these events and became well known to the public. In 2014, this group even attracted state-controlled media’s attention and was praised as the “firm advocates of core socialist values” (Zhao, 2014).

As a significant force in cyber expression, the “Voluntary Fifty-cent Army” is active on a number of websites and forums, such as military boards on *newsmth.net* (水木社區) and *tianya.cn* (天涯論壇).⁵ They are likely to use diversified tactics, such as labelling wars, face-slapping, cross-talk, fishing, and positive mobilisation to solidify their identity and criticise their opponents (Han, 2015: 1012-1019). However, they are not cyber nationalists who are over-emotional and ignored the facts. Instead, they put more emphasis on rationality and evidence, which distinguish them from other groups which also criticise Western governments and liberal intellectuals. Although they only constitute a small group in China’s online ideological space, they can sometime guide and influence public opinion effectively (Han, 2015: 1020-1021).

The Industrial Party (工業黨)

The Industrial Party labels those who laud the industrial, technological and military development, and uphold it as the only way for China to become a strong nation and gain advantage in global competition. Becoming prominent in cyberspace after the 2008 financial crisis (Xin, 2016), this group is made up of avid lovers of military and technology, and China's largest Quora-like site *zhihu.com* is its most important platform for discussion. Opinions of this group are popular among university students majoring in science and engineering or young professionals working in industries related to information and technology. They despise people who talked about ideology, virtue and culture, and disdain their lack of logical, mathematical and scientific knowledge (Wang, 2011).

This group is neither against learning from the West nor critical of the autocratic rule. They would be supportive of the regime as long as it is devoted to industrial development. Many of the opinions demonstrate evident statism orientations, believing a strong and effective state is the guarantee of industrialisation and modernisation. This tendency is announced in their book, *The big goal: Our political consultation with this world*, in which they forthrightly declared that they only acknowledge Chinese history after the establishment of the People's Republic of China in 1949. They see this as the starting point of China's development into a new industrial civilization (Ren *et al.*, 2012). Taking on a social Darwinist view, they strongly believe that China would suffer if it is to slow down in industrial development. To prevent this from happening, they advocate export-oriented industrialisation and control of sea routes for shipping.

New Left (新左派)

The New Left echoes Western left-wing thoughts in terms of their concerns over social equality issues and scepticism of capitalism. Compared to other leftists, such views are more popular among people with higher education levels. This group is likely to be influenced by leading intellectuals such as Wang Shaoguang, Wang Hui, Cui Zhiyuan, Hu Angang, Han Yuhai, Pan Wei and so on. Differing from Western leftists, their proposals have a strong sense of statism, viewing a strong and authoritarian state as the precondition for national rejuvenation. In this sense, they are in support of the authoritarian regime and oppose Western democracy.

However, they do not have a unified economic claim. Some of them accept state-controlled market economy and globalisation on the premise that the country becomes more powerful and prosperous. Others believe that social problems in China now are due to the free flow of capital. They hold negative attitudes towards globalisation and consider it as the political tool of Western developed countries. Therefore, they criticise market economy and think that China has changed into a capitalist society. Their rivals in online debates are mostly Neo-liberals. They blame Neo-liberals for rising inequality in the country. With increasingly social problems emerging in the process of market reform, this camp has earned the support of those who accept that unfairness and injustice are brought about by market.

Mao Fans (毛粉)

Mao fans represent the nostalgic sentiments of Mao's era and the wish to return to Maoist past. This camp regards reform and opening-up as the source of economic inequality and social problems like unemployment

and corruption. Therefore, they miss the state-run economy in Mao times when people lived a relatively equal life and had less corruption. They also support authoritarian governance under a strong leadership and favour collective values.

This group may reflect the views of people who grew up in Mao's time or are believers of Maoist ideology (Tian, 2018). Netizens who are tagged with this label are likely to be former employees of state-owned enterprises who experienced laid-off flows in the course of reform, especially those in the late 1990s (Li, 2016). As the social security network was not set up at that time, they were offered one-off compensation without sufficient welfare protection. The experience made them blame the reform policy and show their preference for the Communist economic system during Mao's time. Some of them often participate in economic and political discussions against other ideological clusters. *Red Song Net* (紅歌會網) and "Support Mao Bar" (挺毛吧) on *Baidu.com* are their important online forums. However, in the current ideological debates online, Mao fans do not gain wide influence. Although they share common views with the party on specific issues, they are critical of the government's pro-market policies.

Young Marxists (青年馬克思主義者)

In recent years, a group of Young Marxists have emerged in Chinese colleges and universities. They seem to sincerely believe in Marxism and Maoist ideology, and have paid much attention to social equality, labor right, as well as rights of other disadvantaged groups. Many of them set up student clubs or societies to discuss Marxism and social issues. Their activities are generally offline, but recently they have gradually widened their influence on the Internet. An eye-catching incident is that when the young Marxists joined a workers' protest in Shenzhen in mid-2018, which involved Marxists students from elite

universities all over the country. Those protesting students were detained or sent back home (*BBC News*, 10 August 2018). The Marxists societies in many universities were reshuffled, which resulted in a new wave of protests from the students. These students have established websites and twitter accounts outside China to publicize their political ideas. Their posts are full of Maoist discourse, for instance, “to unite the workers and the peasants”. They advocate social equality and believe that today’s China is full of unfairness. They also took initiative to investigate the conditions of workers on their campus. Some of them joined China’s #MeToo Movement and played leading roles.

The rise of Young Marxists is largely a byproduct of the party’s endeavors of strengthening ideological education in recent years. At the conference on the national college ideological and political work in 2016, president Xi called on all universities and colleges to give priority to “ideological and political work” throughout the whole process of education (Xi, 2016). Under such circumstances, more and more universities and even some private colleges have established school of Marxism. By the end of 2016, there were over 400 schools of Marxism throughout the country and the number has still been growing until now (Chen, 2017). According to an official report, there were around two million students studying in schools of Marxism in 2017 (Yu *et al.*, 2017).

Furthermore, the party-state has provided more financial support for studies on Marxist ideology, and invested a great deal in compiling a new collection of Marxist classics. Textbooks and other course materials on ideological education have been revised. In 2015, China held the first World Marxism Congress to “discuss the future orientation of the socialist ideology” (*The Economic Times*, 10 October 2015), and over 400 scholars from 20 countries were invited to participate. In May 2018, president Xi delivered a speech at a high-profile conference in

celebration of Marx's 200th birthday. He stressed the importance of Marxist ideologies in China's reform and development, and called on all the party members to "deeply learn and better practice Marxism" (Xi, 2018).

Students have been encouraged to propagate Marxism, as well as CCP's ideologies and policies to their fellow students and local communities. In Beijing, a doctoral student group was established to deliver public lectures on Marxism and the newly-launched Xi's thought in universities, enterprises, government agencies, and local communities. Originally this group was composed of about 150 postgraduate students from universities in Beijing. Now it has expanded to schools in other provinces.

Little Pinks (小粉紅)

The Little Pinks is a prominent group of nationalistic youth that has emerged in Chinese cyberspace in recent years. This group originated from a website for sharing original writings on romantic love. As the background of this website was pink, they were nicknamed "Little Pinks". These literature lovers often discussed politics and gradually migrated to different websites to defend the Chinese government (Fang and Repnikova, 2018). Currently, almost all young and nationalistic netizens in Chinese cyberspace are labelled as "Little Pinks".

The Little Pinks were active in social media sites like *Weibo* (Chinese's largest twitter-like site), and *Emperor Forum* on *Baidu.com*. They would transform into a powerful group when ignited by occasional political events like the South China Sea disputes or South Korea's deployment of American anti-missile defense system. They even skirted the Great Firewall to excoriate anti-Chinese individuals and organisations. One famous event was on 20 January 2016, several days after Tsai Ing-wen was elected as Taiwan's president; they "bombarded"

Tsai's Facebook pages and other pro-independence news media with excessive pro-China messages (Ruan, 2016).

The Little Pinks represent political views of some of the young generations who are born in the 1980s and 1990s. They grew up in the period of China's rapid economic growth and did not experience economic hardship and political volatility. Therefore, unlike their seniors, they are more confident of China's development (*People's Daily Online*, 18 July 2016). Their organisational behaviours and ability have caught Chinese authorities' attention. The Communist Youth League attempted to enlist them as its followers and guide them to defend the government on the Internet (Shan and Chen, 2019). However, the Little Pinks still maintained their fluidity characteristics and have not become subordinated to the government.

Imperial Han (皇漢)

Another nationalist cluster active online in recent years is Imperial Han, or Han Chauvinism. Differing from the Little Pinks who are often mobilised by tensions between China and other countries, the Han Chauvinists are more attracted to historical and cultural issues arisen from the divisions between Han and other ethnic groups in China. They hold the views that Han culture is superior to the cultures of ethnic minorities and other countries and only Han culture represents the "authentic" Chineseness. With regard to Chinese history, the Imperial Hans reject Yuan and Qing as Chinese dynasties. During these two periods China was under the rules of Mongols and Manchu, and official textbooks accept the two as orthodox Chinese dynasties. They argue that the "barbarian" rulership should be responsible for China's falling behind Western countries in modern history because it had destroyed the "best elements" of Chinese civilization.⁶ Believers of Imperial Han propositions partake actively in discussions in history- or culture-related

boards in *Baidu Tieba*, *Tianya* or other social media sites. Their rivals in debates are often netizens from Mongol or Manchu groups as well as Han netizens disagreeing on their views. This group is an avid promoter of the *Hanfu* (Han clothing) movement, which encourages people to wear the traditional dress of Han before the Manchu conquest. (Chris and Katrina, 2018)

As they think highly of traditional Han Chinese culture, imperial Han followers appear to be suspicious of Western values. They tend to believe that China's future to a large degree lies in whether the nation could revive its traditional culture, especially Confucian norms and values. Traditional culture provides a valuable source for China's development, and the goal of this development is to reproduce the glory of the past Chinese empires. The Imperial Han's nostalgia of the past is somehow aligned with the Communist Party's effort to revive traditional Chinese culture (*CCP News*, 13 February 2017). This could be why the government generally is tolerant of their online discussions and offline *Hanfu* gatherings. The Imperial Hans are critical of the government's preferential social economic policies in minority-populated areas and the official ideology of ethnic equality. In this sense, this cluster may not always get along with the authorities. The *Hanfu* movement has generated increasing amount of business opportunities. Many fashion and clothing stores on e-commerce platforms specialise in *Hanfu* (Shao, 2017). Market forces, in turn, may have facilitated the rise of *Hanfu* movement and Imperial Han views.

Comparing these leftist clusters, two features are evident. First, although these labels are categorised as "left", the sources of the ideologies are very divergent. The Imperial Han's and the Little Pinks' propositions are founded on nationalism. The New Left have inherited their thoughts from the Western left-wing tradition. The Young Marxists have been inspired by Marxism and Maoism. The variety of leftist views

may be legacies of China's imperial tradition, Communism, and ambitions for modernisation. Second, these leftist opinions are not always well aligned with the government. The Mao Fans hold grievance against market reform, and the Young Marxists are trouble-makers in eyes of the government. But generally, they are sceptical towards Western liberalism and stands with the Chinese government in this aspect.

4. Ideologies on the Right

At the right side of political spectrum, the number of ideological clusters are not as many as the leftist ideologies, which may be due to the party's control of ideology. However, this does not mean that the party-state completely denies them. Among the right-wing ideologies, "Liberals" labels those views mainly on political issues, while "Neo-Liberals" has a topic of focus on social economic development. The "US-cent Party" refers to a positive attitude towards Western values and are sceptical of nationalism in foreign relations.

Liberals (自由派)

Opinions labelled as "Liberals" favour human rights, press freedom and competitive elections. They advocate the introduction of Western-style democracy through expanding political participation and political reform (Xiao, 2003), while criticising the party-state for corruption and power abuse. Due to such values and pursuit, they are an easy target for attacks as "not loving the country" or "betraying the country".

Netizens with liberal opinions are likely to be found in websites related to book reviews and readings, particularly in the Chinese version of Goodreads, *douban.com*. Others are fans of liberal intellectuals such as He Weifang, Zi Zhongyun, Qin Hui, Ren Jiantao and Liu Junning.

After the advent of social media sites, those intellectuals moved to cyberspace and engaged in a series of online debates. Some of them were once very influential and attracted hundreds of thousands of followers on *Weibo.com*. The right-wing magazine *Yanhuang Chunqiu* (炎黄春秋) was also published online and became an important platform for liberal voices. Since Xi took power, the influence of liberals has largely been suppressed. *Yanhuang Chunqiu* was shut down and social media accounts of He Weifang and a few other leading figures were removed. As a result, their voices currently laid dormant in Chinese cyberspace. It became hard to track the magnitude and changes of this group, but it would certainly not vanish in Chinese society.

Neo-liberals (新自由派)

Compared to liberals, the label “Neo-liberals” is more likely to be used in economic issues. Netizens with such a tag share the same beliefs as their Western counterparts, which uphold economic liberalisation, privatisation, marketisation and minimum state interference or regulation (*ChinaFile*, 8 November 2013). They argue that problems in contemporary China such as inequalities and corruption are mainly caused by incomplete market reform as a result of government interference and state-owned systems. Hence, the fundamental way to resolve these problems is to implement marketisation, liberalisation and privatization to their fullest. This ideological cluster has often shown up in debates on economic policies, for instance, the SOE reform, industrial policies, rejuvenation of the North-east “Rusty Belt” provinces, etc.⁷ Opinions of this group are likely to be influenced by famous economists, like Zhang Weiying, Wu Jinglian, Mao Yushi, Zhang Wuchang and Zhou Qiren.

The Neo-liberals’ propositions could be accepted by the government. In the late 1990s, the Chinese government promoted a

massive wave of state-owned enterprises reform, which to a large degree represents what the Neo-liberals would advocate. At that time a large number of small and middle-sized state enterprises went bankrupt or were privatized and numerous workers were laid-off, leaving space for the rise of private enterprises and market economy in the following decade. Xi's leadership vowed to make state-owned enterprises "larger and stronger", which is not what the Neo-liberals would agree with. However, this does not mean that the party-state completely opposes Neo-liberalism. If Beijing needs private entrepreneurs to help boost the economy during economic slow-down, Neo-liberals may gain more influence in cyberspace.

US-cent Party (美分黨)

US-cent Party are used to label those who favour Western, especially US systems or values, like press freedom, judicial independence, human rights and competitive elections. Their online rivals accused them of "being paid by the US government" or being "traitors", and labelled them as such (Cai, 2018). Netizens tagged as "US-cent Party" may largely overlapped with the liberals. Only this label is more likely to show up when the online debates are involving foreign affairs. The group favours the government's open-door policy but does not share the government's caution against the spread of Western values. They believe that China should learn from the West and not hold a nationalistic stance against the outside world. The party-state is concerned and alert to the US-cent Party, especially when the Sino-US relations go down. Due to their political preferences, they are regarded as ideological antagonists of the party-state and are even characterised as "Paving the Way Party" (帶路黨) which portrays them as paving the way for US intervention. Hence, the party-state has gradually reduced their space for online expression.

While the leftist clusters may be legacies of China's imperial past and Communism, the rightist opinions may be the product of the country's reform and opening-up. The Open Door policy has not only introduced investment and technology into the country, but also ideas from the West. After forty years of market reform, these rightist opinions are still not as diverse as those at the left side of the political spectrum in terms of the number of online clusters. From time to time we can observe divergent ideas among these liberal-oriented netizens. For instance, they had heated discussions on the same-sex marriage issues or the #Metoo movement. However, these divergent ideas have yet to develop into different opinion clusters in the Chinese Internet. The party's ideological control may have prevented those ideas from reaching wider audience and hence nurturing more online opinions. As the party-state further tightens its grip on the Internet, the diversity of the rightist opinions may become even more diminished.

5. Ideological Diversity: Why?

Although seeking to build a unifying ideology is always the CCP's important goal, the party's official ideology is not a unified one, but a mixture of Marxism, Maoism, Deng and other top leaders' legacies, which may have manifested in the plurality of online debates. On the one hand, there is the Maoist legacy which champions central planning, state ownership and equal income distribution, and Deng's endorsement of market economy and increasing inequality. These two conflicting legacies have been intertwining throughout the course of economic reform. On the other hand, the CCP has a strong inclination to nationalism. One major goal of the Chinese Communist Revolution was national greatness and prosperity (Johnson, 1962). After the end of the Cold War, Beijing has resorted to nationalism for popular support and

loyalty (Zhao, 1998). School curricula and propaganda strategies were redesigned to promote patriotism and the party's image as the leader of national rejuvenation. Besides, three factors may have further contributed to the diversity of online ideologies in China.

5.1. Diversified Chinese Society

In the Mao Era when China was embroiled in “class struggle”, the country was a largely flat society with not much heterogeneity in terms of class structure. During this time, society was under the control of the state with the pervasiveness of an official ideology. There is little room for autonomy. The situation has gradually changed since the launch of economic reform. With rapid economic development, new social forces have emerged and have grown to form new social relations. In different stages of reform, members from various social classes experienced different economic impacts. In the early stage of the reform, hundreds of millions of Chinese farmers, workers and self-employed individuals benefitted from the reform. By the end of 1980s, with the springing up of the market economy, private enterprises had the opportunity to rise, while the benefits of some workers and most farmers declined. From the end of 1990s, the original interest structure has further diverged. The gap between urban and rural areas, between different industries, between coastal and central-west regions has become more pronounced (Lu, 2010). China even became one of the most unequal countries in the world (Wallace, 2014).

Market reform has created winners and losers who would have divergent attitudes towards reform policies. New social forces such as private entrepreneurs, the middle class, and migrant workers whose voices can no longer be neglected in the public sphere are growing in numbers. Social plurality leads to a variety of preferences and ideas. Those who received benefits from the economic reform tended to

support market economy and current policies, but those who lost interest in the reform were inclined to criticise the economic and political reforms. They owed social problems like inequality and injustice to reform, and proposed their own blueprints of reform. Mao Fans and Neo-Confucianists wish to “return to the past”. They either had nostalgic feelings for the Mao era or would like to revive the tradition of Confucianism. US-cent Party, Liberals and Neo-liberals claim to “resort to the West”. They prefer Western systems and cultures and explain China’s development with Western theories. They also hold views that the social problems China now faces would be better addressed if it implements further economic and political reforms.

5.2. Rapid Globalisation and the Internet

In the era of globalisation, connections between nations are growing stronger, while competition is becoming more intense and shows new characteristics. Ideology becomes an important resource for strengthening a country’s “soft power”. In this sense, value permeation and value exportation are more frequent further pluralising ideologies in individual countries. On the other hand, globalisation provides a wide range of opportunities for people to conduct social interaction and cultural exchange. People’s living space increasingly expands and breaks through geographical restrictions. Many Chinese who travel or study abroad⁸ are exposed to diversified cultures and different political systems. These situations largely influence the public’s political opinions.

This trend has been enhanced by the rapid development of cyber society. The Internet provides a platform for official and unofficial ideologies and ideas to present themselves. Since 2009 the Internet has covered every Chinese city and 99% of rural villages. As of June 2018, the number of Chinese netizens has reached 802 million, constituting the

largest online population in the world (China Internet Network Information Centre, 20 August 2018). The Internet, especially with the rise of social media like *Sina Weibo* and *WeChat*, is growing into an important space for the Chinese population to voice their opinions. It tremendously reduces cost of communication and information. More and more Chinese people have access to political discussions and even organise collective political action through social media sites or instant messengers.

Since 2013, Xi's leadership has strengthened online ideological control. In February 2014, the party established a central leading group on cyberspace affairs to enhance Internet governance (Xi, 2014). Thereafter, the party has taken a series of actions to control online political expression, such as censoring unfavoured content, shutting down "unqualified" social media accounts and hiring commentators to guide online opinions, to guarantee its leadership on the Internet (*Radio Free Asia*, 1 July 2017). Yet diversity in cyberspace is far from being eradicated. Although official ideologies may have become more influential online, there are still divergent opinions. A recent study found that the CCP has allowed certain diversity and criticism in online ideological debates, an indication of its newfound confidence in manipulating opinions online (Shi-Kupfer and Ohlberg, 2018).

5.3. Vibrant Pop Culture

The vibrant pop culture in Chinese Internet has facilitated netizens in the organization and mobilisation of political expressions. Owing to the market reform, China's Internet economy gave rise to a vibrant fandom culture online. Active users of various social media sites, especially fandom-related, provide the foundation for some of the ideological clusters to recruit and mobilise participants for their online debates.

In fandom culture, fans who share the same idols or maintain similar values form groups through the social media network (Fiske, 1992; Zhang, 2016). These groups often forge common identities through online interactions, and some would adopt a common group name or label to reinforce their identities. Often, different fandom groups would fight online in support of their respective idols and downplaying others. Such fights, which take place in high frequency, force the fandom groups to establish self-organisation (Chen and Lin, 2016). Many of the fan communities even established action guidelines and discipline inspection mechanisms. Different fan groups often intensively fight in Chinese cyberspace. This provides organisational capability for them to participate in online ideological debates.

6. Discussions

In this article we study ideological clusters in Chinese online space. The general trend is the competition between diversified ideologies. These different clusters of ideological positions emerged against the background of globalisation and a network era, and expressed various attitudes towards China's economic and political reform. Meanwhile, some groups attempt to propose their solution to social problems China now encounters. These findings contribute to our understanding on how political cleavages emerge.

Our study also has implications for the understanding on regime stability in China. The ideological clusters we identify do not reveal a cleavage between pro- or anti-government preferences. Those rightist clusters may prefer a political reform towards democracy, but they may not go to opposition as long as the regime still maintains room for market economy. For those clusters on the left, although they are not happy with market reform and rising inequalities, they support the

authoritarian regime. In this sense, the ideological cleavage in China does not suggest the emergence of a consolidated opposition to the regime. In addition, the debates among clusters rarely involve offline mobilisation or collective actions; they therefore do not post a direct threat to the regime.

This study focuses on discussing the political propositions behind each ideology label on the Chinese Internet. The labels, however, are in constant change. For instance, “Angry Youths” (憤青), which was widely used by Chinese netizens a decade earlier (Yang and Zheng, 2012), has rarely been mentioned in the cyberspace nowadays. During Hong Kong’s anti-extradition bill movement in 2019, the Mainland Chinese netizens who spammed Hong Kong protesters’ social media pages were no longer labelled as “Little Pinks”, but “Fandom Girls” (飯圈女孩).⁹ Nevertheless, this does not indicate that Chinese netizens’ ideological structure follows such a capricious pattern. As the labels switch from one to another, their content and the general configuration do not necessarily change accordingly. This suggests the need for more accurate study on Chinese cyber ideology, through the integration of both studies on labelled clusters and surveys on individual netizens’ particulars. In this aspect, the report by the Mercator Institute has made an important first step (Shi-Kupfer *et al.*, 2017). Following such efforts, there still needs further studies on this topic to reveal the determining factors of the Chinese cyber ideologies.

Xi has placed high emphasis on “ideological security”. A couple of central leading groups were set up to oversee “ideological construction” and governance.¹⁰ More and more research institutes and think tanks were encouraged to participate in ideological research (Menegazzi, 2014). The focus of ideological construction is on promoting the “China Path”, which is considered as an alternative to the “Western Model”. Under such circumstances, control over the Internet has been

significantly tightened and the room for online expression reduced. The party-state has been playing an increasingly proactive role in guiding online public opinions, such as deploying the Fifty-cent Army or encouraging certain fandom groups to defend the government. In this sense, we predict that online ideological diversity will shrink in the near future and pro-liberal ideological clusters may be further marginalised.

However, this does not mean that ideological plurality will vanish from the Chinese Internet. A recent study shows that even when there was strict online opinion control, the party-state would purposely leave certain room for dissenting political views online, so as to better monitor and manipulate public opinions. (Shi-Kupfer and Ohlberg, 2018). On the other hand, Chinese netizens have developed many tricks to circumvent the censorship and continue their discussions. During the course of the 2019 Hong Kong protest, netizens used words like “southern little town” or “fishing village” to refer to Hong Kong, avoiding censorship.¹¹ Therefore, the red line set by the government is not a solid line, but a dash line. There is still space, however limited, for Chinese netizens to express unorthodox opinions in the cyberspace.

It is still too early to draw any conclusion on whether political views in the Chinese Internet will have an impact on the long-term political development in the country. On the one hand, the government is not necessarily heeding public opinions from the Internet. Although there are studies revealing that local leaders are responsive towards citizens’ online suggestions, the responsiveness is selective and limited to socioeconomic issues (Meng *et al.*, 2017; Su and Meng, 2016). Anything related to political issues are much less likely to receive a response. On the other hand, online opinions are reflections of netizens’ values and political attitudes in the real world. Whether political views in the cyberspace affect China’s political development depends ultimately on political orientations of Chinese netizens, most of whom

belong to the young generation. Some recent studies show that the young generation in China increasingly holds values similar to their Western peers, as modernisation theory predicts. For instance, they are becoming more and more individualistic and attaching more importance to post-materialistic values like environmental protection, gender equality, and identity issues (Inglehart and Welzel, 2005). Contrary to modernisation theory, however, Chinese youth may not necessarily embrace Western democracy when it comes to their political preferences (Shan and Chen, forthcoming). The clusters of Chinese online ideologies, like Imperial Han, Young Marxists, and the Little Pinks, are manifestation of the youth resembling their Western peers in values yet not becoming more pro-democratic. To understand the evolving Chinese politics would require us to follow more closely how the modernisation process affects citizens' values and political orientations. Simultaneously, we would also need to pay close attention to how the party-state adjusts its ideology to guide citizens' political preferences.

Notes

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1. Many scholars argue that multiple party competition is an important source in shaping the public's political attitudes, which helps to form dimensional structure of ideology in democratic regimes (Jacobson, 2012; Bakker *et al.*,

- 2012).
2. We benefit from the research of Kristin Shi-Kupfer *et al.* in identifying the ideological clusters (Shi-Kupfer *et al.*, 2017).
 3. It means the Fifty-cent Army without payment (自帶乾糧的五毛).
 4. The “Fifty-cent Army” is considered to be a group of hired and paid commentators by the government. This term is well known because they are rumoured to be paid 50 cents for each post they have made (King *et al.*, 2017).
 5. Apart from those, there are other websites and forums like MITBBS (未名空間, *mitbbs.com*), *Worldlook* (國際觀察), *CCTHERE* (西西河, *ccthere.com*), as well as military forums such as *CJDBY* (超級大本營, *it.cjdbby.net*) and *SBANZU* (上班族, *sbanzu.net*) and so on (Han, 2015).
 6. Please see the post summarising major propositions of Imperial Han at *Douban* (28 January 2011). <<https://www.douban.com/note/132119390/>> (accessed on 18 August 2019).
 7. Netizens who are tagged this label often debate these issues in social media sites, e.g. *zhihu*. Please see discussion threads at <<https://zhuanlan.zhihu.com/p/33155124>> and <<https://www.zhihu.com/question/67644094/answer/263971209>> (accessed on 20 August 2019).
 8. According to a big data report on China’s overseas tourism, the number of Chinese tourists who travelled abroad in 2018 reached 149 million; the figure has since been on an upward trend. In 2018, there were over 0.66 million Chinese people who studied abroad, constituting the world’s largest source of overseas students. See <<https://www.travelweekly-china.com/73800>>, and <http://www.moe.gov.cn/jyb_xwfb/gzdt_gzdt/s5987/201903/t20190327_375704.html> (accessed on 26 August 2019).
 9. This label is widely used in Chinese social media site *Weibo*. Netizens who are tagged this label are fans of different pop stars. Their actions of defending the government received extensive attention and were even praised by official media. Please see *Weibo* discussion thread on Fandom

- Girls. <<https://s.weibo.com/weibo/%23%E9%A5%AD%E5%9C%88%E5%A5%B3%E5%AD%A9%23>> (accessed on 18 August 2019).
10. Including the Central Small Leading Group on Propaganda and Ideological Work, the Central Small Leading Group on Cyberspace Affairs, the Central Small Leading Group on Humanities and Social Sciences, and the Central Small Leading Group on External Propaganda Work.
 11. Hong Kong was a fishing village in southern China before British colonial rule. Therefore, Chinese netizens use these terms to refer to Hong Kong.

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Reviewing the Fourth Plenum: Governance and Morality in the Era of Xi Jinping

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Abstract

Plenums are an opportunity for the Central Committee members to meet, and, of course, discuss a number of important issues pertaining to the state of the domestic economy, but also to national governance. As tensions are rising inside the Party-State apparatus – mainly the results of the aftermath of the anti-corruption campaign, the tenuous trade war or the chaos spreading in Hong Kong, all eyes were looking at Xi Jinping to announce the fourth plenum of the nineteenth Party Congress. The latter would come more than 600 days after the third plenum (February 2018), in the context of a tensed post-summer retreat at Beidaihe. The fourth plenum expressed tensions in the top leadership structure, but also highlighted some confusion and uncertainties as to what the Party plans to do to remedy the economic slowdown, to solve the ongoing Hong Kong crisis, and to untangle the trade talks with the United States – talks that only recently reached a tentative agreement. As such, this article reviews and focuses on the conclusions of the fourth plenum of the Central Committee of the Chinese Communist Party.

Keywords: *fourth plenum, Hong Kong, Macau, Chinese Communist Party, trade war, morality, governance, political security*

1. Introduction: Fourth Plenum of the Nineteenth Communist Party of China Central Committee (October 28 to 31, 2019)

As it is now customary under Xi Jinping (习近平) at every annual meeting, there is a “wave” of investigations aimed at “cleaning up” the Party apparatus. Not only does this continue to solidify the position of the Disciplinary Commission, it also yields dividends for the anti-corruption campaign – making the latter an increasingly more effective tool for Xi to consolidate his position. The Fourth Plenum was no exception. Prior to the opening of the meeting (more than 600 days after the third¹), two prominent “electric tigers” (电老虎) – Yun Gongmin (云公民), general manager for Huadian Group (华电集团)², and Li Qingkui (李庆奎), president of the same group from 2013 to 2016³ – were put under investigation. A team had previously been sent to investigate Huadian Group back in February and May 2018⁴, three months prior to Li’s retirement from China Southern Grid (中国南方电网), the state-owned company in charge of the country’s electricity infrastructure in the south.

The military structure, which is also a focus of Xi, has also been targeted by the anti-corruption campaign (yet again): Rao Kaixun (饶开勋, deputy commander of the People’s Liberation Army Strategic Support Force) and Xu Xianghua (徐向华, deputy commander of the Western Region) were both “taken” on October 26. Rao and Xu have been mentioned in the Fang Fenghui (房峰辉) affair⁵ back in late 2018. Fang was then tied to the Guo Boxiong (郭伯雄) / Xu Caihou (徐才厚) corruption cases.

2. Reshuffling at the Center

Investigations aside, important personnel changes were made during the last few days leading up to the Fourth Plenum: (1) Li Jiheng (李纪恒), Yunnan Party secretary (2014-2016) and Inner-Mongolia Party secretary (2016-2019), was removed from the roster of the provincial leadership. Li was transferred to the infamous Ministry of Civil Affairs on October 26, thus replacing Huang Shuxian (黄树贤); (2) Shi Taifeng (石泰峰), Ningxia Party secretary (2017-2019), filled in for Li Jiheng on October 25; Chen Run'er (陈润儿), Governor of Henan (2016-2019), was sent to hold Shi Taifeng's Ningxia position.

The case of Shi is of little concern as he is Li Keqiang's (李克强) old associate, but also Xi's associate from his time at the Central Party School. Chen Run'er was a protégé of Zhang Chunxian (张春贤), but also an associate of Mei Kebao (梅克保)⁶, as well as several other members of the late 1990s' "Hunan gang" (湖南帮). This affiliation could, in time, be detrimental for Chen.

The last case, that of Li Jiheng, a veteran of the factional struggle of the early to mid-2000s – during which time he ousted Liu Qibao (刘奇葆) from Guangxi – is of more concern. Despite being considered as "one of Xi's men" by some, especially since his time in Inner Mongolia, Li is not able to completely distance himself from the previous regime (under Jiang Zemin (江泽民)): his "mishu" (秘书) Zhao Zhuangtian (赵壮天) was put under investigation in 2017 during the proceedings of the Bai Enpei (白恩培) and Qin Guangrong (秦光荣) corruption cases.

This reshuffling, prior to the 4th plenum (which usually aims at assessing recurring issues)⁷ is peculiar, yet not abnormal when it comes to Cadres' appointment/dismissal patterns (e.g. one must hold a position at least two years prior to being transferred or promoted)⁸. However,

these changes reflect important points with the leadership of which I will list two: (1) Xi, through his ally Chen Xi (陈希, Central Organization Department and Party School director), is able to grasp every opportunity to move/remove potential allies/rivals inside the Party-State apparatus; (2) loyalty remains an important issue for the top leadership, which is eager to get rid of/promote certain individuals.

During the plenum itself, held from October 28 to 30, 2019, two new Central Committee members were selected: (1) Ma Zhengwu (马正武) and (2) Ma Weiming (马伟明). The first Ma, an alternate member of the 19th Party Congress (中央委员会候补委员), is president of the Chengtong Holdings Group (中国诚通控股集团, wholly owned by the State-owned Assets Supervision and Administration Commission (国务院国有资产监督管理委员会)) for more than 17 years⁹. Ma Weiming, an alternate member since 2012, is a “first class” military engineer since the time of Hu Jintao. That said, the selection of the two Ma was far from surprising, considering that they were listed as No. 1 and No. 2 (on the overall list) in terms of “brush strokes”¹⁰.

Lastly, Liu Shiyu (刘士余), ex-president of the China Securities Regulatory Commission (中国证券监督管理委员会), who has been under investigation since May 2019, was more formally punished in front of the Party. The latter, who “surrendered” on May 19, is part of the “reformers clique” (改革派) of Zhu Rongji (朱镕基)¹¹. Suspicions arose after the arrest of Dai Juan (戴娟) (January 2019), just twenty or so days before the transfer of Liu to the All-China Federation of Supply and Marketing Cooperatives (中华全国供销合作总社). The issue at the time was the abnormal number of IPOs coming from Jiangsu – where Liu is from – which was higher than that of Guangdong, Zhejiang, Beijing and Shanghai back in 2018¹². As such, corruption charges were set forward and Liu decided to surrender as rumors were spreading¹³.

3. Governing Capabilities and the Issue of Governance

Regardless of the expectations (especially when it came to a discussion regarding the line of succession¹⁴, the Shaanxi villa issue¹⁵, etc.), the main points of order were the issue of governance and the economy.

For the latter, Xi put the emphasis on the public sector's role in the development of the "basic socialist system", without diving into the role of the "free" market¹⁶ or the development of the private sector – which will remain under tutelage of the Party-State Apparatus for the time being. As such, this point raised even more contradictions between the private and public sectors in China, which in turn might influence the influx of private foreign capital¹⁷. To be fair, expectations were not particularly high, especially after Li Keqiang – during his Xi'an symposium on China's economic situation (October 14) – sat down with the provincial leadership in order to ask them to follow the objectives set by the Central government¹⁸. This type of request, highly unusual for the Premier, did underline the severity of the situation. That said, the message sent might have missed the target: was Li out of ideas to the extent that he had to ask the provinces for help? The conclusion of the plenum leads us to believe that an overall plan to remedy the effects of the trade war has yet to be decided upon.

In terms of the military, the Party kept talking about the need to consolidate its leadership over the army. The anti-corruption frame of mind was still present, especially while referring to the Cadre selection measures implemented last year, which aimed at creating a collective responsibility system (between who selects and the selected) in order to "eradicate" corruption¹⁹.

As previously mentioned, the main theme of the Fourth Plenum was that of "governance" – of the Party's capacity to govern (治理能力) China – and of the modernization of the National Governance System (国家治理体系). This refers, of course, to the Party's leadership, to its

institutional and administrative structures set to manage society, the economy, and political affairs²⁰. However, nothing was actually said regarding governance-related issues (economic downturn, intra-Party struggles, Hong Kong protests, rise in public grievances, etc.) in a progressively more uncertain environment (both abroad and at home). As such, this “modernization”, of which we still know nothing about, will most likely focus on the security and on the protection of the Party through the usage of new technologies. This lack of clarity might be the result of intra-Party tensions, or simply due to the fact that the Party is simply playing the “wait and see” game, or both.

This approach, which consists in saying everything and nothing at the same time, is based on prudence, but definitely not on actual content (e.g. talking about the socialist way, the Party’s leadership). As it is often the case, Party’s discourse has two (or more) layers of meaning, especially when talking about “sensitive” topics such as security, governance and development. For example, talking about a “harmonious society” made explicit the social tensions that were left in wake of the reforms; talking about a “Chinese dream” implies that today’s China is now unable to fulfill its promises to the new generation (in terms of opportunities) that might be set up to achieve less than their parents’ generation. As such the “dream” might also be the sign of a growing nightmare (e.g. saturated job market, real-estate bubble making access to property highly problematic, stagnant real wage growth).

Talking about “political security”, “governance”, and of the “Party’s leadership” conveys this idea that there might be some insecurity lurking below the surface. The more the Party talks about control, the more we feel it signifies a lack of control, a feeling of uncertainty, especially when faced with “tests” (in terms of both governing capabilities and legitimacy), such as the trade war and the Hong Kong protests. That said, the Party did score some points when talking about social policies

(especially when Xi has been talking about poverty alleviation for a while now).

4. What about Hong Kong?

As previously mentioned, the Hong Kong issue was an important element to be discussed during the Fourth Plenum. To this effect, it is of no surprise that Xi met with Carrie Lam (林鄭月娥) on November 4 in order to convey support and to make clear his position: (1) Hong Kong must manage this issue – in accordance with the “One Country, Two Systems” principle; (2) Carrie Lam remains in charge (at least until March)²¹. Xi asked her directly to restore order, punish violence and to govern according to Hong Kong’s Basic Law. The President was then accompanied by Ding Xuexiang (丁薛祥) – director of the General Affairs Office, the foreign affairs team and the Minister of Public Security Zhao Kezhi (赵克志). This meeting, which took place in Shanghai, allowed Lam to meet with Xi’s new envoy in the Hong Kong and Macao affairs system (that is Zhao Kezhi)²². Zhao, now deputy director of the Central Coordination Group for Hong Kong and Macau Affairs (中央港澳工作协调小组), will act as a more direct channel of communication between Xi and Lam, circumventing in part the leadership of Han Zheng (韩正). This visit also indicates that Liu He’s (刘鹤) trade negotiation team (with the US) has made enough progress to allow for Xi’s monitoring of this other “open front”²³. As such, Zhang Xiaoming (张晓明) – director of the Hong Kong and Macau Affairs Office (国务院港澳事务办公室), but also Wang Zhimin (王志民) – director of the Liaison Office of the Central People’s Government in Hong Kong (香港中联办)²⁴, might soon find it difficult to be shielded from Xi’s scrutiny.

Xi previously tried to block the succession the succession of Zhang Xiaoming – back when Zhang Dejiang (张德江) was still in position – to instead promote one of his allies, Chen Dong (陈冬), who was at the time Party secretary for the Political and Legal Affairs Commission of Fujian Province²⁵. Failing to do so, Chen was positioned under Wang Zhimin. However, since September this year, signs have been pointing towards a reshuffling in the Hong Kong affairs (港澳系统) team.

Following this meeting, Xi issued the now infamous “3+3+3+1” allocation²⁶. However, since then (December 16), the second of the “3 firmly supported elements” (坚定支持) was altered. The third point, which should read “firmly support Hong Kong’s judiciary system in punishing violent criminals (according to the law)” (坚定支持香港司法机关依法惩治暴力犯罪分子), now reads “firmly support the patriotism (towards Mainland) and love the strength of Hong Kong” (坚定支持爱国爱港力量)²⁷. This change of words is confusing, maybe even by design. It provides little insight as to what is actually being supported by the Party. Is it a call to restore Hong Kong’s economic strength while crushing the protests in order to demonstrate the administration’s patriotism? Or more of an educational project – as rumored before – focused on promoting patriotism in Hong Kong in order to avoid generational chaos?

What we know now is that Beijing is going for the long-haul solution; when it comes to contentious politics, the State, as it holds much of the resources (military, financial, logistics), can sustain and defend against the insurrection that will, at some point, become untenable for protesters. Given the present dynamics of contention, even if one side is sustained by a shared form of identity, which include a Special Administrative Region (SAR), a Leninist State and a not-so-favorable international environment, it is most likely to result in a stalemate – a financially costly stalemate for Hong Kong.

5. The Era of Xi Jinping, an Era of Morality

The Fourth Plenum, which made even more explicit the cracks at the top of the Party-State structure, concluded without officially confronting the Hong Kong issue or even the real problems plaguing the Chinese economy – same goes for the subsequent meetings between Carrie Lam and Xi. Furthermore, the Party even took steps to try to circumvent the “Hong Kong issue” by praising its other SAR and by announcing its intentions to try to replace Hong Kong with Macau²⁸. Yet Macau is not Hong Kong²⁹.

On the ideological side, aside from security and governance slogans, the Party published on the eve of the plenum (October 27) the *Outline on the establishment and implementation of citizen morality for the new era* (新时代公民道德建设实施纲要). This promotion of morality in a “new era” (Xi’s era) repositions Xi’s thoughts at the center of “Socialism with Chinese Characteristics”, sidetracking Mao, Deng, Jiang and Hu – no more scientific development, no more learning from the “most advanced” civilizations, etc. These adjustments, which also talk of traditional values, also express the tensions that are on the rise inside the Party’s leadership between Xi and his allies and what is left of the “old regime”.

If the Fourth Plenum allowed Xi to consolidate his position, the intra-Party struggles are far from over. Beyond the Fourth Plenum, the lack of a clearly identified successor ready to ascend in 2022³⁰ could allow Xi to actually tackle important domestic issues that could eventually destabilize the leadership. As such, while Xi was still talking on November 2 of socialist development³¹, the “factional game” is far from over between the Xi-Wang (Qishan, 王岐山) team and the malcontents who are seeking to destabilize him.

Notes

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1. The wait, considerably longer than any other in recent Party history, can be explained by way of (1) intra-Party struggles regarding the trade war and the Hong Kong issue; and (2) due to the extremely brief interlude between the second and third plenums (January to February 2018).
 2. Yun was then arrested on corruption charges linked to his time at Shenhua Group (神华集团 , vice-president from 2006 to 2008), but also for his association with the old Shanxi Gang (山西帮) back in the early 2000s, associated with the likes of Ling Jihua (令计划), Jin Daoming (金道铭), and Shen Weichen (申维辰).
 3. Li was put under investigation on October 22, and Yun on October 24.
 4. Huo Li (霍利), general manager of the science and tech section of Huadian Group, was then arrested by the investigation team.

5. The public profile of Fang Fenghui, ex-Chief of the Joint Staff, on *Baidu* no longer exists, which is odd considering that those of Zhou Yongkang (周永康), Bo Xilai (薄熙来), and Guo Boxiong are still “active”.
6. Changsha’s Party secretary from 2001 to 2006 and provincial deputy secretary from 2006 to 2013.
7. All things being equal, first plenums are usually the ones during which the new leadership team is selected; second plenums are the ones before the “two meetings” (两会) and aim at preparing the ministerial reshuffling; third plenums are the one used to assess larger issues for the Party, while subsequent plenums (fourth, fifth, etc.) are annual updates. The last plenums (sixth or seventh) are the ones during which the transition is prepared.
8. Major decisions have been taken during past fourth plenums: (1) in Fourth Plenum of the Fifteenth Congress, Hu Jintao was named Vice-President of the Central Military Commission (CMC); (2) in Fourth Plenum of the Sixteenth Congress, Hu was then selected to be President of the CMC.
9. Ma is the successor of Tian Yuan (田源), current CEO of China International Futures Co. (中国国际期货公司).
10. Besides, we need to point out the absence of Wang Xiaoyun (王晓云), general manager of China Mobile’s tech department, and of Guan Qing (官庆), ex-CEO of China State Construction Engineering Group (中国建筑集团). Guan, who has since been replaced by Zhou Naixiang (周乃翔, the son of Zhou Xiaochuan’s (周小川) brother), has not been cleared for another position.
11. Liu also served as one of Zhu’s “mishu”.
12. <http://www.hkcd.com/content/2018-12/14/content_1114483.html>
13. <<https://news.hexun.com/2019-05-20/197244498.html>>
14. We refer here to the discussion surrounding Chen Min’er (陈敏尔) and Hu Chunhua (胡春华) since Xi’s visit to Chongqing back in April. Back then, some speculated that the visit was in fact an informal introduction of

China's new leadership team to the outside world. Furthermore, the visit of Heng Swee Keat (王瑞杰) – Singapore's vice-premier and finance minister – in Chongqing back in September to see Chen Min'er brought the speculation to an all-time high. That said, the current political climate will surely test the strength of the relationship between Chen and Xi up until 2022.

15. Rumors surrounding the situation of Zhao Leji (赵乐际), following the arrest of Zhang Yongchao (张永潮 , mayor of the Huiyi (郿) district of Xi'an) on October 15, and his possible ties to the Shaanxi Villa corruption case were running wild before the Fourth Plenum. Considering that Zhao was Party secretary of Shaanxi from 2007 to 2012 made him a prime target following the downfall of his former "mishu", Wei Minzhou (魏民洲 , Party secretary of Xi'an from 2012-2016) – formally accused on October 25, 2019. Furthermore, Zhao was fairly acquainted with many individuals currently under investigation. The order to demolish the villas must also have been a shock, considering that Zhao was in Shaanxi at the time of their construction. Same goes for the "Shaanbei 100 billion mining rights" issue (陕北千亿矿权案), first publicized by Cui Yongyuan (崔永元). This corruption case, villas aside, was tied to Zhao Zhengyong (赵正永 , Shaanxi Party secretary from 2012 to 2016) – under investigation since January 2019, and also to Zhou Qiang (周强), the President of the Supreme People's Court of China. As such, it was (and still is) unclear to what extent Xi would protect Zhao Leji.
16. This idea and type of monitoring (regarding the private sector) is not new. That said, even if Xi had talked about supporting the private sector several times before, under the principle of "the State enterprises advance, the private sectors retreat" (国进民退), the private sector to this day cannot benefit from State support (while SOE are crumbling under subsidies).
17. This remains highly confusing as oftentimes they (the private sector) are needed, but remain monitored.

18. <http://www.xinhuanet.com/politics/leaders/2019-10/14/c_1125104123.htm>
19. That said, the recent case of Zhang Qi (张琦) – Haikou’s (Hainan) Party secretary from 2016 to 2019 – who was put under investigation back in September (with an impressive reported 13.5 tons of gold stashed in his house) does not seem to be in tune with these efforts.
20. Other are bound to be directly associated with Wang Huning’s (王沪宁) “Chinese Model of Governance” (中国之治), which implies the Party’s complete governance over China).
21. Lam remains unable to “move” as the protesters do not intend to let her go (as her whereabouts are constantly being posted and updated on *LIHKG* (連登網) for protesters to corner her), nor is the Party willing to let her resign for the time being.
22. Zhao also accompanied Xi back in September to meet Ho Iat Seng (賀一誠), Macao’s chief executive.
23. At the time of reviewing this article, the Chinese team led by Liu He only recently (December) made a “breakthrough” during the negotiations as both parties did tentatively agree on the first part of what might become a bilateral treaty. It is also worth mentioning that both Yang Jiechi (杨洁篪) and Wang Yi (王毅) made public appearances prior to this early conclusion in order to criticize the accord.
24. Wang Zhimin was also Liao Hui’s (廖晖) “mishu”.
25. Chen met Xi during the late 1980s. Chen was then part of the secretariat of the provincial government (where “mishu” are usually found).
26. <http://www.xinhuanet.com/politics/leaders/2019-11/17/c_1125241601.htm>
27. <http://www.xinhuanet.com/politics/2019-12/16/c_1125353595.htm>
28. <<https://www.reuters.com/article/us-macau-politics-exclusive/exclusive-protest-free-macau-to-win-financial-policy-rewards-from-china-idUSKBN1YG0EJ>>

29. The idea that another stock exchange could be set up in Macau sounds ill-advised at best. Despite a constant clogging in the IPO process in Shenzhen and Shanghai – due mostly to poor and inefficient regulatory framework – Hong Kong will remain the preferred option over Macau any day. Furthermore, this CNY exchange will most likely fuel corporate debt from Mainland and thus potentially creating more systemic issues for the Chinese domestic economy.
30. Considering the fact that Xi changed the constitution last year (term limit removal for the president and vice-president), in addition to enshrining his name next to Mao, Deng, Jiang, and Hu, selecting someone now would have been problematic as it is “too late” to properly prepare a succession team before 2022.
31. <<https://www.bbc.com/zhongwen/simp/chinese-news-50285833>>

Does Hong Kong Have a Future?

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Abstract

Hong Kong, China's highly autonomous Special Administrative Region, appears to have uncertain future. Affected by social unrest, and overshadowed by its increasingly mighty sovereign, Hong Kong seems to have less and less going for it. Yet within high-value-added areas such as finance, management, and professional services, Hong Kong still plays a crucial role as China's gateway to the world. More importantly, China itself will have open-up further to access the international input crucial to its future development, but nationwide opening-up is incompatible with its state-permeated system. The only realistic option for China, then, is opening-up via the enclave model – of which Hong Kong is the supreme exemplar. Hong Kong thus has a doubly-assured role as China's gateway to the world and China's gateway to its own future.

Keywords: *One Country Two Systems, China gateway, development strategy, Belt and Road, Made in China 2025, enclave model*

1. Introduction

Fortune Magazine's iconic June 1995 cover story, "The Death of Hong Kong", may have been premature. But in recent years, more and more commentators have sounded a similar note.¹ China's remarkable rise to economic and geopolitical prominence has made the Special Administrative Region (SAR) seem less important. Hong Kong's traditional role as a China gateway is threatened as the international connections of other Chinese cities multiply. Meanwhile, the erosion of Hong Kong's autonomy and the unrest triggered by the Bill (now withdrawn) to facilitate extradition to Mainland China have done further harm, prompting at least one credit rating agency to downgrade², thus impacting the city's economy. Is it Hong Kong's fate to lose its autonomy and become just another Chinese city?

Questioning a society's future is usually a rhetorical exercise. Britain's Remainers might lament Brexit, but post-Brexit Britain clearly has a future, just not one that Remainers might wish for. However, in Hong Kong's case the question is real. Hong Kong exists as an entity distinct from Mainland China under the Joint Declaration, a treaty between China and former sovereign the UK which China has already dismissed as a "historical document that no longer has any realistic meaning".³ Even if honoured, the arrangement expires fifty years after the transfer of sovereignty, in 2047. There were concerns even prior to the present unrest about China's growing intervention in Hong Kong's affairs. Hong Kong's special status seems to depend on China's pleasure, which can be – perhaps is already being – withdrawn.

This paper considers the basis for Hong Kong future. It describes Hong Kong's proposition, clarifying related misperceptions. The paper then elaborates the value of that proposition to China and to the world. China's existing development model is then considered, together with

the impending exhaustion of that model. Options for the model's extension are discussed, namely expansion via the Belt and Road Initiative and innovation via "Made in China 2025". The limitations of these options are elaborated. Finally, a special role for Hong Kong in China's future is suggested.

2. Hong Kong's Proposition

From its establishment as a British colony in 1842, Hong Kong's rationale has been that of a free port and a base for international trade with China. In the early twentieth century, Hong Kong was overshadowed by Shanghai which with its International Settlement and foreign participation became the "Paris of the East". However, with Shanghai's closure to the world following the Communist revolution in 1949, Hong Kong became the de facto international gateway to China, a role it has played ever since. How does Hong Kong's China gateway role fare today, and what are its prospects in the future?

2.1. Challenges and Misperceptions

Hong Kong, a tiny territory 1/190 of China's population and 1/9,000th of its land area, punches above its weight. On transfer of sovereignty in 1997, Hong Kong's economy was about 20 percent the size of China's. However, with China's rapid economic growth and development since, Hong Kong's economy is now about 2.7 percent of China's, although its per capita GDP is still 5 times as high.⁴ Hong Kong's contribution is significant, but much less so than before.

Meanwhile, China has emerged as a global power, the world's second largest economy. China has investments and influence not only in the Asia-Pacific but also in Africa, Latin America, Eastern Europe and Central Asia – now loosely connected under the Belt and Road

rubric (discussed in section 4.2 below). Hong Kong has limited contact with these regions, and – because foreign affairs and defence rest with the sovereign – it is constrained in its geopolitical outreach. Moreover, China's economy, of continental size and diversity, is now generating world-leading initiatives in artificial intelligence, quantum computing, FinTech, and even space travel – fields in which Hong Kong has little showing. What does Hong Kong have to offer its vast, diversified, and increasingly advanced sovereign?

This question has, rightly, concerned Hong Kong's leaders (Chief Executives), who under the territory's unique constitution are elected by a 1,200-strong committee controlled by Beijing. Unfortunately, these leaders have come up with ideas that in many cases hinder rather than help the territory. The ideas include, bringing Hong Kong into China's Five-Year Plans, fostering "innovation" by tech cooperation with Shenzhen, pursuing the Closer Economic Partnership Arrangement (CEPA) with the Mainland, and aligning with Mainland infrastructure.

The ideas are considered below in turn.

Firstly, inclusion in China's central plan. As discussed in section 3.1 below, China is a state-permeated economy (Otero-Iglesias and Vermeiren, 2015) where even private sector companies have their communist party cell, banks lend according to state direction, and the state itself decides on and invests in major initiatives – all cohered by a flow of propaganda and censorship, and sanctioned by courts which are subordinate to the Communist Party of China (CCP). In contrast, Hong Kong is a free market economy, its firms making investments according to the views of their owners and managements rather than government plan, in which all parties, including the government, are subject to the rule of law. Article 5 of Hong Kong's constitution the Basic Law provides that the capitalist system be maintained and the socialist system not practiced there. The Hong Kong government does not even have a

planning apparatus. It had no business trying to insert Hong Kong into the Mainland plan.

The “innovation” strategy is actually rather un-innovative, its main project being the development of the Lok Ma Chau Loop as the Hong Kong/Shenzhen Innovation and Technology Park⁵ – in effect, a base for imported Shenzhen tech workers. The site is presently a wasteland of toxic mud, its ownership equally opaque; the park will take years to create.⁶ More importantly, Hong Kong does not have particular strength in high-tech products. The government’s attempt to help by expanding research grants and fostering smart city initiatives is unlikely to change that materially – links between academia and business in Hong Kong are not strong⁷, and the smart city effort has problems of social acceptance⁸. Nor is Hong Kong necessarily a good base for developing products targeting the Mainland market, as seems to be the main purpose of the park⁹ – Hong Kong’s strengths lie rather in facilitating Mainland outreach into the international arena. The Hong Kong private sector is already cooperating with Shenzhen in ways that it finds fruitful to do so.

CEPA is now in its 16th year, the original agreement having been expanded by ten supplements and three subsidiary agreements.¹⁰ However, it does not respect the reality of local (and indeed national) protectionism in China. Agreements to open particular sectors or industries to Hong Kong players in Guangdong or farther afield are repeatedly stymied by layers of local regulation or non-cooperation (Goodstadt, 2018). Lei (2017) finds that the efficiency of Hong Kong’s exports to China has been on the decline since 2000; nor is there evidence to support CEPA having attracted foreign investment to Hong Kong for tariff-free export to the Mainland. Meanwhile, Hong Kong manufacturing investment in Guangdong has been decimated by the province’s decision to end the processing trade; by 2015, the numbers employed by Hong Kong firms there had halved from the 2007 figure,

the Chief Executive being powerless to help (Goodstadt, 2018).

Infrastructure alignment could be useful. However, because the projects are highly politicised, time- and cost-budgets are routinely overrun and the design is poorly adapted to the community's needs. The Macau-Zhuhai road bridge cost Hong Kong HK\$120 billion,¹¹ yet traffic so far is modest. The HK\$624 billion Lantau Tomorrow vision is intended to develop housing on artificial islands aligning with Pearl River Delta development.¹² Yet while housing is needed, this project's huge cost, twenty-year timeline, and doubtful practicality in an era of climate change render it a likely white elephant, while Hong Kong's core areas and present needs are neglected.

The above ideas, even if successful, would only help to make Hong Kong a second-tier Chinese city – and are too piecemeal even to achieve that. Essentially, these initiatives run against the grain of Hong Kong's attributes, and yield marginal benefit if not net disbenefit. Meanwhile, Hong Kong's core strengths receive little attention or understanding from its leaders.

2.2. Enduring Advantage

What are Hong Kong's core strengths? What is Hong Kong's proposition?

Taking Hong Kong's proposition first, this is what it has always been – that of a gateway between China and the wider world. Far from being “old hat”, the nineteenth century concept of an entrepôt linking a closed China with an open world is as relevant as ever.

Consider Hong Kong's actual role today. Hong Kong's relative footprint in physical trade has diminished since the handover, although it is still Mainland China's fourth largest trading partner contributing a far-from-negligible 6.7 percent of the latter's total trade.¹³ However, in the more sophisticated trade services Hong Kong still excels. Its airport has

170 international routes and some 50 to the Mainland, making 220 in all; it is also the world's busiest air cargo terminal.¹⁴ Guangzhou Baiyun International Airport has 100 routes, mostly domestic.¹⁵

Of higher value-added than even air transport is finance. Hong Kong is a major financial centre¹⁶, arguably the leading international financial centre in Asia. It has 200 authorised institutions, including 70 of the world's top 100 banks. In HKEX it has the world's fifth largest stock exchange by market capitalization, ranking first in initial public offerings (IPOs) in 6 of the past 10 years. In terms of funds under management, Hong Kong is the largest centre in Asia. It is Asia's third largest bond issuance centre.

Hong Kong's financial proposition is particularly geared to China. The stock market is the major international listing venue for China enterprises – the “gateway” for these enterprises to meet international investors. Hong Kong lists over 1,200 China enterprises, which make up 69 percent of market capitalization and 76 percent of turnover.¹⁷ HKEX also hosts the leading derivatives markets on China stocks. Hong Kong has the world's deepest offshore RMB pool, and settles 70 percent of international RMB payments.¹⁸

In terms of foreign direct investment, both stock and flow, Hong Kong plays the leading intermediating role between China and the world. Hong Kong has channeled a cumulative 54% of China's inward foreign direct investment (FDI), and in 2017 channeled 66 percent; the corresponding contributions to outward FDI are 54 percent and 57 percent respectively.¹⁹

However, Hong Kong's service is not only to China. Its gateway opens in both directions. Hong Kong is the natural entry point for international firms seeking to expand into China and East Asia. For these firms, it is a window onto China and the region. Hong Kong hosts some 1,500 regional headquarters,²⁰ which are attracted by the territory's

strategic position, its sound legal framework, and its excellent professional and business services.

Nor is Hong Kong's contribution limited to the economic. Its academic sector excels, with three of its thirteen higher education institutions in the global top sixty, compared with three of the Mainland's 2,900 universities and colleges in the top ninety.²¹ Hong Kong's academic advantage appears to relate to the autonomy of its institutions, their effective governance, institutional leadership based on merit rather than politics, the internationalism of their faculty and approach, their use of English, and the high social status and pay of academics in society (Altbach and Postiglione, 2012).

Overall, Hong Kong has played and continues to play a crucial role for China and for the world. In the 1980s and 90s, Hong Kong's channeling of manufacturing investment, trade, professional services, and knowhow helped launch and sustain China's high-growth trajectory, distinguishing the nation from other transition economies that were not so fortunately endowed. By the same token, Hong Kong enabled the world to benefit from China's low-cost manufacturing capability and vast new markets. In the current era, Hong Kong provides crucial high-value-added services that China cannot provide for itself, facilitating China's relationship with the world to the continuing benefit of both sides. Far from being of lower relevance, Hong Kong today is as valuable as ever.

On what factors or core strengths does Hong Kong's proposition rest?

The foundation of Hong Kong's continuing value in the post-retrocession era is the One Country Two Systems policy elaborated in Hong Kong's constitution, the Basic Law. Under this policy Hong Kong maintains its preexisting free market capitalist system. The *Joint Declaration* summarises the rights and freedoms which Hong Kong

enjoys, which include, "... those of the person, of speech, of the press, of assembly, of association, of travel, of movement, of correspondence, of strike, of choice of occupation, of academic research and of religious belief ... Private property, ownership of enterprises, legitimate right of inheritance and foreign investment will be protected by law."²² The *Basic Law* sets out the totality of the rule-based system under which Hong Kong maintains its openness to flows of goods, services, capital, people and information, operating under the rule of law in accordance with common law principles. Hong Kong's open and rule-based system is the foundation of its success.

It may be asked whether the social unrest triggered by the Extradition Bill will damage Hong Kong's system or degrade its proposition. At time of writing, although the retail, hotel, and tourism sectors have been hard-hit such that the economy is in recession, the overall impact has been less severe. The US-China trade war is a more important factor for the health of the economy as a whole. Into the sixth month of the unrest, the benchmark Hang Seng Index is only slightly lower (26,359 on 15 November) than it was before the unrest began (26,761 on 4 June).

The Hong Kong system is by no means perfect. Its weakest part is the governmental institutions. Governmental effort should be directed towards meeting citizens' aspirations and protecting and strengthening the system that makes Hong Kong's proposition possible. The government should try to make Hong Kong a good place to live and work, and one which continuously upgrades its offering to provide services and attributes which Mainland China lacks. Unfortunately, as described in section 2.1 above, the Hong Kong government too often works in the opposite direction, mistakenly attempting to align with the Mainland and neglecting or even undermining the Hong Kong system while favouring big business. Nonetheless, despite its imperfections, the

Hong Kong system has fundamental strengths and constitutes an enduring advantage.

How will the Hong Kong proposition play out in the future? As China grows yet more developed and powerful, will Hong Kong be marginalized even despite its advantages?

3. China's Development Model

To answer this question, it is necessary to consider China's development model in more depth, together with how the model will likely evolve in the future.

3.1. Existing Model and Challenges

China's rapid development since 1978, following the exhaustion of central planning and self-reliance under Mao, is based on the policy of reform and opening-up (*"gaige kaifang"*: 改革開放). International know-how and resources were harnessed – to a large extent via Hong Kong – and exploited in increasing numbers of special zones which were allowed to experiment with new forms of industrial and administrative organization. The successful initiatives were then promulgated nationwide. The policy was successful, lifting hundreds of millions out of poverty, creating wealth for many, and enabling the nation to become a global power. China is now an emerging middle-income country, with 2018 per capita GDP at US\$9,776.²³ This success helped legitimize the rule of the CCP, enabling it to resist demands for political reform. As a result, China today is a hybrid – a state-permeated system that retains controls over the movement of capital, goods, services, information and people, while market-based mechanisms operate throughout much of the economy.

Under the Xi Jinping government, the state has expanded its role, to some extent reversing the trend of reform and opening-up. China's private sector contributes some 60 percent of GDP and 80 percent of urban employment, but state-owned enterprises enjoy priority access to finance, favourable regulatory treatment, and more secure property rights – and their role seems to be expanding.²⁴ Larger private enterprises, including those listed overseas, are required to establish a CCP branch so that their operations and management fall under a degree of central control (Yan and Huang, 2017). The state takes an active role in setting development priorities and building national champions. Expression of ideas and flow of information are censored; human rights are subordinate to ideological and national security concerns; the courts are subject to the overriding control of the CCP.²⁵

However, the continuing legitimacy of the CCP depends on the continuation of relatively high economic growth. Sustaining such growth, and avoiding the so-called “middle-income trap”, is becoming a challenge. The twin engines of growth have been exports and infrastructure spending, and both have run into difficulties (Schnabl, 2019).

As regards exports, China has exploited the international trading system in a mercantilist manner, since 2001 exporting under cover of World Trade Organisation membership while keeping its own market relatively closed. By 2007, China's trade surplus had reached 10 percent of GDP,²⁶ while by June 2014 foreign exchange reserves had reached US\$4 trillion.²⁷ These problems have since moderated. China's current account is now nearing balance, with a 2018 surplus equivalent to 0.4 percent of GDP, and by August 2019 forex reserves had reduced to US\$3.1 trillion.²⁸ Restrictions on foreign investment have been somewhat loosened, leading to a record US\$135 billion of FDI in 2018.²⁹ However, trading partners continue to complain of continuing

unfair trading practices, including closed markets, forced technology transfer, theft of intellectual property, state subsidies enabling unfair competition, and non-tariff barriers.³⁰ In 2018, US President Donald Trump launched a trade war, imposing tariffs on Chinese imports and pursuing alleged violations by Chinese companies like Huawei.

The trade war is damaging to the US as well as China – and indeed to the rest of the world – and may not continue for too much longer. However, even in the event of a US-China trade agreement, China could not continue to rely on mercantilist export-led growth. The world economy is not large enough to absorb endlessly-increasing China exports, even if trade partners were willing to receive them. So China's development model must turn towards domestic consumption.

This need is well recognized in China policy circles and indeed progress has been made. Domestic consumption has risen from a low of 35.6 percent of GDP in December 2010 to 39.4 percent in December 2018.³¹ However, exports are still a crucial contributor to China's growth, and rebalancing of the economy will take a long time (Liu and Yang, 2019). Because of constraints – such as the insecure condition of migrant workers, and the limited nature of welfare, health and pension arrangements for the general population – Chinese consumers still tend to prefer precautionary saving to current spending.³²

The other growth engine, infrastructure investment, has therefore had to take up the slack. The creation of infrastructure can boost productivity – indeed, in many instances such as China's unrivalled high-speed rail network (Yao *et al.*, 2019) it appears to have done so. However, there have been many wasteful projects. Excessive infrastructure spending has been a major contributor to total social indebtedness rising by March 2019 to 248 percent of GDP.³³ The externalities of the rapid growth decades, such as depleted water resources, pollution, and climate change, are also catching up on policy

makers. Although much is being done to address these problems, with China the world leader in renewable energy, there is still much more to do – it is the world's biggest carbon emitter.³⁴ Meanwhile, the demographic dividend China enjoyed in the boom years with cohorts of young workers thronging its factories is now going into reverse. The population is ageing rapidly as habits ingrained by the former One-child policy prove difficult to change. Migrant workers, themselves ageing, are returning home.³⁵

Facing this daunting complex of problems, the Chinese leadership has narrowing options. Before discussing these, however, it is necessary first to dispose of two strategies that appear to allow the long-term continuation of the present model. They are, the Belt and Road Initiative (BRI), and “Made in China 2025”.

3.2. Extension via Belt and Road?

The Belt and Road Initiative (BRI) was promulgated by President Xi Jinping in 2013 in response to the US-led Trans-Pacific Partnership that was to exclude China, but which in the event was not ratified by the US Congress.³⁶ The BRI was essentially a rebranding of initiatives that were already in progress as China reached out internationally for commercial and geopolitical clout commensurate with its economic size. Based on an Economic *Belt* recalling the historic Silk Road between China and Europe, and a notional 21st Century Maritime Silk *Road* through the Indian Ocean,³⁷ the BRI focuses on infrastructure investment to better connect less-developed countries with the world economy – and with the economy of China itself. The main objectives are, Policy Co-ordination among the countries concerned, Facilities Connectivity, Unimpeded Trade, Financial Integration, and People-to-people Links.³⁸

The shortfall in infrastructure is real, and there is certainly room for new providers. The Asian Development Bank has identified a need for

US\$26 trillion of infrastructure investment in the region over 15 years. China itself envisages US\$5 trillion of investment within 5 years via the BRI, although without a definite plan. China founded the Asian Infrastructure Investment Bank (AIIB) to support BRI financing, albeit that the bank's contribution so far is marginal. RMB Internationalisation is also intended partly to support the BRI, although the modest progress made – in September 2019, the RMB contributed less than 2 percent of international payments and foreign exchange reserves³⁹ – means that BRI financing is largely in dollars. In any case, China cannot finance the BRI by itself.⁴⁰

The BRI promises a more open world – a more level playing field for developing nations outside the West's hegemony (Zhang, 2018). Some 138 countries have signed up for it, including advanced nations such as Italy, and even nations in Latin America, Oceania and Africa that are remote from the original geographic concept.⁴¹ Through the BRI, China gains influence over these nations, in some cases acquiring specific assets such as a port, and enhances its soft power (Rahman, 2019). At the same time, China gains new markets for its excess production, so extending the life of its existing export-driven development model.

However, although the idea of the BRI has merit, delivery is another matter. Less-developed countries like Pakistan and Sri Lanka need infrastructure but may lack the means to pay for it. The fact is that the BRI is supposed to be commercial, not a system of grants like the post-World War 2 US Marshall Plan with which it is sometimes compared. As part of a debt restructuring, the Chinese enterprise concerned did take over management of Sri Lanka's Hambantota port,⁴² although to date that seems to be the only case. Hambantota's main problem was lack of profitability, and this has bedeviled other BRI initiatives. Moreover, China has applied its domestic practices directly to overseas projects,

employing Chinese workers and China-sourced materials and driving the project through without regard to local sensitivities; there are also allegations of bribery of local officials and opaque project terms.⁴³ Some see the BRI as “neo-colonialism” based on debt diplomacy (Diamond, 2019). At home, some question whether the resources going into the BRI would be better spent on China’s domestic needs.⁴⁴

Overall, the BRI has much to offer the world, but to be sustainable it has to become less China-centric. China’s rhetoric of a more open world has to be matched by a fairer and more transparent mode of project management – and also by better commercial sense in project selection. It is hard to see the BRI constituting a new informal empire for China, let alone a self-contained trading bloc. The BRI countries are too disparate, too far-flung, and too diverse in their interests to be so managed. In any case, imposing as it does so many barriers on its own people’s interaction with the wider world, China lacks the deep bench of internationally-experienced personnel that would be needed.

3.4. Extension via Innovation – “Made in China 2025”?

If the BRI offer no external escape from China’s looming development trap, what about internal escape via self-reliance? Under the 2015 plan, “Made in China 2025”, China seeks to rely less on international input, driving the domestic content of production to 40 percent by 2020 and 70 percent by 2025. Further, China aims to contest advanced industries presently dominated by foreign companies, including pharmaceuticals, automotive (green vehicles), aerospace, semiconductors, IT (Artificial Intelligence (AI), Internet of Things (IoT), smart devices), and robotics (AI and machine learning). The aim is to become a powerful manufacturing country by 2025, a middle-level world manufacturing power by 2035, and a top world manufacturing power by 2049.⁴⁵ World leadership implies trading with the rest of the world rather than total

isolation, but the aim is self-reliance in key sectors – a go-it-alone strategy – and hence the continuing relative closure of China’s borders. Is this a feasible path?

The Chinese leadership has itself had to downplay “Made in China 2025”, as the plan’s protectionist overtones upset trading partners.⁴⁶ Since then, with the deepening of the trade war, such feelings have hardly gone away. Yet, more fundamentally, the plan is not realistic.

In international trade, to quote President Xi’s own words, China is, “big but not strong”.⁴⁷ It produces goods which are of medium quality and price but fall short on the increasingly important inputs of service and design. With an underdeveloped service sector, China will be hard-pressed to make up this shortfall. Even in the key sectors targeted by the plan, China is highly dependent on international inputs, particularly US-developed software and microchips. Huawei leads in 5G gear, but its networking gear uses semiconductors and other specialised components from US companies.⁴⁸ Import substitution for these is imaginable, and that is indeed the strategy – Huawei has declared plans to make its own chips, and the state has committed to investment in chip manufacture. Yet self-reliance is costly and cannot be done for everything. By the time China’s chip plants are built, overseas competitors may have moved on.

The quest for economic self-reliance is a persistent theme in China’s development policy, driven by the desire to avoid dependence on foreign powers (Tisdell, 2013). However, self-reliance has a cost, namely the loss of the benefits of trade based on comparative advantage. The nation has to do everything itself, rather than focusing on what it does best and buying in products and services produced better and more cheaply elsewhere. The associated benefits of exposure to overseas best practice are also lost. Such costs may be tolerable if borne in respect of limited sectors, such as those crucial for national defence. However, as a broad

strategy, self-reliance is ultimately the route to poverty – as demonstrated by examples such as Cuba, India in the post-independence decades, North Korea, and China itself under Mao. Long before such extreme conditions were reached, the CCP would encounter faltering growth, and would lose the Mandate of Heaven in the eyes of the people.

3.5 “Sinicization of Everything?”

If neither the BRI nor self-reliance ultimately offer a viable path, China is faced with a dilemma. To continue high economic growth and escape the middle-income trap, China needs international input – not only goods but increasingly the services and structured information that are critical to the functioning of a modern developed economy. China will have a growing need for international capital as well, since its current account will likely trend into deficit as consumption rises. However, international providers of services, information, and capital are more demanding than international manufacturers, requiring law-based protection and the right of withdrawal. Their involvement in the economy is difficult to contain, tending as it does to stimulate ideas and discussion. This is unpalatable to the CCP leadership, which under the Xi Jinping government has clamped down on independent thought, denied legal rights, and enforced party orthodoxy to strengthen the state-permeated model.

The US trade war demands illustrate the stark nature of the dilemma. They include, protection for foreign investment, an end to subsidies to state-owned enterprises (SOEs), protection for intellectual property, a ban on forced technology transfer, and a level playing field for foreign enterprises. All these commitments are to be embodied in Chinese law and regulations so that enforcement will be effective and can be monitored.⁴⁹

These demands are difficult for the CCP to accept. Chinese laws are generally vague, to leave room for the exercise of the official discretion on which the state-permeated model depends. If China were to accede to an independently adjudicated law-based system, the state-permeated model would collapse and an existential crisis for the CCP ensue. It will not happen. And while China may be able to buy off Trump with lesser concessions or otherwise segue to a less-conflicted relationship, even that will not suffice for too much longer. To sustain growth, China needs to be more open to international input. But how?

If nationwide opening is ruled out, there remains opening in selected areas via the enclave model. This model has seen a revival in recent years via the creation of Free Trade Zones in China with a mandate to experiment with new administrative and business forms. However, before discussing the enclave strategy it is necessary to address one more, apparent possibility of obtaining needed international input without changing the existing development mode.

This possibility which, consciously or unconsciously, is being pursued by the CCP leadership today, can be termed, the “sinicisation of everything” (Wong, 2019). The concept here is that China’s gravitational force as a market of 1.4 billion people and perhaps eventually the world’s largest economy will be strong enough for the CCP’s view to sway the world, or a sufficient portion of it, to trade with China on the latter’s terms. Already, many international businesses and organisations, even states, have felt the force of Chinese displeasure as voiced by netizens and amplified by Chinese corporates and state media, and have hastened to make amends. The list of recent converts includes international hotels, airlines, Disney, the US National Basketball Association, Gap, Dolce & Gabbana, Apple, Nike, and many more. If the BRI represents China’s bid to draw the developing world into its

orbit, the actions described here impact the commanding heights of the international economy. Can China indeed sinicise everything?

The sinicisation strategy is in effect a form of ideological mercantilism, and as such is subject to the same limitations as those of the trade version, discussed in section 3.1 above. As a point of fact, business corporations as such are not well-positioned to resist this kind of society-wide pressure. Focused by mandate on shareholder value, individual business executives may feel, whatever their personal convictions, that their duty to shareholders obliges them to go along with China's demands in order to tap the China market, it not being their main job to act as advocates for free speech. That view may ultimately not be supported by their shareholders, increasingly focused as they are on ESG (Environmental, Social and Governance) performance; domestic customers may also exert countervailing pressure. Governments, too, may take issue with abuse of their companies. However, the concentrated power of China's all-of-society assault, backed by its market size, can score initial wins, at least.

Nonetheless, such wins do not help China much economically, indeed they may hinder rather than help. Forcing Marriott Hotels to acknowledge Taiwan to be part of China, or an NBA executive to withdraw his tweeted support for Hong Kong protests is one thing. It is quite another to force an international firm to invest in China or to sell technology to a China firm or to buy China bonds. Even if China can cow business executives into acquiescence or silence over ideological questions, that does not necessarily translate into business advantages for China. Indeed, the experience of aggression and personal humiliation may make those executives more wary of China deals, and add to their respective governments' list of complaints about China market access. The aggression also affects China's soft power projection, turning it into "sharp power" which although penetrating may provoke reaction and be

less effective in the long run. Finally, there is the impact on China's own consumers. NBA matches were highly popular viewing in China; although many Chinese were outraged by Daryl Morey's tweet, that may not translate into indefinite support for the NBA boycott. Popular outrage can take an unpredictable course.

3.6. Opening-up – via Enclaves

The remaining option for gathering vital international input is opening via enclaves – geographically limited areas for experimentation. This too has been recognized by the leadership. From 2013 onwards, so-called Free Trade Zones (FTZs) have been created in Shanghai, Guangdong and other regions. However, the 12 existing FTZs are too small and their approach too piecemeal and inconsistent to make much difference.

Nonetheless, the enclave model represents China's best hope of sustaining growth while preserving the state-permeated system. An enclave is like an airlock – allowing two-way flow under a control mechanism. China has a long history of utilizing enclaves – Hong Kong and Macau from historic times, Shanghai in the pre-revolutionary era, and the vast numbers of special zones that sprang up from 1980 onwards under the Open-Door policy. Enclaves of some form may be the only route to a future that is acceptable to both the Chinese population and its leadership. But what form should these enclaves take?

The Special Economic Zones of the 1980s and 1990s were particularly successful in attracting low-cost manufacturing investment, much of it from Hong Kong. Low-cost manufacturing requires relatively simple inputs of land and labour, and can be conducted in a limited geographical area. However, in China's more developed economy, no longer low-cost, the requirement is for more sophisticated products and services. These require more complex inputs, including contact with the mass consumer markets the products and services are intended for. The

existing FTZs, some located in empty fields or the wharves of existing ports, are unsuitable for these activities, containing neither sufficient markets of their own nor specialised inputs such as professional services and adjudication by independent courts. Unclear legal and regulatory foundations and ongoing intervention by the central authorities further clouded the picture. On the other hand, an initiative to allow “FTZ accounts” to be opened at banks across the country threatened to disrupt the nation’s financial system and so had to be curtailed.⁵⁰

The FTZs have had some success in physical trade and support for e-commerce; Mainland companies have registered to take advantage of the looser regulation. However, in general the FTZs have seen low innovation, high dependence on policies, and no distinctive advantages or functions (Chen *et al.*, 2018). There is no unified FTZ law; the roles of the various administrative authorities in the FTZs are not clear; measures taken in the FTZs may not be consistent with China’s WTO obligations (Peng and Fei, 2017). Foreign investment has generally been minimal. Potentially useful reforms such as a more independent court system and intellectual property court in Shanghai FTZ may not be constitutional (Liu, 2018).

While a small geographical area can provide a good base for physical trade and manufacturing (as under the SEZ model), it is not well-suited to services, especially financial services, in China’s now more mature economy. The FTZs were also intended to experiment with new administrative initiatives. However, they are too small and unrepresentative of the nation as a whole to act as a trialing ground for national reforms. The grand objectives of the FTZs were essentially unachievable.

A comparison between the existing FTZs and Hong Kong is instructive. Unlike the FTZs, Hong Kong is:

- of sufficient economic size to be self-sustaining and make a difference even to the vast China economy;
- a complete societal system, with its own executive, legislature and courts;
- highly autonomous vis-à-vis the central government;
- properly founded on its own constitution, the Basic Law, rather than on administrative departures from or waivers of national laws and regulations;
- governed by the rule of law adjudicated by an independent court system;
- delineated by clear physical and legal borders from the rest of China so that experimentation within the enclave is containable;
- operated in accordance with free market principles.

(An equivalent analysis could be done in respect of China's other SAR, Macau. However, Macau is one-tenth Hong Kong's size and has a different orientation; it will not be discussed in the present paper.)

The substantial, indeed, irreplaceable benefits China draws from Hong Kong are detailed in section 2.2 above. If China is to draw Hong Kong-scale benefits from any further enclaves, it has to make those enclaves more like Hong Kong. This requires much bolder thinking than has been evident to date.

The enclave strategy, then, would entail identifying one or more candidate areas within the Chinese mainland which could be revamped as SARs. Where can such candidates be found?

Mainland China has no Hong Kongs or anything like a Hong Kong. However, it is possible to imagine that certain areas that are today relatively developed and open, such as the Greater Bay municipalities and in particular Shenzhen, could make a start. Indeed, Shenzhen is

slated for bolder experimentation in the future.⁵¹ The challenge will be to be bold enough. To make a difference, it will be essential to provide Shenzhen with its own constitution and grant it a high degree of autonomy from the Central Government.

4. Implications for Hong Kong

If the strategy of further enclaves is adopted by the Chinese leadership, what implications would that have for Hong Kong? Would it just mean supersession of Hong Kong's role by other means?

Promulgation of the enclave model more widely in China would be positive for Hong Kong.

Firstly, it would be a strong endorsement of the Hong Kong system. Secondly, since it is unimaginable that any new enclave could be granted freedoms equivalent to those in Hong Kong, let alone match the territory's accumulated 170 years of experience, it would elevate Hong Kong to the *de facto* chief among the enclaves – the leader of the flying geese. Thirdly, Hong Kong would be the model and exemplar of China's future – the nation's hope.

Fourthly, to the extent that these successor enclaves actually function as intended, it would provide healthy competition for Hong Kong. The territory's main problem – apart from its governance mechanism – is that in its China gateway role it is too secure. There is too little competition, which breeds complacency in Hong Kong's leadership and rent-seeking behaviour among its business conglomerates. More competition from Shenzhen, say, would prompt a creative response from business and meaningful reform from the government, releasing fresh energy in the people.

Last but not least, new enclaves would provide more development space for Hong Kong. These enclaves, particularly if like Shenzhen they

are in Hong Kong's near neighbourhood, could provide accommodation and recreation as well as business opportunity in a more secure and "Hong Kong-like" environment than the Mainland presently provides.

5. Final Words

Ideally, fundamental doubt about Hong Kong's future would not arise. The Hong Kong system is assured until 2047 by international treaty. In any case, the right to self-determination is the most fundamental human right recognized in Article 1 of the United Nations Charter.

Nonetheless in the real world, rights are not a given, or even if given they have to be continually asserted. Hong Kong has made a very convincing assertion of its right to a future. It has performed, and continues to perform, immense service to both China and the international community in its gateway role, not to mention its broader prowess as an international financial centre and as management headquarters and a professional services centre for the Asia-Pacific region.

Even this impressive catalogue is not the full statement of Hong Kong's value. For in its enclave role, Hong Kong represents the only viable model for China to transit to more developed status. China needs more Hong Kongs. It should cherish the Hong Kong that it has.

Notes

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The Dynamics of Migration within China: A Study on Socio-Economic Aspects

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Abstract

Based on socio-economic aspects, the article describes the overall trends and factors of migration in China. The Chinese society was divided into urban and rural areas since 1949 under a rigid *hukou* (household registration) system. The analysis is concerned with the historical and structural environment in which rural people move to the city and trying to become new urban citizens. This study has chosen 1995 as the starting year because it is from this year that large-scale migrations started towards Chinese cities. The urban reform led to a certain degree of marketization, which gave rise to peasant migration and this migration, in turn, pushed further the institutionalisation of the market. The Chinese economy was in transition from a socialist planned economy to the more market-driven economy during reform period. The article begins by defining migration and floating population in both general and Chinese perspectives. The second section discusses the trends and factors of migration. The third part deals with socio-economic aspects of migration. The fourth part talks about the impact of migrant labour.

Keywords: *China, economic reform, migration, household registration system, labour*

1. Introduction

An underdeveloped nation for three decades after its founding, the People's Republic of China (PRC) experimented with new economic policies and opening up of its borders for Foreign Direct Investment (FDI) in the late 1970s. These reforms led to the creation of a new social order and ushered in some economic prosperity in the country. China has shown a tremendous and consistent economic growth during the past three decades with an average growth rate of 9.5 per annum (Li and Roulleau-Berger, 2013). China's open door policies and market reforms are the major steps taken by the Chinese leadership in 1978 to overcome its economic crisis. These reform policies were the starting point of Chinese industrial and economic developments. What are those factors that accelerated the Chinese economic growth? Are they only the state policies, the institutional mechanism, FDI and the role of science and technology? Yes, definitely these all contributed towards its economic prosperity, but the real role player behind its boom is the millions of its floating population (*liúdònggrénkǒu*, 流动人口)¹. Since the 1980s, China has transformed itself from a relatively segregated society to one where migrant work has become the way of life for rural families and where migrant workers are part of everyday urban life. They were the wandering beggars in the 1990s and now the new urban citizens of China. Almost all the large cities, small cities and towns are filled with this migrated population. An approximate number of migrants amounted to more than 275 million distributed in different cities (Becker, 2014) which are noted as the largest peaceful migration ever in human history. From the traditional agricultural sector, they started exploring other life

and employment opportunities in the cities. With the economic liberalisation policies, the invitation of FDI in Chinese land created a lot of employment opportunities for these poor and unskilled farmers. They began moving to cities by leaving their fields and searching for jobs. Migration is becoming an important topic in the scholarly approaches that study China. There are an enormous number of studies that have been done on internal migration in China. However, most of them are macro-level researches which are not addressing the basic issues of migrants and migration process.

In this article, the author argues that the relaxation in *hukou* (*húkǒu*, 户口)² system led to the massive population movement from rural to urban areas. Also, the author argues that the vast income gap between rural and urban people and economic reforms that created abundant employment opportunities in urban space invited the surplus agricultural labour into the cities. So certain questions need to be addressed at this juncture: What are the economic and social factors that led peasants to migrate to cities? What are the main determinants of floating population? How do the rural peasants find employment in cities?

1.1. Definition

Migrants are commonly categorised according to their registration status. The Chinese government officially uses the word “migrant labour” (*nóngmíngōng*, 农民工) only to refer to those who have crossed an administrative border with permission, transferring their *hukou* with them. These migrants may also be referred as legal, formal or official migrants (Davin, 1999). We can call these the state-led or -sponsored migration and migrants. In other words, *hukou* migration is only considered migration in China, and the remaining all is just floating population. Unofficial migrants are those who move to cities without permission and are referred to as the floating population

(*liúdònggrénkǒu*, 流动人口). This kind of migration is a relatively new phenomenon in China at least since 1949. The *liudongrenkou* is a unique terminology used in China that is tied to the *hukou* system. Individuals who are not living at their particular *hukou* location are considered “floaters”. This concept is based on the notion that the *hukou* location is where one belongs and that migration is not considered official and permanent until the migrant’s *hukou* location is also changed. The floating population is a stock measure. Regardless of when actual migration occurred, a person is counted as part of the floating population as long as his or her usual place of residence is different from the *hukou* location (Fan, 2002). Presently approximately 277.5 million such floaters are working in China’s cities; they contribute about 36 percent of the total workforce of around 770 million in China (according to a survey conducted by the National Bureau of Statistics on migrant workers in Chinese cities, 2015).

“Migrant workers” (*nóngmíngōng*, 农民工) can be defined in the Chinese context as referring primarily to individuals who are from rural areas, have a rural registration (*húkǒu*), and are working outside their village and town (Wu *et al.*, 2014). For better understanding, in this article, the author uses the terms “migrants”, “migrant workers”, “migrant population”, “floating population”, “floaters”, “transient population” and “sojourners” interchangeably. The research on migrants in China is increasingly getting attention into two groups of people, i.e. the new generation and old generation of migrants. However, the usage, criteria and definitions of the terms are not consistent. To add to the confusion, other terms such as “first generation” (*diyidai*) and “second generation” (*di’erdai*) are also used and sometimes interchangeably with, respectively, the terms “old generation” and “new generation” (Fan and Chen, 2014). However, here it is talking about migration in general.

1.2. “Floaters” in Cities

The phenomenon of migrant labour is hardly new in China. Lee (1995) has documented the pattern whereby particular localities cultivated specific occupational skills, ranging from academic and administrative talents, military specialists, traders, business people to carpenters, barbers and blacksmiths, for export to other localities in late Imperial China. During the pre-1949 era, with the opening of treaty ports along coastal provinces and the establishment of manufacturing enterprises, peasant workers migrated from the countryside into Tianjin and Shanghai. Like these previous sojourners, those who swarm train stations during the Lunar New Year month in the 1990s become migrant workers under specific political, economic contexts. Two developments in the political economy of south China have played prominent roles in shaping the politics of migrant labour: rural economic reforms in the mainland and economic restructuring in Hong Kong.

In 1996, China’s total labour force increased to 688.5 million, of which 340.8 million were non-agricultural, over the period 1952-96, 194.6 million workers had moved from agriculture to non-agriculture. Between 1978 and 1996, a total of 156 million agricultural workers were absorbed by various non-agricultural sectors, accounting for more than 80 percent of the cumulative off-farm migration of labour over the entire period since 1953. This population is equivalent to more than half of China’s total non-agricultural labour force at that period (Lloyd and Zhang (eds.), 2000: 212).

The story of rural reforms in China is by now well-known. Most relevant to the present discussion is the release of massive surplus labourers, many of whom became migrant labourers after the demolition of the commune system in the early 1980s. Numerous articles in the Chinese press asserted by the mid-1980s that some 30-40 percent of China’s rural labour force was redundant. It was widely estimated that

by 1993, there was between 150 million and 260 million surplus labour in rural China, and it was predicted that by the year 2000, the figure would reach 300 million. The gradual erosion of the Household Registration Regulations, which had for four decades restricted the movement of peasants into cities, also facilitated rural-urban migration. The year 1994 has seen further development in the loosening of the registration system. A proposal has been drafted by the Public Security Ministry allowing peasants to obtain residence registration in small towns and cities provided that they could find stable accommodation and employment (Lee, 1995).

In the age of globalisation with the compression of space and time, population mobility has increased substantially, and the patterns of migration have become more complex and diverse, facilitated by relaxed regulations on migration, close economic integration, and an expanded communication and transportation infrastructure. The assumption of the neoclassical economic theory of migration that migration is driven by wage differences has been challenged. Instead of unidirectional migration, return migration and circular migration have become common in both internal and external migration driven by economic, social, cultural, political, household, and personal factors (Shen, and Chiang, 2011).

Fan's article on this issue questions two conventional assumptions about migrants and families: migrants move in order to settle down, and the family lives together in the same place most of the time. Fan argues that settling down in the city is not inevitable. By circulating between the city and the home village, the migrants can obtain the best of both worlds. Migrants can earn urban wages but support the rest of the family at a lower cost (Fan, 2002).

Largely because of the existing *hukou* system and associated institutions and attitudes, new migrants in cities are easily marginalised.

The situation of these Chinese newcomers face is comparable to the experiences of ethnic minorities and immigrants in cities elsewhere (Solinger, 1999). Except those who are working in factories with housing provided, migrants have to find accommodation in the still rudimentary urban housing market. One of the results has been the establishment of “migrant villages” based on village houses or land rented at the urban fringes. These migrant enclaves are places where new migrants from the same native place, speaking the same dialect, congregate. This is a self-help mechanism, as well as a natural outcome of non-*hukou* migration, most of which is chained by social networks based on native place. Migrant villages are often without proper infrastructure services and may present a menace to public health. In the second half of the 1990s, as migrants become more established, many family members also arrived in the cities. Providing affordable schooling for migrants’ children has now become a major issue of concern among the migrant communities in Beijing and Shanghai (Chan, 2001: 144).

Another concern is that migrants have too many children. China’s draconian population planning policy tries to limit urban families to having only one child and rural couples two. Communes, urban work units and city neighbourhoods have been the most important instruments of policy enforcement. When communes vanish, rural governments are less capable of enforcing this structure, and migrants away from home escape this control. More significantly, 70 percent of city migrants are in the most fertile age group (sixteen to thirty-five). According to official estimates, most of the unplanned births in cities are attributed to temporary residents. Such hysterical labels as “above plan birth guerrillas” or “corps that break the birth control policy” underscore state worry over unbridled fertility as well as the state’s failure to manage the problem (Wong, 1994).

1.3. What Determines Migration within China?

A simple yet crucial step in emphasising the central position of the migration phenomenon is to recognise that any economic and social policy that affects rural and urban real incomes will directly and/or indirectly influence the migration process. This process, in turn, will itself tend to alter the pattern of social and geographic economic activity, income distribution and even population growth. Since all economic policies have direct and indirect effects on the level and growth of either urban or rural incomes or both, they all will have a tendency to influence the nature and magnitude of the migration system. Although some policies may have a more direct and immediate impact (e.g. wages and income policies, programmes of employment promotion, etc.), there are many others which, though less obvious, may in the long run be no less important. These policies would include, for example, alterations in the system of land tenure, commodity pricing, rural credit allocation, taxation, export promotion, import substitution, commercial and exchange rate policies, the geographical distribution of social services, the nature of public investment programmes, attitudes towards private foreign investors, the organization of population and family planning programmes, the structure, the content and orientation of the educational system, the structure and functioning of urban labour markets, and the nature of public policies, towards international technological transfer and the spatial allocation of new industries. There is a clear need to recognise this by integrating the two-way relationship between migration and population distribution, on the one hand, and economic and other variables, on the other, into a more comprehensive analytical framework designed to improve development policy (Todaro, 1976).

Over the past 50 years, China has achieved quite rapid economic growth. The structure of the economy also changed dramatically.

Regarding output composition, China can no longer be seen as an agrarian economy. Regarding the sectoral distribution of labour, however, China remains an agriculture-oriented economy: in 1996, over 50 percent of the labour force is engaged in agricultural production, though the sector produces only 6 percent of GDP (Lloyd and Zhang (eds.), 2000).

According to last population census in November 2010, the total population in Mainland China was 1.34 billion. There was a “temporary population” of 221 million people. They were not living in the town, township, or urban districts where their *hukou* (household registration) was located and had left the place of *hukou* for over half a year. Such rural migrants constitute the bulk of migrants in mainland China. Some of them have lived and worked in urban areas for a long time. However, many rural-urban migrants in mainland China circulate between the city and their home village, and they have not settled down permanently in the place of working and living. The *hukou* system has been considered the primary cause of such temporary population in previous studies. However, recent studies have pointed to other structural factors, household strategies, and migrants’ agency. Some recent studies have focused on the settlement intention of rural migrants (Shen and Chiang, 2011).

2. Internal Migration: Policies, Trends and Factors

Migration became a significant topic at the beginning of the 1990s after the Chinese paramount leader Deng Xiaoping’s Southern Talk in 1992 (Sen, 2011). Migration has been uncontrollable in that period. Therefore the state came up with specific policies to control it.

2.1. State Policies and Migration

The modern household registration system (*hukou*) was officially declared as a permanent program in 1958 in China to control and prohibit peoples' flow from one place to another, especially rural to urban migration. It was implemented since 1958 and this system used to ensure the socio-economic and political stability of the state. *Hukou* acts the state's institution to provide welfare scheme of the government. It primarily divided Chinese society into rural and urban by their class character (peasant or working class). During the first decade of the PRC, the population of the urban area was limited which was around 10 percent of total population (Zhan, 2011). The PRC wanted to maintain the urban population in a limited size and phase of urbanisation was low. The urbanites had many privileges to which their rural counterpart were not entitled. The state had created an invisible wall between rural and urban people and migration was only allowed in certain cases such as military recruitment, people displacement due to dam construction and natural disaster.

Since 1978, with the opening up and market reform policies, the invisible wall broke and the officials deliberately ignored some migration from rural to urban areas especially to work in newly created Special Economic Zones (SEZs). However, this migration was only possible when both the rural and urban local authorities pass their order. But the migration was in slow process with knowledge of the state. However, when the necessity of labour was becoming demanded by the infrastructural development in the cities, the local authorities had loosened their grip on people. This situation led to a large people flow from rural areas to cities especially to the southern provinces. So the central government decided to control the migration with various means according to the respective local government's capacity.

The first step for coping with the migrant population was to introduce a system of registration for temporary residents. In July 1985, the Ministry of Public Security announced a set of temporary regulations. People visiting cities and towns for three days or more are required to notify the local police. Outside visitors over age sixteen who intend to stay for more than three months have to obtain a temporary residence permit (*zànzhùzhèng*, 暂住证). On 6 September 1985, the Twelfth Meeting of the Standing Committee of the Sixth National People's Congress promulgated the People's Republic of China Residents' Identity Card Regulations (Fan, 2002). These require all citizens over sixteen to apply for a personal identity card and support the police to make identity checks. No doubt useful as a tool of law enforcement, the ID card is also a pass to mobility and business transaction. In place of a letter from one's work unit or village official, Chinese citizens can buy a rail ticket, check into a hotel, and apply for a job or a business licence upon presenting this document (Wong, 1994). In the late 1980s and early 1990s, many urban local governments began charging migrants high fees which were ranging from five thousand to tens of thousands of *yuan* in exchange for *hukou* in urban localities. Those governments justified this act because they should be compensated for extending urban privileges and rights to migrants. In the mid-1990s, big cities, such as Shenzhen and Shanghai, began to issue the "blue-stamp" *hukou* to rural migrants who met high skill requirements and were able to make decent investments (Wong, 1994). The blue stamp *hukou* could be converted into a permanent urban *hukou* after a specified period. In 1997, the State Council approved a scheme to grant urban *hukou* to migrant workers who held better jobs for two years and had resided in selected towns and small cities (Chen and Hoy, 2002). In this case, reform did not require qualified migrants to pay a hefty sum, unlike earlier practice. The State Council approved specific

policies to expand *hukou* reform in 2001 after testing the scheme in 450 towns and small cities. Then the core requirement for obtaining *hukou* in small towns and cities was a legal and permanent place of living and a decent and stable source of income (Cai and Wang, 2003). However, in the major cities, *hukou* still acts as a gatekeeper. There are no such *hukou* reform policies implemented in the major cities like Beijing, Guangzhou and Shanghai.

2.2. Trends

Internal migration in China follows some specific trend which shows an outflow of population from less developed Central and Western provinces to highly developed provinces and large cities in the Eastern parts.

The creation of the Special Economic Zones (SEZs) in the coastal cities in the 1990s needed a huge labour supply, in which the doors of some Eastern provinces open in a way for it. Since the 1990s, when income disparity began once more to widen in different regional levels and, at the same time, markets became much more important forces in the allocation of capital and labour, the booming coastal cities have attracted massive flows of labour. The coastal provinces have been leading in the development of markets and their economies due to benefiting from the early openness of their economies towards foreign direct investments (FDIs). This situation eliminated the institutional barricades which prevent factors of production from moving across regions, and it causes those regions to become major destinations of labour flows.

China witnessed a big population wave since 1995 into its cities. They started migrating from one province to another and within the provinces. Table 1 gives an illustration of the regional distribution of migration which shows the origin point and destination places of floating

Table 1 Regional Distribution of Migration (%), 1987-2000

Destination	Origin			
	East	Central	West	National
East				
1987	91.0	13.6	9.7	40.5
1990	87.0	18.6	18.1	43.2
1995	92.6	30.5	22.5	54.5
2000	95.4	32.0	22.5	54.5
Central				
1987	5.6	82.7	4.7	30.3
1990	8.4	75.8	7.5	29.2
1995	4.1	62.9	4.9	21.6
2000	2.5	65.1	2.6	22.7
West				
1987	3.4	3.7	85.6	29.2
1990	4.6	5.5	74.4	26.9
1995	3.3	6.6	74.4	26.9
2000	2.0	3.3	74.9	22.8

Source: National Bureau of Statistics, *China Labour and Social Security Yearbook* (various years).

population. The data examine a primary view that most of the population movement has occurred within regions, which means they move either within provinces or to nearby provinces in their particular region. Such movement seems like very high in Eastern region of China and their

percentage at the national level was also high when compared to other regions. During 1987 to 2000 only small percentage of people were willing to go to another province which proves that rural people do not want to go to long distant places for jobs; rather they would like to move to live in a nearby place so that they can easily have a connection with their respective villages.

Based on the 2000 census, there were around 124.6 million counted as internal migration in China in which 73.4 percent of whom were inter-provincial migrants. When we consider only inter-provincial migration, it is visible that the Eastern region is the prime destination chosen by migrants. The data in Table 2 show the spatial distribution of such migrations. In 2000, about 65 percent of migration (inter-provincial) in the Eastern region happened within this region. However, 84 percent of migration from the Central region and 68 percent from the Western region have moved to the east. The trend shows that the share of migration happened in inter-provincial level within the east increased by nearly 15 percent, and from Central and Western to Eastern regions increased by around 24 percent.

For the better understanding of the features of the origins and destinations of migrations, it is helpful to divide the flows of migration into four different categories: (a) urban to urban migration, (b) urban to rural migration, (c) rural to urban migration, and (d) rural to rural migration (Cai and Wang, 2003).

The rural to urban migration (40.7 percent of the total) and urban to urban migration (37.2 percent) are the two major forms of migration in China during the reform period. Other migration types like rural to rural migration shares 18.2 percent and urban to rural only 4 percent of total migration.

Table 2 Regional Distribution of Inter-provincial Migrants (%), 1987-2000

Destination	Origin			
	East	Central	West	National
East				
1987	49.7	61.7	44.2	52.0
1990	56.0	59.0	49.3	54.6
1995	63.5	71.8	56.5	63.1
2000	64.4	84.3	68.3	75.0
Central				
1987	31.3	21.8	21.2	24.6
1990	28.4	23.5	20.4	24.0
1995	20.5	12.7	13.4	18.8
2000	19.7	7.1	7.9	9.8
West				
1987	18.9	16.6	34.6	23.3
1990	15.6	17.5	30.3	21.4
1995	16.1	15.5	30.2	18.1
2000	15.9	8.6	23.9	15.3

Source: National Bureau of Statistics, *China Labour and Social Security Yearbook* (various years).

2.3. Factors

The phenomenon of migration always depended upon various social, economic, cultural and geographic reasons. As like any other country,

China also follows same reasons for its internal migration, but here in this case, the total structure of migration is very different due the strong presence of *hukou* policies.

2.3.1. Push and pull factors

Rural poverty was major push factor which led peasants to go away from their villages. The continued crop failures and bad weather conditions made peasants' life miserable which led to poverty in the rural areas. The rural migrants totally depended on their yield rather than any other income; as they worked in the collectives they only get grains and low income to survive. Unlike working class in the urban area, peasants were not protected under the state scheme. The Chinese agricultural sector was very labour-intensive in nature and they did not have many options for earnings. They had to work in rural collectives, but since reforms those collectives were dismantled in villages. Peasants' income fluctuated with the success of yield. The crop failures always brought them into great difficulty and they experienced widespread starvation. The establishment of Township and Village Enterprises (TVEs) gave peasants work in those firms. The abolition of the collective system created an enormous rural off-farm labour and surplus labour availability in the countryside. The relaxation of *hukou* policies allowed these labour forces to move into cities and search for jobs. So a massive number of off-farm peasants started going to urban areas for better earnings and job opportunities.

Social structure was another push factor for migration. The structure had created two sections of people in China which were a privileged working class in the urban area and ordinary peasants in the rural area. The urbanites were entitled many rights and social benefits such as lifelong employment opportunity, free rations, health insurance and so on, whereas villagers had not had such good facilities. So this structural

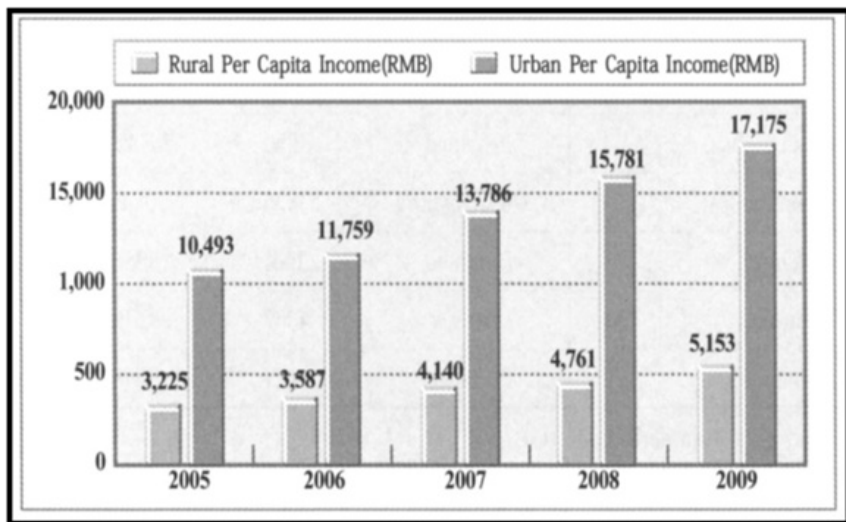
discrimination always brought inferior feelings in the peasants giving them urge to be an urbanite. They always carried a dream of going to the cities and staying there as an urbanite.

Natural calamities were a push factor for migration where peasants did not want to stay in their villages anymore. The natural calamities like flood, earthquakes made peasants' life problematic and they somehow wanted to leave their place and settle in the cities.

On the other hand, economic motives were the major pull factor for migration in China. The peasants were much aware that they can earn a better income and good life in the cities. The market reforms in urban centres and inflow of Foreign Direct Investment (FDIs) in China's coastal regions attract labour there. For the infrastructural developments and other low-skilled works, the state wanted more and more workers. Migrants get jobs very easily in the cities due to economic and infrastructural development process. Because of higher wages and better employment opportunities the villagers migrated largely to the cities.

2.3.2. Regional inequality

The unequal exchange between agriculture and industry has existed for a long time in China, and consequently, this has been an important factor for the rural-urban differences (Zhang, 2003). Despite a political responsibility to bring about greater equality, economic development till the 1970s has not succeeded in eliminating regional inequalities. Indeed, regional inequality still exists, but with the help of migration and remittance China's rural areas are also under the developmental phase. Peasants started moving to cities which shows a flow from the place with less development and fewer employment opportunities to the place with high development and large job opportunities. So people slowly moved into the highly developed coastal regions from the relatively less developed Central, Western and Northern parts of the country.

Figure 1 Rural-Urban Income Gaps, 2005- 2009

Source: National Bureau of Statistics, *China Labour and Social Security Yearbook* (various years).

Figure 1 presents the income gap between the rural and urban people. The data show the per capita income of rural and urban people from 2005 to 2009 to throw light on the income inequality in the geographic location-wise. The data reveal the huge income difference between rural and urban people. It is very clear that all these five years (2005-2009) the urbanites earn more than three times what rural people earn. This region-wise income inequality was another factor for migration in China because rural low-earning people also wanted to earn more income for their better life.

2.3.3. Rural surplus labour

In the countryside, different factors in social development, such as the decrease in cultivated land and rapid increase in the rural population, have impelled larger number of people to migrate from villages to cities. The most important factor was the large surplus labour force in the countryside caused by higher labour efficiency since the introduction of the production responsibility system in the late 1970s (Zhang, 2003). Table 3 shows the numbers of labour engaged in agricultural and non-agricultural sectors. It examines that the ratio of agricultural to non-agricultural is greater in Central and Western regions when compared to Eastern region. So there is surplus labour flow from these two regions to the Eastern region.

Table 3 Comparison between Agricultural and Non-agricultural Labour among Various Regions in China in 1996

	Agricultural labour		Non-agricultural labour	
	(million)	% of whole labour force	(million)	% of whole labour force
East	149.14	66.50	75.12	33.50
Central	155.25	79.88	39.10	29.12
West	120.02	84.38	22.23	15.62

Source: National Bureau of Statistics, *China Labour and Social Security Yearbook, 2000*.

The high urban economic growth and creation of many employments attract the rural population to come to urban areas and work there. To increase production with low wages, urban industries

hired more migrants than locals so that there is no need to pay extra for their pension, insurance and medical care. The number of employees in many urban firms are higher than the local urbanites only because of this reason (for example, the main cotton mills in Shanghai and urban construction industries). However, the number of surplus rural labour continued to exist and this labour keeps on moving into the urban labour market.

With the presence of such a surplus labour in the rural area which is always providing a supply of labour to the urban industrial growth, it is an advantage for a state like China to provide employment to surplus rural labour through migration and it helps to keep the momentum of economic and industrial growth of China.

3. Migrant Labour and Urban Society in the Era of Market Reforms

Another interesting area which has been explored by various scholars on China's society is about its social stratification and social mobility. Along with economic transition the Chinese society was also in transition process where the peasants are trying to compete and merge with urban society. The three things that have always been focal points of debate since the 1980s are politics, economy and society within China as well as abroad. There were only two distinguished classes in China since the formation of PRC till the end of the 1970s, i.e. working class and peasant class which were also based on *hukou*. Those who were staying in the villages and working in farmlands and carrying agricultural *hukou* belongs to peasant class (basically working in rural collectives) and those who stayed in urban centres and working in State-Owned Enterprises (SOEs) or other state-led functionaries and carrying urban *hukou* are known as working class (basically working in *danwei*). Ironically, the post-1978 regime under the leadership of Deng Xiaoping

began what now is known to be a remarkable reform policy that has de-collectivised and commoditised both rural and urban economies, eroding the institutional bases of the pre-reform status hierarchy. Since then, an open, evolving class system has been in the making (Davis, 1995).

Solinger (1999) claims that social structure is one of the major factors which lead to vast internal migration in China. There was an apparent structural discrimination in China which divides Chinese into two distinct groups according to people belonging to their place. The urban residents enjoyed many privileges (“iron rice bowl”³) from the state which was not given to the villagers and those staying in the periphery. They have had to feed the urban working class. The village people had to be fully dependent on agriculture and remain marginalised and live in poverty. Chinese society witnessed a drastic transition from its dual class system into the emergence of different classes from the very beginning of market reforms both in rural areas and urban centres. Peasant class has faced the major transformation here in the Chinese case; the majority of them wanted to leave the field and go to cities for the better other life opportunities. *Farewell to peasant China* (Guldin, 1997) gives a clear idea of peasants moving into the cities and transition of their peasant life into peasant labourers in various urban jobs after substantial field work.

3.1. “Making” of New Urban Classes

However, social transition and market reform implementations in urban centres occurred only after the rural reforms, apparently from the mid-1990s and these have been strictly guided and adjusted by the state. Then there was a move to decentralise state industry and the fiscal system, giving financial incentives to local governments, factory managers, and individual workers. However, the redistribution-oriented polity and macroeconomic structure were coupled with a paternal

factory culture, which presented resistance to reform directives. The emergence of labour and capital markets after 1992 finally put the urban economy under a market allocation of resources, although the new policy of “grasp the big, release the small” created a state monopoly sector containing strategically vital industries and firms and sent the rest of state firms to an “open” sector to compete with non-state entities. Massive layoffs and organised transfers of state-sector workers paralleled the flooding of migrant peasants who work in the informal, expanding labour market in the cities.

Bian (2002) in his article states that post-1978 market reforms eroded this status recognition and differentiated the working class into wage labour in the private sector (12 million as of 1998), unprotected labour in the state sector (70 million), layoff labour wandering in search for a job (30 million), and deprived migrant peasant-labour (60 million). One vivid description that appears in the local newspaper is the “3-no world” of private-sector wage labour: no definite working hours, no medical insurance, and no labour contract (“*wuriye, wuyiliao, wushouxu*”). While state properties are becoming productive assets for officials’ and managers’ private gains, the unprotected state labour has begun to feel that they are truly proletarians (*wuchanzhe*). A new urban poverty stratum is emerging from layoff labour and retired labour and labour opposition became a sensitive and serious issue in a changing structure of state and society. On the other side, communist cadres give up their political commitments in order to catch the growing opportunities due to market reforms. The first decade of market reform led to the phenomenon of “local state corporatism” in which local government played pivotal role of becoming the industrial firms and in that local officials either gain benefits “from within” or build “network capitalism” by taking advantage of being local leaders and their political and social capitals. During the second decade of reform, assets and

profits of state enterprises were massively diverted into the private hands of cadres through “informal privatisation”, organisational proliferation, consortium building and “one manager, two businesses”. The most recent move is a state-imposed property rights reform, letting administrative and managerial cadres be the shareholders of the transformed state enterprises (Bian, 2002: 96-97).

Another predominant and newly emerged class was private entrepreneurs like a bourgeois cadre class. Nationally, registered private entrepreneurs reached more than 2 million in 1997 and hired 12 million workers. However, intellectuals, professionals, cultural elite and technocrats have always had an ambiguous class status since the foundation of PRC. These classes have always been under surveillance during the Maoist era, but later they were cheerful when given a “working class” status in 1979 by Deng Xiaoping. Middle class is another group of people in present China: state factory workers, because of their lifelong employment and a high level of benefits, were seen to be Mao’s “quasi-middle class”, and this once politically and economically protected group has become differentiated in the reform era (Bian, 2002).

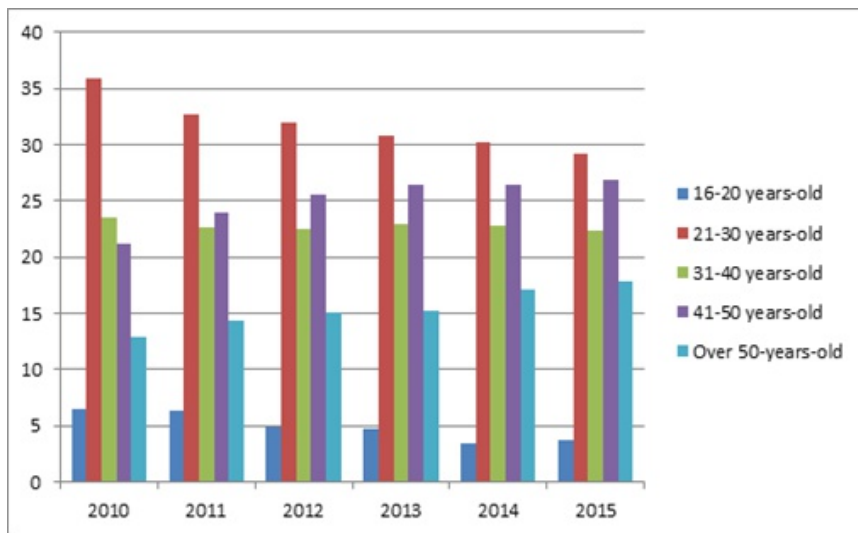
3.2. Demographic Distribution of Migrants

The Chinese state claims that those who migrate to urban centres from rural areas are not officially recognised as migrants and they are known as floating population. However, contrary is that peasant labour comes to cities and they stay there quite long time. The age groups which are travelling to cities are mainly youngsters. China has a huge number of youth population which always helps in the labour force and actively participates in its economic development. The present generation of migrants have very little knowledge about peasantry or they hardly knew anything about agricultural works. They do not want to do their

traditional agricultural works. They feel migrating to cities will give them better life status than staying in villages.

Figure 2 illustrates the age distribution of migrants in China during 2010 to 2015. The data show that age group lies between 21 and 30 decreases during last five years. At the same time, the age group lies between 31 and 40 maintains the uniform growth rate. On the other hand, the age group above 40 but below 50 steadily increases during these years which shows particularly migrants' long stay in the cities. The youth as well as middle-aged population almost reached the equal in numbers in the recent times. These data substantiate that China is having a large human resource in that major portion of the age group of 20-40.

Figure 2 Age Distribution of Migrants, 2010-2015



Source: China Labour Bulletin report, 2015.

3.3. Education Level of Migrants

Normally rural migrants are less educated when compared to their counterpart in the cities in the 1990s whom we could call the first-generation migrants. But almost all migrants attained primary education from their villages.

Table 4 Migrants by Educational Attainment (%)

Educational level	National population 1990 (Age 6+)	1990 Census		Rural migrant labour	
		<i>Hukou</i> migrants	Non- <i>hukou</i> migrants	Jinan Survey 1995	MOA National Survey 1993
College	1.6	22.2	2.2		
Technical middle	1.7	11.3	1.9	12.1	9.8
Senior middle	7.3	13.6	9.6		
Junior middle	26.5	26.3	43.2	71.0	54.1
Primary	42.3	20.5	30.8	16.0	31.6
No or little education	20.6	5.6	11.2	0.9	3.8

Note: MOA = Ministry of Agriculture.
Source: Chan (2001: 134).

Table 4 shows the educational attainment of first generation of migrants in the 1990s. The 1990 census data reveal that around 74 percent of non-*hukou* migrants attained primary or junior middle class education rather than higher education. The percentage of junior middle class educational status of non-*hukou* migrants is higher than *hukou* migrants (non-*hukou* migrants: 43.3 percent, and *hukou* migrants: 26.3). At the same time, other survey reports like Jinan survey 1995 and MOA (Ministry of Agricultural) survey 1993 also support the 1990 census survey that majority of the rural migrants attained primary and middle class educational status. Less education and rural unemployment along with poverty are the major factors for mass migration in the beginning of 1990s. However, the new-generation migrants are attaining higher educational level than the old-generation migrants.

4. Migrant Labour and Economic Condition

The major factor that has led to massive internal migration in China is the economic motive of the migrants. Therefore one must study the economic condition of the migrants and their job opportunities in the Chinese cities for the better understanding of China's domestic population movement. The sojourners come to the cities with various aims which include better earnings, seeing the outside world, making a new living, learning new skills etc. However, not all rural migrants are able to fulfil their dreams after arriving in the city. Some of these people have to return to their villages when they become older or suffer injuries related to work. Some decide to settle down in the medium or small-sized cities, and others who are more successful settle down in larger cities permanently. Many scholars find that *hukou* is still limiting migrants' life chances in cities, but in reality, *hukou* is no longer a major factor in limiting their life chances. Zhan finds that the impact of *hukou*-

based legal exclusion has declined substantially due to market reforms and policy changes since the 1980s (Zhan, 2011). Indeed, migrants find different kinds of employment opportunities and try to fit with the urban culture.

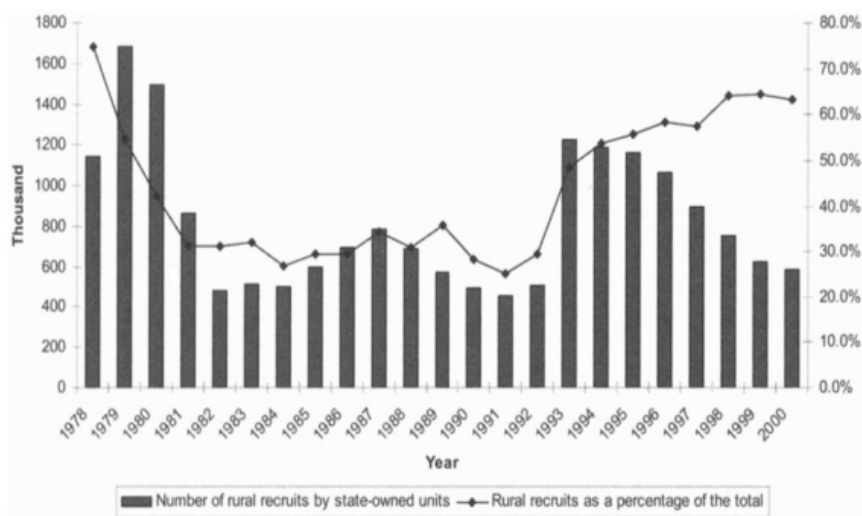
4.1. Migrants Recruitment in State-owned Enterprises

Since the reforms in the late 1970s, rural people were moving into cities and some of them got a chance to work in the state-owned enterprises. During Mao's period, the state-owned units used to dominate the economy of China. In the 1990s, these units had undergone several rounds of reform. The extent of the state enterprises' employment of migrant workers varied by region and by industrial sector. There were a large number of migrants employed by the state industries in regions traditionally dominated by the state economy (Guang, 2005). In 1996 about 14 percent of the migrants from Sichuan and Anhui started working in the state sector. Regarding sector-wise concentration, more migrants were employed in state industries like textile, mining and construction than other industries (Solinger, 1999). A national survey conducted by China's official trade union, the All-China Federation of Trade Unions (ACFTU), in 1997 revealed that migrants comprised 8 to 14 percent of the workforce in textile, mining, construction and agricultural-related industries. But the relatively small proportion of all rural migrants ended up working in the state sector rather than in the informal or private economy.

Figure 3 presents the rural recruitment by state-owned enterprises during 1978 to 2000. It shows that immediately after reform the number of rural recruitment was high when compared to following years (see 1979 and 1980). But from 1981 to 1993, that means till urban reform begins, the rate of rural recruitment was less than before. However, with the beginning of urban reforms, the state-owned enterprises recruited

more migrants in these industrial sectors. But it also slowly went down and migrants had to rely more and more on informal and private industries. Presently the number of migrants working in the state-owned units is smaller in size than ever.

Figure 3 Rural Recruitment by the State-owned Units, 1978-2000



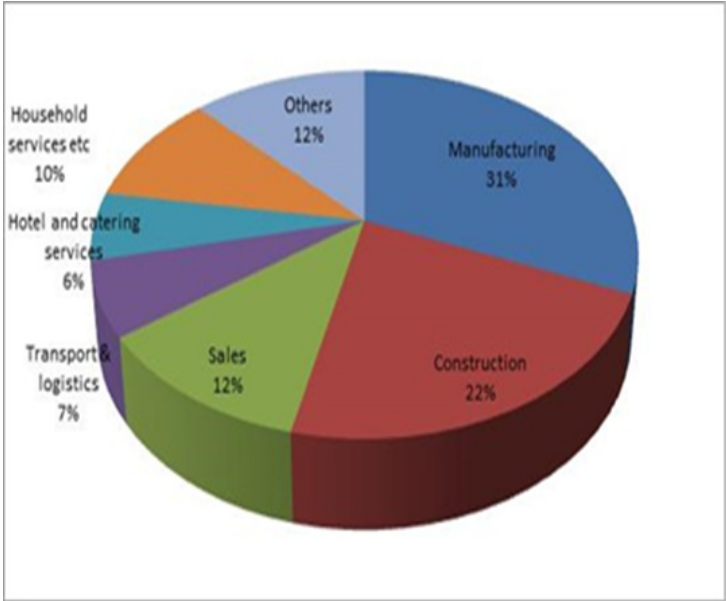
Source: Guang (2005).

4.2. Employment Opportunities for Migrants in Urban Area

As already mentioned, *hukou* policies never limited life chances of any migrant; instead the migrants have been a vital part of the urban labour market since market reforms began. Once they enter the labour market, they take on whatever jobs they get. They do not worry about the working conditions. Migrants are willing to do any work even the ones which are highly risky. In the beginning, we saw that generally migrants

used to go for 3D works (dirty, dangerous and difficult) and they were ready to work on very low wages. So the employers preferred migrants than the local people for their industrial works. Even today the situation is the same: the migrant workers continue to work in low-paid, labour-intensive, less prestigious and manual jobs. Fan argues that the old-generation migrants were engaged in a variety of works which were agriculture, retail, catering, construction, wholesale and manufacturing. But the new-generation migrants are mostly and heavily concentrated in the manufacturing sector (Fan and Chen, 2014). An interesting finding is that the present migrants are hardly aware of agricultural-related work and they do not want to engage in those works anymore (Wu *et al.* (eds.), 2014).

Figure 4 Job Opportunities for Migrants



Source: China Labour Bulletin report, 2014.

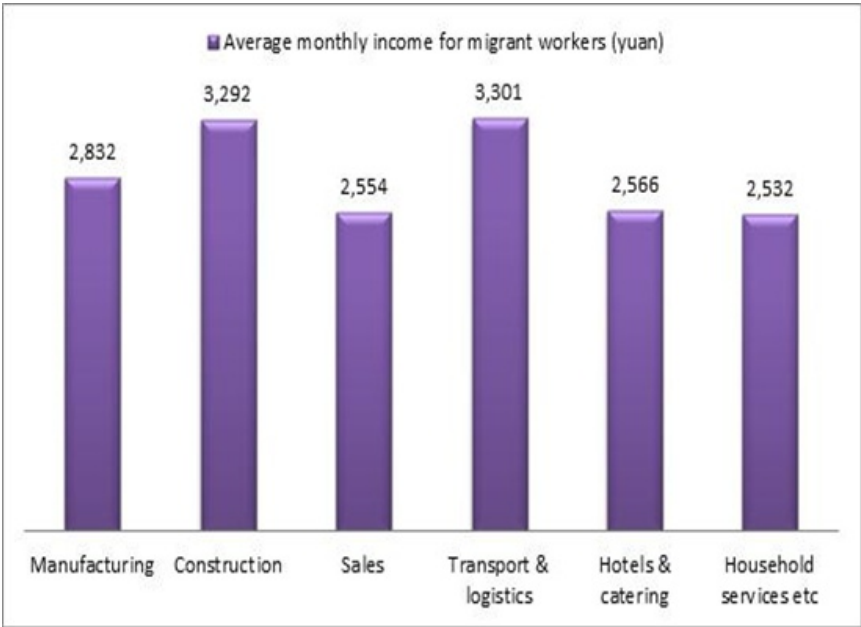
Figure 4 represents the different job opportunities for migrants in the Chinese cities according to China Labour Bulletin data in 2014. These data find that the vast numbers of migrants are working in their favourite field which is manufacturing sector (31 percent). The second largest area where the migrants are distributed is in construction (22 percent). With the growing infrastructures and real estate boom in China, migrants easily find jobs in this sector. While 12 percent of rural people work in sales, only 7 percent is involved in the transport and logistics sector; 6 percent of migrants work in hotel and catering services whereas 10 percent is involved in the household service. This figure substantiates the view that most of the present migrants like to work in manufacturing and construction fields rather than any other jobs.

In the next section, we discuss the income of migrants from these above-mentioned sectors and comparison of migrants' earning in the past and present as well as the income inequality between rural migrants and local urbanites.

4.3. Migrants and Income

Despite different jobs, the amount of time they spend in their work area is the same. Some reports find that they need to work 26 days in a month and minimum nine hours per day of work (*China Labour and Social Security Yearbook, 2010*). Based on the "Floating Population Monitoring Survey" conducted by National Population and Family Commission (NPFPC) in 2010, it is clear that the migrants work more than six days a week and more than 10 hours a day (Fan and Chen, 2014). The present-day migrants earn pretty good income and they send a decent amount to their family.

Figure 5 Average Monthly Income for Migrant Workers (*yuan*)



Source: China Labour Bulletin report, 2015.

Figure 5 presents the average monthly income of migrant workers in *yuan*. As already mentioned the favourite sector of migrants is manufacturing, but here data reveal that the average monthly income from manufacturing sector is comparatively lesser than construction and transport and logistics. The migrants earn only 2832 *yuan* from manufacturing sector, whereas migrants get 3292 *yuan* from construction field. The highest earning sector is transport and logistics and in this migrants make an average 3301 *yuan* in a month. Migrants work in other sectors like sales, hotel and catering and household services and here they make an average income of 2500 *yuan*. However,

despite more income motive many migrants like to prefer manufacturing sector than other high-earning construction and transport and logistics. It shows that migrants consider working in manufacturing (31 percent of total migrants like to work there as described in the previous section) as more prestigious than working in any other field.

Migrants' entry into the cities somehow helped to overcome the labour market shortage since the late 1970s. Their presence in the urban centres accelerated the total economic growth in China. Most importantly they created positive impact not only in the urban economy but also their remittance contributed towards the development of rural villages. So the next part will be discussing different impacts of migration in China and how it affects the rural and urban areas.

5. The Impact of Rural-to-Urban Migration

The rural-to-urban migration created a huge impact in China's labour market in the 1990s. After four decades of segregation, the rural and urban economies started to be linked by massive labour mobility. Millions of rural people, attracted by better urban incomes, moved to the cities. The economic implications of this continuing migration from the countryside to the cities are enormous.

5.1. The Uniqueness of Rural-Urban Migration

The phenomenon of migration is very new to China since its foundation in the late 1940s. The rural population were segregated from the main stream of China. The segregation only ended at the end of 1970s when China went for market reforms and opening up its economy. The *hukou* system is the one which kept the Chinese population into two distinct categories, i.e. rural and urban. This system has provided urban residents with generous subsidies and benefits that rural residents are not entitled

to. The agricultural population is ineligible for such subsidies and benefits and they cannot gain urban residency right by simply moving to the cities. They were not allowed to obtain permanent positions even if they are employed in the state-owned sector (Meng, 2004). The *hukou* was enforced strictly till mid-1980s. Since then, such enforcement has been gradually liberalised, but institutional barriers to people's migration still exist in some way.

In addition, floating population is not entitled to the any social benefits provided in urban areas. In the case of children's education, it is very a serious concern to migrants. Although free primary education is provided in China, migrants' children are not eligible to claim that in the cities. They have to pay high fee to send their children to school. So in most of the cases, those who migrate are usually young and those without children. All these factors show China's uniqueness in its internal migration and that the role of migrant's in economic growth in China is somewhat different from any other developing country.

5.2. Urban Unemployment

There has been always urbanities blaming migrants for the urban unemployment situation. But in reality many surveys indicate that migrants are mainly allocated in jobs that are relatively inferior in nature. For urbanites, these are less privileged works and migrants mostly do go for 3D jobs (dirty, dangerous and difficult). The different studies reveal that migrants work in construction and manufacturing or service sectors rather than white-collar jobs. A survey conducted by the institute of Population Studies at the Chinese Academy of Social Sciences in 1996 suggests that around 42 percent of transients worked as construction workers, and 15 percent worked in the service sector (Meng, 2004). Another survey by the Rural Development Institute finds that about 33 percent of rural workers employed in construction sites and

around 31 percent in the service sector (*ibid.*). Still there is a large wage gap and income inequality existing in urban areas between urbanites and migrants. However, certain jobs were occupied by migrants in the cities which urbanites are also willing work in. But employers hire migrants instead of local people due to low salary for the migrant workers.

5.3. Impact on Urban Economy

Rural-urban migration has greater impact on urban economy especially in urban labour market. The massive presence of migrant labour in the cities brought a reduction in urban labour costs. The average income gap and income inequality were very high between rural and urban at the end of 1980s but with the help of migration, migrants' entry into urban labour market leads to reduction in the average income gap between those categories.

Presently an approximate number of 300 million migrants entered into the urban labour market which comprises more than 50 percent of total urban work force in China. The cheap labour as well as the remittance sent by the migrants to their villages creates huge impact in both rural and urban areas. So migration is a serious concern about China's economic development and people's prosperity.

6. Conclusion

The study of migration is very important to understand the rapid economic growth of China. Migration played a vital role in socio-economic prosperity of the people as well as the nation. China arose from an underdeveloped nation to world's second largest power now. Migration is a new phenomenon in the People's Republic of China since its foundation in the late 1940s. The *hukou* system acted as gatekeeper till the end of 1970s to prevent internal migration in China. Chinese

government introduced a number of policies to relax *hukou* and informally promote internal migration to satisfy the increasing labour force requirement in the newly opened SEZs and boost the urban economic reforms. China has witnessed massive population flow between the regions and within the regions, especially a huge flow from less developed regions like Central and Western to Eastern coastal regions. There are many factors influencing internal migration like regional inequality, surplus rural labour, abolition of rural collectives, etc. The economic reforms and opening up in the late 1970s led to changes in urban society and emergence of new classes. The present generation of migration brings both quantity and quality of people from rural areas due to better educational qualification of rural migrants than before. The income gap has been reduced to a certain level with the help of migration and migration has created huge impact in urban economy as well as in its social structure. The major issues with migrants in the cities is that already many big cities carry more people than its actual capacity which leads to increase in health and hygiene issues and increase in crime rates.

Notes

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1. *Liúdònggrénkǒu* (floating population) is the official term used by the Chinese government to refer to the population mobility and movement from rural areas to different urban centres in a transient manner. But the reality is that those migrants used to stay in cities for more years and travel from one city to another according to their idea of better earning and livelihood. These are people having agricultural *hukou*.
2. *Hukou* refers to the household registration system in China which was established in 1958. It determines one's belonging to the locality. Chinese population has been divided into two categories under the *hukou* dual classification which are agricultural and non-agricultural population staying in rural and urban areas respectively.
3. Urban people have many privileges in China such as guaranteed employment and many social and individual rights and benefits but peasants are not entitled to many privileges like their urban counterpart.

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Beyond the Sea

The Philippines and the Maritime Security Order in Southeast Asia: The Risks of an Appeasement Policy on an Expansionist China⁺

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Abstract

This article examines the shift in Philippine foreign policy under the Duterte Administration, and how this development unravels the volatility of Southeast Asia's open, global, and liberal maritime order. His predecessor, President Benigno Aquino, challenged China's expansive territorial claim in the South China Sea throughout his six-year term. However, President Rodrigo Duterte's actions and pronouncements are undoing the former president's geopolitical agenda of thwarting China's expansive design in the disputed waters. He distances the Philippines from the U.S., its long-standing treaty ally, and gravitates toward China. This stance aims to earn China goodwill so that the Philippines can avail itself of Chinese economic largesse particularly the enormous aids and loans from the Belt and Road Initiative (BRI). Nevertheless, by appeasing an expansionist power, the Philippines becomes complicit in China's long-term strategy of maritime expansion to ease the U.S. out of East Asia. In conclusion, the paper warns that the

Duterte Administration might end up jeopardizing the country's territorial rights in the South China Sea and losing the trust and confidence of its security partners. More significantly, its appeasement policy on China might eventually lead to the erosion of Southeast Asia's global, open, and liberal maritime order.

Keywords: *maritime order, Southeast Asia, Philippine foreign policy, appeasement, Duterte Administration's foreign policy, Philippine-China relations*

1. Introduction

On 18 May 2018, the People's Liberation Army's Air Force (PLAAF) announced that it landed an H-6K bomber on one of its outposts in the South China Sea (*Asia Maritime Transparency Initiative*, 18 May 2018). The H-6K undertook similar takeoff and landing exercises on islands and reefs in the disputed waters to improve the PLAAF's ability to reach all territories and to conduct air strikes at any time and in all directions (*ibid.*). A Singapore-based Chinese academic, Professor Wang Mingliang, off-handedly commented that the successful aerial maneuvers of the Chinese bomber would help the PLAAF's combat capability to deal with maritime security threats. Specifically, the PLAAF bombers operating from any of the Chinese outposts can conduct routine peacetime patrol and wartime air interdiction operations in the South China Sea. This will put the Philippines, Singapore, and much of Indonesia within the range of Chinese strategic airpower (*ibid.*). The deployment of the H6-K bomber is part of China's efforts to control the South and East China Seas by extending its security perimeter and reinforcing strategic influence over these crucial sea-lines of communication (SLOC) linking the Indian and the Pacific Oceans.

In the face of international and domestic concerns over Chinese actions in the South China Sea, however, President Rodrigo Duterte commented that he would not provoke China into war (*The Philippine Star*, 22 May 2018). He asked what would happen to the Philippines should war erupt in the South China Sea and whether the United States (U.S.) would remain on the side of the Philippines if war would break out (*ibid.*). He argued that the more feasible solution is to forge a joint exploration pact with this regional power bent on altering the territorial status quo and violating international law (*ibid.*). In August 2018, President Duterte told Filipinos that he expects China to be just and reasonable on the South China Sea dispute and that they should accept Beijing as a good neighbor (Kyodo News, 17 July 2018). He said, “I am sure that in the end, China will be fair and the equity will be distributed.” (*ibid.*) He was also optimistic that “in the days to come, we would realize that China ... is really a good neighbor.” (*ibid.*)

President Duterte’s good but misplaced faith on China reflects his administration’s appeasement policy on China.¹ The concerted efforts of Filipino foreign affairs and defense officials are aimed at fostering closer relations with China, coupled by calculated moves to distance the Philippines from the U.S. and its allies (Japan and Australia) related to the South China Sea dispute in particular, and to other international issues in general. This policy stems from the government’s belief that appeasing China is worth pursuing because it makes the Philippines a beneficiary of the Belt and Road Initiative (BRI). However, by appeasing an expansionist power, the Duterte Administration facilitates China’s long-term strategy to ease the U.S. out of the East Asia as it builds a maritime great wall in the South and East China Seas. Paradoxically, it colludes with China in violating international law that it is supposed to uphold in the light of the 12 July 2016 Permanent Court

of Arbitration (PCA) Award to the Philippines. More significantly, its appeasement policy adversely affects Southeast Asia's maritime order.

This article examines the Duterte Administration's appeasement policy on China and how it undermines Southeast Asia's maritime order. This paper raises two interrelated questions: Why and how does the Duterte Administration pursue an appeasement policy on China? And how does this policy threaten regional maritime security order? It also addresses these corollary questions: What is the nature of the Southeast Asia's maritime order? How is China altering this order? How did the Aquino Administration challenge China's maritime expansion in the South China Sea, and in the process, uphold the regional maritime order? Why has the Duterte Administration adopted a policy of appeasement on China related to the South China Sea imbroglio?

2. Small Powers in Quandary: Balancing or Appeasement?

Mainstream realist literature depicts an anarchic world where states have two choices in responding to an emergent power. Accordingly, some small powers balance the emergent power to preserve their security, while others join the cause and choose appeasement to secure economic gains or otherwise expand their influence (Levy, 2003). Small or minor powers have limited economic and military capabilities. Many of them consider balancing an emergent regional power detrimental and risky. For a balancing policy to succeed, states must have the necessary military power, a demographic advantage, and a strong technological/industrial base. Generally, however, small powers have scarce natural resources, constrained geography, small population, diverse ethnic composition, and, in many cases, weak state institutions (Neack, 2003).² They also have lean foreign affairs bureaucracies, inadequate military capabilities, few diplomatic posts abroad, and

deficient intelligence agencies that altogether hamper the scope, vitality, and conduct of their foreign policy. Thus, it is assumed that balancing cannot be effectively applied by small or minor powers since they have marginal capabilities to affect international outcomes. Given their strategic vulnerabilities and inadequate military capabilities, small/minor powers often succumb to bandwagoning to appease the established, rising or emergent powers.

Whether a small power will adopt a policy of balancing or appeasement depends on domestic politics, geography, and the ability to manipulate its circumstances to gain even disproportionate power relations with the big powers. A small power still controls its foreign policy choices and ultimate destiny. However, this control is contingent upon its leaders' willingness to exploit opportunities in the international system. If global conditions for its balancing gambits are ripe, it can either draw on their geostrategic location to exert advantage on the powerful state or rely on other major powers for military assistance and security guarantee. It should be pointed out, however, the small power's range of opportunities for an independent, vigorous, and self-interested foreign policy is more limited than any of the more powerful states (*ibid.*). A small power is not necessarily powerless. However, it is still boxed in by virtue of its relative weaknesses vis-à-vis middle and great powers.

A small power can generate limited power over its foreign policy choices and ultimately its fate, but this power is contingent on the opportunities existing in the international system, the willingness of its political leader to take advantage of these opportunities, and in many cases, its pressing domestic agenda. Confronted by an emergent power, a small power may think that it has overextended itself in terms of seeking to challenge this threat risking greater international and domestic complications, if not outright foreign policy failure and disaster. On the

contrary, if it has already discounted the prospects of challenging a great power, and the unlikelihood of achieving its desired goal of balancing this power, it might opt for lesser and less risky goal of appeasing this emergent power. Furthermore, powerful elements or interests within the state might prefer domestic consumptions or investment, via government expenditures in internally oriented programs rather than prioritizing foreign policies that put a premium on geopolitics. Confronted by this situation, a small power can adopt satisficing policies such as appeasement, buck-passing, and bandwagoning.

Appeasement refers to a small state's efforts to conciliate or buy off an emergent power by initiating unilateral diplomatic and strategic concessions (Trubowitz, 2011). Bandwagoning involves a small power subordinating itself to the stronger power with the hope of diffusing the threat poised by the latter (*ibid.*). Despite obvious differences among these foreign policy approaches, they share three common features: (a) they are undertaken in response to an external threat; (b) they are comparatively cheap; (c) they seek to preserve the status quo at low but extremely risky cost. Although they are considered as status quo strategies, they, nevertheless, imperil the existing international order as they embolden an aggressive power to advance its revisionist agenda. This is especially the case when a small power pursues an appeasement policy based on weakness and fear.

From 2011 to 2016, the Aquino Administration applied a balancing strategy on China related to the South China Sea dispute. After he was elected president, Mr. Rodrigo Duterte adopted an appeasement policy on China. The difference between these two administrations' foreign policies lies on President Aquino and President Duterte's respective domestic agendas. On the one hand, then President Aquino was concerned about Chinese incursions into the country's EEZ and the Philippines' strategic leverage as a maritime littoral state vis-à-vis

China's maritime expansion. These encroachments deprived the Philippines of vital fishery and mineral resources from the South China Sea. On the other hand, President Duterte took note of China's emergence as a major power in general, and its launching of the BRI. He was apprehensive that if the Philippines pursues a balancing policy on China, the country would not be able to avail of Chinese investments and aid under the BRI. This drove him to choose a policy of appeasement characterized by strategically distancing the Philippines from the U.S. and gravitating toward China.

The Duterte Administration is convinced that its appeasement policy is worth pursuing because it makes the country a beneficiary of China's emergence as a global economic power. By appeasing an expansionist power, however, the Duterte Administration becomes complicit in China's long-term strategy of maritime expansion designed to ease the U.S. out of East Asia. This will upset the current balance of power in the region. Furthermore, China's long-term plan to project its maritime power in the Western Pacific, and to gain control of the regional maritime commons, will adversely affect the Philippine's territorial, strategic, and economic interests as an archipelagic state in the Indo-Pacific. This will also lead to the eroding of the Southeast Asian regional maritime order.

3. The Southeast Asian Maritime Order

The South China Sea and the smaller seas of eastern Indonesia open to the Pacific and are separated from the Indian Ocean to the south and west by straits that perforate Indonesia's southern islands. Located in the heart of Southeast Asia, the South China Sea is a semi-enclosed sea surrounded by China and several small and militarily weak Southeast Asian powers such as the Philippines, Vietnam, Malaysia, and Brunei.

It is sometimes referred to as an Asian Mediterranean as people of the archipelagoes comprising Indonesia, East Timor, the Philippines, Malaysia, and Taiwan have a common ancestry and speak related languages (Paine, 2013).

For several centuries, fishermen, salvagers, sailors, and navigators on board their small trading or fishing vessels comprised the vast majority of seaborne traffic in the South China Sea whose islands remained largely uninhabited (Raine and Le Miere, 2013). The ancestors of the present-day inhabitants of the Philippines, Malaysia, Indonesia, and other Southeast Asian countries maintained contacts with one another by using the waters of the South China Sea as their traditional fishing grounds and local trading routes. The extensive maritime trade in the South China Sea between the 15th and 17th centuries generated a high degree of commercial intercourse connecting several maritime cities of Southeast Asia and created a pan-Asian trade network with India and China serving as important nodal points (Acharya, 2012). Describing this maritime region before the coming of the Western powers in Asia, Professor Craig Lockard wrote:

This huge but politically fragmented and often sparsely populated region around “a sea common to all” spawned a fluid multiethnic transnational economic zone and flexible political boundaries in which waterborne commerce and the string of ports that facilitated it were essential. This canvas of interaction also linked the mainland with the Southeast Asian archipelagoes (Indonesia and the Philippines) in a myriad of exchange relationship.

(Lockard, 2010)

Consequently, the long-established trade routes between India and China crisscrossing the South China Sea led to the formation of several ancient

Southeast Asian maritime kingdoms that thrived because they had control over sources of export products (Acharya, 2012). Maritime trade in Southeast Asia created these ancient kingdoms as it provided new resources such as arms and weapons and luxury goods for distribution; gave local rulers new ideas for political organization and legitimacy; and connected the great maritime cities of Southeast Asia into an intraregional trading system (*ibid.*).

All of these developments occurred because the South China Sea has evolved into a regional commons in which all parties pursued their interest without fear of molestation or sovereign control by the authorities of any coastal state (Dutton, 2011). There is simply no evidence that points to unique economic or naval interest of China or any other single country in or around the islands of the South China Sea (*ibid.*). The intervention of external colonial powers in the 16th century and the application of their superior naval technologies enabled European sea power to ensure that the South China Sea and Southeast Asia more broadly, become an integral component of an open, global, and liberal maritime order (Dutton, 2016).³

4. The Unravelling of Southeast Asia's Maritime Order

The end of the Second World War in 1945 and the wave of decolonization that swept Southeast Asia in the late 1940s to the late 1950s caused former colonies to attain their independence from Western powers. Formed in the process were active claimant states that sought territorial and economic exploitation rights in the South China Sea (Gregor, 1989). This trend was reinforced by the profound changes in the traditional law of the sea whereby the legal regime governing the sovereign coastal states' territorial and adjacent waters and subsea land extension, as well as the ownership and control of land-features in the

South China Sea, underwent a dramatic transformation. Created in 1982, the United Nations Law of the Sea (UNCLOS) established a legal regime under international law that describes the maritime areas over which a state can exercise exclusive jurisdiction outside its territorial sea, such as the exclusive economic zone (EEZ) (Eifuku, 2018). With all the coastal states in Southeast Asia becoming States Parties to the UNCLOS, a general legal regime was established in Southeast Asia that allowed littoral states to have maritime interests of their own in a vast expanse of maritime areas that defy comparison in the past. These two post-1945 developments consequently weakened Southeast Asia's open, global, and liberal maritime order.

Since the mid-20th century, the littoral states have considered the South China Sea as a maritime zone of abundant hydrocarbon and protein resources which are important for their increasing populations that have consumed and exhausted their coastal waters' fishery resources. Consequently, by the second decade of the 21st century, disputes over sovereign control of land features, the extent and delimitation of maritime jurisdictional waters happened side-by-side with competing nationalist narratives alluding to alleged ancient discovery, historic rights, and occupations of the South China Sea. Way into the 21st century, the South China Sea became the represented projection of the cultural consciousness of centuries-long relationship that each coastal nation has with its adjoining seas (Dutton, 2011). Consequently, this maritime area has become an arena for littoral states' competitions over territorial sovereignty, overlapping claims to islands, rocks, and reefs, disputes over which coastal states claim legitimate jurisdiction over waters and seabed, and contentions over the appropriate balance of coastal-state and international rights to use the seas for military purposes.

The greatest threat to the open, global, and liberal maritime order in Southeast Asia, however, is China's naval presence in this strategic maritime area. Its naval activities are upending the post-World War II status quo and shifting the power dynamics that have maintained stability in the region (Bowers, 2018). Enjoying a phenomenal economic boom during the first decade of the 21st century, China was transformed into an engine of growth in East Asia and the wider world. With its gross domestic product (GDP) surpassing that of Japan in 2010, it has become the second largest economy in the world next only to the U.S. Its economic success has not only made it confident and assertive in foreign affairs but also intensified its military prowess (National Institute for Defense Studies, Japan, 2015). Strong economically and militarily, China has taken provocative actions in the South and East China Seas. These include the unilateral declaration of an Air Defense Identification Zone (ADIZ) in the East China Sea; the active conduct of several live-fire naval exercises by the PLAN and the PLAAF in the Western Pacific/South China Sea; and the hardline responses by the PLAN in coordination with Chinese maritime law-enforcement agencies on territorial rows with the Philippines and Vietnam in the contested sea (*ibid.*). These moves worry the other littoral states about China's maritime design in the region (*ibid.*).

China also created thousands of kilometers of artificial islands and built facilities on these land features to project its power farther into the South China Sea and closer to the territories of other littoral states. In 2015, China began constructing artificial islands over the eight reefs it occupied in the Spratlys. It also created new artificial islands at Hughes, Johnson, Gaven, Fiery Cross, and Mischief Reefs. China relies on these artificial islands and reefs to help create a "large maritime defense system" for power projection (McCaslin and Erickson, 2019).

These large artificial islands have harbors and airstrips that are used by maritime militia and People's Armed Forces Department personnel to monitor the maritime domain, maintain a constant forward presence and conduct peacetime operations roles that would be much more visible and sensitive if performed by military units (*ibid.*). On 9 April 2015, the Chinese foreign ministry justified China's massive artificial island constructions as a means of "satisfying necessary military defense requirements" while simultaneously providing "civilian facilities such as typhoon shelters, fishing services, and civil administration offices" for China, its neighbors, and international vessels sailing in the South China Sea."

All these efforts are aimed to weaken the ability of the other states to support their territorial and resource claims and to accept without question China's maritime expansion (Dutton, 2016). From the other claimant states' viewpoint, these bullying tactics smack of Chinese territorial expansionism and adventurism (Scott, 2007). However, from China's perspective, it is a case of the country outgrowing its subordinate status in the past and feeling confident enough to stand its ground in the western Pacific – to resolutely manage its territorial and sovereignty issues in the East and South China Seas (Swaine, 2015). Consequently, China's creeping expansion into the South China Sea poses a challenge to the capacity of naval and other power-projection forces that ensure an open, global, and maritime liberal order in Southeast Asia (Dutton, 2016).

From 2011 to 2016, the Aquino Administration applied balancing strategy on China related to the South China Sea dispute. After he was elected president, however, Mr. Rodrigo Duterte adopted an appeasement policy on China. The difference between these two administrations' foreign policies lies on that between President Aquino's and President Duterte's respective domestic agendas. On the one hand,

then President Aquino was concerned about Chinese incursion into the country's EEZ and the Philippines' strategic leverage as a littoral state vis-à-vis China's maritime expansion. This encroachment deprived the Philippines of vital fishery and mineral resources from its EEZ in the South China Sea. On the other hand, President Duterte took note of China's emergence as an economic power in general, and its launching of the BRI. He was apprehensive that if the Philippines pursues a balancing policy on China, the country would not be able to avail of Chinese investments and aid under the BRI. This drove him to choose a policy of appeasement characterized by strategically distancing the Philippines from the U.S. and gravitating closer to China.

The Duterte Administration is convinced that its appeasement policy is worth pursuing because it makes the country a beneficiary of China's emergence as a global economic power. By appeasing an expansionist power, however, the Duterte Administration becomes complicit in China's long-term strategy of maritime expansion designed to ease the U.S. out of East Asia. This will upset the current balance of power in the region. Furthermore, China's long-term plan to project its maritime power in the Western Pacific, and to gain control of the regional maritime commons, will adversely affect the Philippine's territorial, strategic, and economic interests as an archipelagic state in the Indo-Pacific. This will also lead to the erosion of the Southeast Asian regional maritime order.

5. Challenging China to Uphold the Maritime Order

On March 2, 2011, two Chinese patrol boats harassed a survey ship commissioned by the Philippine Department of Energy (DOE) to conduct oil exploration in the Reed Bank (now called Recto Bank), 150 kilometers east of the Spratly Islands and 250 kilometers west of the

Philippine island of Palawan. The Aquino Administration was stunned by this maritime encounter which happened within the Philippines' EEZ. Two days after the incident, the Philippine government filed a protest before the Chinese embassy in Manila. A Department of Foreign Affairs spokesperson commented, "The Philippines is (simply) seeking an explanation for the incident." Brushing aside the Philippine complaint, a Chinese embassy official insisted that China has indisputable sovereignty over the Nansha Islands and their adjacent territory. Beijing then went on to demand that Manila first seek Chinese permission before it can conduct oil exploration activities even within the Philippines' EEZ. China, in fact, was badgering the Philippines and other claimant states to recognize China's sovereign claim over the South China Sea (*BBC Monitoring Asia-Pacific*, 10 June 2011).

In June 2011, the executive branch of the Philippine government and the Armed Forces of the Philippines (AFP) agreed on a multi-year, multi-billion peso defense upgrade spending and military build-up. The Philippines' immediate territorial defense goal is to establish a modest but "comprehensive border protection program" anchored on the surveillance, deterrence, and border patrol capabilities of the Philippine Air Force (PAF), the Philippine Navy (PN), and the Philippine Coast Guard. This monitoring and modest force projection capability should extend from the country's territorial waters to its contiguous and 200-mile exclusive economic zones (National Security Council, Philippines, April 2011).

From 9 April to 18 June 2012, the Philippines was pitted against China in a tense naval standoff at the Scarborough Shoal. A triangle-shaped, 150 square kilometers of barren reefs and rocky islets, the shoal is about 135 miles from the Philippines and 543 miles from China. Both countries have staked a claim to the shoal and have figured in hostile encounters over control of the area since the late 1990s. The standoff

highlighted China's maritime strategy. It involved "drawing a line" in the sea using civilian vessels to challenge littoral states that ran the risk of exacerbating a critical situation by resorting to military means and engaging the PLAN ships lurking in the background (*The Straits Times*, 21 April 2012).

China's stratagem was to put the onus on the use of force on these small littoral states – outclassed by its naval prowess – by bringing them to the brink of a naval confrontation to resolve what was essentially a maritime jurisdiction issue (*ibid.*). When the tension eased at the Scarborough Shoal, China consolidated its control over the area. Crewmembers of the Chinese Maritime Surveillance vessels constructed a chain barrier across the mouth of the shoal to block the Philippine access to it. China also deployed these ships to protect the fleet of Chinese fishing boats operating deep into the Philippines' EEZ.

An important factor behind the Aquino Administration's balancing policy on China, despite the latter's preponderant economic and military capabilities, was the strengthened and reconfigured Philippine-U.S. security relations. At the height of the Philippines' territorial row with China in mid-June 2011, the Aquino Administration publicly acknowledged the exigency of U.S. diplomatic and military support. Conscious of its military inadequacies, Manila asked for an unequivocal U.S. commitment to Philippine defense and security as provided for in the 1951 Mutual Defense Treaty (MDT), specifically American naval/air support in the Spratlys. Philippine officials rationalized that an armed attack on Philippine metropolitan territory and forces anywhere in the Pacific, including the South China Sea, should trigger an automatic U.S. armed response.

The Scarborough Shoal stand-off and later, China's occupation of the shoal made it crucial for Manila to negotiate the "Framework Agreement on Increased Rotational Presence and Enhanced Agreement"

(IRP) with Washington. On 28 April 2014, the Philippines and the U.S. signed the Enhanced Defense Cooperation Agreement (EDCA). Actually, EDCA is not a new security pact; it is simply an updated and enhanced version of the 1951 MDT (Philippine News Agency, 2014). This executive agreement provides the framework by which the two countries can develop their individual and collective (defense) capabilities. Such task can be accomplished through the rotational deployment of American forces in Philippine bases (Targeted News Service, 28 April 2014). However, though the American forces are allowed to utilize AFP-owned and -controlled facilities, the Philippine base commander has unhampered access to those locations. Likewise, the AFP can use the infrastructure built or improved by the U.S. With the implementation of the agreement, a small contingent of U.S. forces would be deployed in Philippine territory temporarily.

6. Upholding the Maritime Order through the UNCLOS

Lacking an adequate military capability to stand up against China's naval prowess in the South China Sea, the Philippines opted for the liberal/legal approach leading to the use of lawfare to resolve its maritime dispute with this emergent power. In other words, by availing itself of the arbitration mechanism of the UNCLOS, the Philippines adopted international law as a "lawfare" or the use of law as a substitute for traditional military means to achieve an operational objective (Scharf and Andersen, 2010). In other words, "lawfare" involves the application of legal or judicial processes to enable a weaker adversary to engage in political and legal battle against a superior opponent (Palmer and Johnson, 2016).

In January 2013, the Philippines directly confronted Chinese realpolitik approach in the South China Sea dispute by filing a statement

of claim against China in the Permanent Court of Arbitration (PCA) at The Hague in the Netherlands. In its Notification and Statement of Claim, the Philippines asked the arbitral tribunal to determine the country's legal entitlements under the UNCLOS to the Spratly Islands, Scarborough Shoal, Mischief Reef, and other land features within its 200-mile EEZ. The claim was filed to show that the Philippines' exercise of its territorial rights over six-islands and other land features within its legitimate maritime jurisdiction is firmly grounded on international law – specifically the UNCLOS.

As expected, China refused to participate in the international mediation and openly expressed its opposition to the Philippines' filing of a case with the arbitral tribunal. To justify its non-participation in the proceedings, China cited its policy of resolving disputes on territorial and maritime rights only through direct consultation and negotiation with the countries directly involved (*BBC Monitoring Asia-Pacific*, 14 July 2015). It repeatedly declared, "It will neither accept nor participate in the arbitration unilaterally initiated by the Philippines," and maintained – through the publication of a position paper, the *2014 December Position Paper* and in other official statements – that, "the tribunal lacks jurisdiction in this matter" (Permanent Court of Arbitration, 2016). For a crafty player that had benefited from the ambiguity of its goal and the full extent of its South China Sea claim, China had much to lose in the ruling (Waxman, 2015). Since 2009, however, it has gradually shifted its strategy from delaying the resolution of the dispute to one that emphasizes its sovereignty over the contested waters. This tactic aims to deter smaller and weaker claimant states like the Philippines and Vietnam from cementing their claims and to enable China to negotiate with these small powers from the position of strength (Taylor, 2011). Furthermore, it does not want to extend any legitimacy to the tribunal since it holds other instruments of power –

economic, diplomatic, and strategic – that it can wield to settle the dispute according to its own terms (Waxman, 2015).

Without China's participation, the arbitration proceeded in accordance with the provisions of UNCLOS. Representatives from Indonesia, Japan, Malaysia, Thailand, and Vietnam also attended the hearings (*Asia News Monitor*, 21 July 2015). On 29 October 2015, after almost three years of proceedings, the arbitral tribunal unanimously decided that it has jurisdiction over the maritime dispute between China and the Philippines in the South China Sea. In its ruling, the tribunal held that both the Philippines and China are parties to the Convention and are bound by its provisions on the settlement of the dispute (*BBC Monitoring Newsfile*, 21 July 2015). It also stated that China's choice not to participate in the proceedings does not deprive the tribunal of its jurisdiction over the case and that the Philippine decision to commence arbitration was not an abuse of the UNCLOS's dispute settlement procedure (*ibid.*). The tribunal's ruling meant that it would hold further hearings to settle the highly contentious territorial dispute between the Philippines and China in the South China Sea. On 30 November 2015, the Philippine panel concluded the presentation of its claims against China to the tribunal.

7. Pursuing an Appeasement Policy

In his first few months in office, President Duterte appeared to be adhering to his predecessor's geopolitical agenda vis-à-vis China's expansion in the South China Sea. President Duterte, however, changed gears after the U.S. became critical of his war on drugs and criminality that had claimed more than 3,000 lives since May 2017. His current statements and decisions clearly indicate an apathetic and cynical attitude toward the U.S. At the same time, he fosters cordial and closer

relations with China despite the PCA's ruling and the presence of Chinese Coast Guard vessels around the Scarborough Shoal and the Mischief Reef, which are within the Philippines' EEZ.

During the two ASEAN Summits and the East Asian Summits (EAS) in Laos, President Duterte made remarks that were interpreted as insulting to then President Barack Obama. These slurs led to the cancellation of the bilateral meeting between two heads of state. President Duterte also skipped the U.S.-ASEAN Summit and instead of reading his prepared speech on the PCA Award to the Philippines, he denounced American atrocities committed against the Filipino Muslims in Mindanao in the early 20th century. This was President Duterte's overreaction to Washington's condemnation of human rights violations resulting from his anti-narcotics/anti-criminal campaign in the Philippines (Oxford Daily Brief Service, 2016).

In late September 2016, President Duterte announced that he would revitalize relations with China and Russia to cushion the impact of the possible withdrawal of the U.S. from the Philippines in 2017 (*Philippine Daily Inquirer*, 28 September 2016). Speaking in Pampanga, he urged the Filipinos to make a small sacrifice for his plan of proverbially crossing the Rubicon in his ties with the U.S. as he forms partnerships with rival countries (China and Russia) or the countries on the other side of the ideological barrier (*ibid.*). He also revealed his plans to visit China and Russia, and chart an independent foreign policy, and "open (new) alliances" with these two major powers.

Later, in December 2016, then Secretary of Foreign Affairs Perfecto Yasay Jr. said that it would be beneficial for the Philippines and the U.S. to reassess their relationship in the light of the current geopolitical realities (Kyodo News, 22 December 2016). Apparently, he was referring to President Duterte's earlier statement "that China now is the power (in East Asia), and they (the Chinese) have military superiority in

the region.” Echoing China’s rhetoric on the South China Sea dispute, he commented that “the present circumstances, such as the South China Sea (dispute), may no longer require a strategy based on the old concept of the Cold War.” (*ibid.*) Moreover, he indicated that the Duterte Administration intends to utilize the EDCA “to come up with a rapid response during natural calamities, to address terrorism, and to enhance Philippine law-enforcement capabilities.” (*ibid.*) He added that that “joint military exercises will not be given focus or just downgraded, at least.” (*ibid.*) In effect, the continued existence of the Philippine-U.S. alliance would revolve around the Duterte Administration’s war on drugs, Humanitarian Assistance and Risk Reduction (HADR), and counter-terrorism operations against Islamic militants in Mindanao. This thrust has essentially rendered the alliance useless in constraining and deterring China’s maritime expansion in the South China Sea.

8. Pursuing an Appeasement Policy on China

After a three-year wait, the PCA decided on the maritime dispute between the Philippines and China on 12 July 2016. The five-judge PCA unanimously ruled in favor of the Philippines on almost all of its claims against China. It determined that China’s claim to historic rights through its nine-dash line in the South China Sea is contrary to international law (Permanent Court of Arbitration, 2016). The court noted that none of the Spratlys are legally islands because they cannot sustain a stable human community or independent economic life (*ibid.*). Finally, it found China guilty of damaging the marine environment by building artificial islands, and of illegally preventing Filipinos from fishing and conducting oil explorations in the Philippines’ EEZ (*ibid.*).

Despite its overwhelming legal triumph, the Duterte Administration met the eagerly anticipated decision with sober, cautious, and even

-muted reaction. Its response was ultra-low key as it neither flaunted the victory nor taunted China with the favorable ruling. Although the domestic reaction was overwhelmingly positive and jubilant, then Foreign Secretary Yasay merely said that he welcomed the ruling and called on the Filipinos to exercise restraint and sobriety. During the 49th ASEAN Foreign Ministers Meeting in Laos, Foreign Secretary Yasay withdrew the country's motion to include the PCA decision in the ASEAN Joint Communique after Cambodia objected to its inclusion. Designated as the country's special envoy to China, former President Fidel Ramos suggested that the PCA award be set aside as the Duterte Administration is still pursuing bilateral negotiations with China. Irrefutably, the government is adopting an appeasement policy on China despite the PCA ruling favorable to the Philippines.

President Duterte is evidently forging a calibrated foreign policy by gravitating toward China. He declared that he is amenable to direct bilateral negotiations with China. In contrast, former President Aquino brought the South China Sea dispute for international arbitration at the PCA. Sounding subservient, President Duterte said that the PCA Award to the Philippines is purely a bilateral issue between the Philippines and China, and is not a concern of the ASEAN (Oxford Daily Brief Service, 2016). Then Foreign Secretary Yasay argued "that the relationship between the two countries (China and the Philippines) was not limited to the maritime dispute. There were other areas of concern in such fields as investment, trade, and tourism and discussing them could open the doors for talks on the maritime issues." (*The Philippine Star*, 18 September 2016)

Intentionally, President Duterte has created a diplomatic/strategic cleavage between the Philippines and the U.S. by leaning on China and Russia (Agence France Press, 2016). Accompanied by 250 Filipino businesspersons, he visited China on 20-21 October 2016 to seek a new

partnership at a time when tension between the Philippines and the U.S. was mounting (*Business Insider*, 11 October 2016). President Duterte's foreign policy agenda involves developing and maintaining an independent and pro-active posture so he can adroitly balance the major powers in East Asia. This is aimed to foster Philippine-China bilateral relations that would enable the two countries to embark on major infrastructure and investment projects, as well as other forms of cooperation to restore mutual trust and confidence.

During their first meeting, President Xi Jinping and President Duterte talked about enhancing practical bilateral cooperation. Specifically, President Xi asked President Duterte to coordinate their development strategies and cooperate with each other within the framework of the BRI (National Institute for Defense Studies, Japan, 2017). Both leaders issued a joint communique that laid down areas for comprehensive cooperation and signed memorandums of cooperation in 13 areas including economics and trade, investment, financing, and construction of infrastructure (*ibid.*). The total amount of money committed by China to boost economic cooperation between the two countries was US\$13.5 billion, of which US\$9 billion was earmarked for Philippine infrastructure development (*ibid.*).

In his speeches and policy initiatives after his 2016 trip to China, President Duterte intimated that he is diplomatically and strategically disengaging the Philippines from the U.S. while tilting the balance in favor of China and Russia (Agence France Press, 2016). Toeing the line, then Foreign Secretary Yasay admitted that the Philippines is helpless in stopping China's maritime expansion and militarization activities on the disputed islands in the South China Sea (*Philippine Daily Inquirer*, 17 December 2016). He mentioned that it is wiser and more prudent to let other countries that are concerned with China's activities take action (themselves), citing the U.S. and Japan which have raised their concerns

on the freedom of navigation and overflight operations (*ibid.*). He announced as well that the Philippines has its own bilateral engagement with China to ensure no further actions (*ibid.*).

On 20 December 2016, Chief Presidential Legal Counsel, Salvador B. Panelo, recommended that the PCA ruling favoring the Philippines be set aside temporarily “since the country cannot enforce it against China” (*BusinessMirror*, 21 December 2016). He went on to say, “instead of trying to enforce it against China with a minimal chance of success, the Philippines should take advantage of economic benefits resulting from better relations with China.” (*ibid.*) On 22 December 2016, President Duterte himself declared his readiness to shelve aside the PCA ruling amidst reports that PLAN has installed weapon systems in the seven land features occupied by China (*The Philippine Star*, 18 December 2016). Succinctly, he said the changing nature of international politics in Southeast Asia prompted his decision. This stance radically differs from President Aquino’s position of standing up to China.

President Duterte’s position of not challenging China on building structures on the disputed shoal springs from his calculation that appeasing China has its rewards. His pro-China stance could spell billions of US dollars in deals including an agreement for agricultural exports to China, and loans for infrastructure projects such as railways and hydroelectric dams through the BRI. By early 2017, President Duterte’s efforts to appease China began to bear fruit. In February 2017, the vice-governor of the state-owned China Development Bank visited one of Manila’s main terminal facilities to look at the prospects of investing in Manila, Cebu, and Davao. The ocular inspection came on the heels of the Philippine decision not to challenge Chinese expansionist efforts in the South China Sea (Mooney, 2017). Moreover, the Philippines tries to interest the China National Technical Import and Export Corporation to expand the Manila Harbor Center Port Terminal

by constructing an additional 20 hectares (49 acres) of handling, and storage space and 1,000 meters (3,280 feet) of new berthing space (*ibid.*). On the one hand, from China's perspective, proximity to the South China Sea makes Philippine ports attractive to Chinese capital. On the other hand, the Philippines urgently needs investments and expertise to improve the economy's seaborne trade network (*ibid.*).

In March 2017, President Duterte admitted that the Philippines could not stop China's reported plan to construct an environmental monitoring station on the disputed Scarborough Shoal (*The Philippine Star*, 20 March 2017). Questioned by a journalist about his view on the prospect of China building a radar station on the shoal, President Duterte exposed his appeasement scheme vis-à-vis Chinese maritime expansion when he answered: "We cannot stop China from doing this thing. So what do you want me to do ... declare war on China? I can, but we'll all lose our military and policemen tomorrow." (*The American Interest*, 2017) Interestingly, President Duterte even wants Chinese ships "to pass or come and dock" in the Philippines as long as "they will not do anything to the Philippine Coast Guard (PSG) as it patrols the country's maritime waters." (*The Philippine Star*, 20 March 2017)

In March 2017, Chinese third vice-premier Wang Yang visited Davao City and witnessed the exchange of letters between Philippine and Chinese officials on the feasibility studies on infrastructure projects that China will finance (Philippine News Agency, 2017). The Chinese vice-premier visited portions of the proposed Davao Coastline and Portland Development Project. He was also briefed on the planned Davao City Expressway and the Mindanao Railway. Vice-Premier Wang duly expressed China's interest to fund the various infrastructure projects presented to him while he was in Davao City (*ibid.*). After that, the Philippines and China signed a six-year economic cooperation agreement (*The Philippine Star*, 19 March 2017). The agreement

commits China to finance 15 big-ticket infrastructure projects such as the US\$53.6 million Chico River Pump Irrigation, the US\$374 million New Centennial Water Source – Kaliwa Dam, and the South Line of the North-South Railway (*ibid.*).

Not surprisingly, President Duterte is acquiescent to increased Chinese island-building activities in the South China Sea. Obviously, he has been lured by the Chinese promise of trade concessions, grants, loans, and investments. Consequently, his administration has parroted Beijing's official line "that after several years of disruption caused mainly by non-regional countries (Japan and the U.S.), the South China Sea has calmed with China and Southeast Asian countries agreeing to peacefully resolve [their] disputes." (Sutter and Huang, 2017)

In mid-May 2017, President Duterte and his cabinet went to China for the second time in less than a year to attend the BRI Forum for International Cooperation. They all literally chanted the mantra "that the BRI complements the administration's Build-Build-Build Infrastructure Plan" (*Asia News Monitor*, 16 May 2017). The plan involves the building of nationwide infrastructure network that will connect the Philippines' seven thousand and one hundred islands into one cohesive and dynamic whole and make the country one of Asia's tiger economies (*MENA Report*, 2017). Top government officials are convinced that BRI could provide the necessary capital for the Philippines to improve its infrastructure and connectivity, and thus create the international context for the infrastructure plan of the Duterte Administration (Xinhua News Agency, 2017). They accept without any doubt Beijing's official line that China has a surplus of capital as well as experience and expertise in infrastructure construction. They also regard the BRI as more than an infrastructure-building enterprise as it will also expand the regional market, diversify the investment scheme, and reinforce people-to-people connectivity.

The Chinese host told the Philippine delegation that as part of the ASEAN connectivity plan, Indonesia, Malaysia, and the Philippines will be connected directly to Singapore, then all the way to Kunming in Southwest of China (*BusinessMirror*, 14 May 2017). From there, the Philippines will be further linked to Central Asia and then to Europe (*ibid.*). Elated by this scheme of direct connection to Eurasia and Europe, the Philippine business delegation released a statement in Beijing lauding the BRI:

We note that (President Xi) desired the Belt and Road as a bridge for peace, a road to prosperity, a way to boost inclusive growth and balanced development, and to promote equality. The Philippines shares the view that a peaceful environment is needed to achieve development goals. We are looking forward to the One Belt, One Road Initiative in promoting a prosperous and peaceful community of nations.

(Xinhua News Agency, 2017)

The current strategy of sustained economic and inclusive growth of the Philippines is anchored on an unprecedented infrastructure program that entails Php (Philippine peso) 8.4 trillion (estimated US\$17 billion in funds) over the next five years. The Philippines eyes a sizeable portion of the estimated US\$1 trillion that China will invest in 60 countries to develop land and maritime routes following the old Silk Road network that once connected China to Central Asia and Europe. Furthermore, it is projected that China-led program will not only help the Philippines' infrastructure development will also promote global free trade and integrate Asian and European economies (Xinhua News Agency, 2017). Philippine finance secretary Carlos Dominguez III articulated the administration's high expectations from the BRI when he opined:

The Philippine is building a lot of infrastructure, of course with the help of China, and among the infrastructure that we are building are ports and airports. That will lower the cost of shipping our goods to say Hong Kong or to Shanghai and that will open markets to us along the corridor between China and the Middle East and Europe... We are the largest exporters of tropical fruits (in Asia) so definitely there will be a lot of benefits to us if we are able to open markets in let's say Kazakhstan, in Uzbekistan, along the One Belt, One Road area...

(Xinhua News Agency, 2017)

9. Pursuing the Appeasement Agenda in ASEAN

During President Aquino's term, the Philippines brought the South China Sea dispute to the attention of the ASEAN. The Philippines hoped that this regional association could convince China to accept a more binding code of conduct in the South China Sea to prevent it from building more military outposts on the islets and shoals and from conducting provocative actions against the other claimant states. In April 2012, the Philippines tried to elicit ASEAN's support for its proposal for a creation of a "Zone of Peace, Freedom, Friendship, and Cooperation". This proposal simply sought the clarification on the maritime boundary claims in the South China Sea by all parties, as well as the conversion of disputed areas into special enclaves where disputing parties could jointly develop projects (International Crisis Group, 2012). China, however, did not want the dispute to be multilateralized, preferring to resolve it bilaterally.

During the 30th ASEAN Summit Meeting in Manila, however, President Duterte downplayed this territorial row. He announced on April 27 that he would not raise the PCA rulings on the South China Sea during the ASEAN summit (Associated Press, 2017). During a press

conference at the Malacañang Palace two days before the event, he emphatically declared that “we [ASEAN] will skip, I will skip the arbitral ruling. It is not an issue here in the ASEAN.” (EFE News Service, 2017) By accepting Chinese economic largess and rejecting former President Aquino’s confrontational stance on the South China Sea dispute, President Duterte dismissed benefits that could come out from the PCA ruling. Responding to his domestic critics, President Duterte deridingly pointed out: “What would be the purpose of discussing it? Who will dare pressure China?” (*The Wall Street Journal*, 30 April 2017)

True to his word, President Duterte as chairperson of the 30th ASEAN Summit avoided any adversarial statements directed at China. The chair’s communique neither included any references to China’s island building and weapons deployment on the reclaimed land features nor touched on the PCA ruling that declared China’s excessive claim in the South China Sea as a violation of international law. ASEAN diplomats alleged that the Chinese government pressured the Philippines to keep the South China Sea issue off the ASEAN agenda. The communique, however, retained the phrase “the need to demonstrate full respect for legal and diplomatic process in resolving the dispute”. This was a subtle reference to the PCA ruling and to the regional negotiations for a code of conduct (COC) in the South China Sea (Sutter and Huang, 2017). Still, the statement also welcomed China’s cooperation with ASEAN on the drafting of a COC framework.

Some ASEAN leaders tried to include the phrase “such reclamation and militarization (in the South China Sea islands) that may further complicate the situations”. However, President Duterte determined that it was pointless to discuss China’s island reclamation in the disputed waters and the PCA ruling, calling both as non-issues (*The Straits Times*, 1 May 2017). Pleased by the Philippine president’s moves to soften the

chairperson's communique, the Chinese foreign ministry noted: "Mr. Duterte's remarks said that it would continue to deal with the Philippines to create a sound environment for stable development of bilateral relations." (Associated Press, 2017) Consequently, during the Philippines' chairmanship, Chinese premier Li Keqiang cited previous ASEAN meetings to substantiate that the tension in the South China Sea has eased and the two sides are making notable progress in negotiating for a COC to manage the maritime dispute (Sutter and Huang, 2017). Other Chinese officials gloated over China's remarkable success in preventing ASEAN from challenging Chinese expansion in the South China Sea, which means that the process of negotiating a COC and its eventual outcome will legitimize Chinese control of the disputed sea.

10. Weighing the Cost of the Appeasement Policy

Philippines has not collected any substantial returns from its appeasement policy. As a littoral country separated from continental Asia, there was uncertainty on how the Philippines could benefit from the BRI. China excluded the Philippines from countries that are projected to be part of a web of six economic corridors linking China with each of its neighboring sub-regions (Wuthnow, 2017). This was because of the two countries' territorial dispute on the South China Sea (*The Manila Times*, 2 December 2016). China envisioned that the BRI would help manage the territorial rows in the South China Sea by pulling states away from the zero-sum mindset. China projected Vietnam's participation in the BRI projects since this will lead to the stronger Sino-Vietnamese relations. However, Chinese analysts saw the Philippines as a Southeast Asian country that is wary about its role in the South China Sea (*ibid.*). The Philippine, under the Aquino Administration, might perceive the Maritime Silk Road (MSR) as a type of strategic weapon

that China will be using to press its territorial ambition in the disputed waters (*ibid.*).

China only considered the Philippines as a possible BRI-aid related recipient after President Duterte effected his appeasement policy on China in the latter part of 2016. However, when the Philippines became a BRI beneficiary in 2017, the initiative suffered a major setback. Projects from Pakistan to Tanzania to Hungary were cancelled, renegotiated, or delayed. This was because of disputes over cost or complaints from the host countries that alleged that they get too little financial returns from infrastructure projects built by Chinese companies and financed primarily by Chinese loans (*The Manila Times*, 18 April 2018). BRI participating countries complained that China provides not only funding but also project management, equipment, construction materials and even workers. This, however, triggered public backlash and questions over the actual benefits of BRI projects, especially on domestic job generation. High-profile BRI-financed high-speed rail projects in Thailand and Indonesia were all marred by significant delays due to execution problems ranging from land acquisition to cost overruns and other constraints (Paracuelles, 2018).

In May 2017, President Duterte went to Beijing to follow up on his initial negotiation with President Xi in October 2016 (*ibid.*). The Philippines then sought Chinese investments in the reclamation of the Davao coastline, seaport and the construction of bulk terminal projects in cities such as Davao, Cebu, and Manila, and the building of highways and railways amounting to US\$9 billion. The Philippine ambassador to Beijing, however, admitted that “there were several discussions between the countries regarding these BRI projects, but they remained discussions way into 2019.” (*China Daily*, 4 January 2018) Existing BRI-related projects in the Philippines included the constructions of two bridges in Manila and a projected larger South Long Haul Railway that

will connect ports and special economic zones in the main island of Luzon (*The Manila Times*, 18 April 2018). However, there is no single major port constriction project that “would have been more in line with the BRI’s thrust of increasing regional connectivity and allow the Philippines to be linked to the Maritime Silk Road.” (*ibid.*) The absence of such projects constrains the Philippines from fostering closer economic ties with Asia and Europe. The Nomura Institute observed that “most of the big-ticket multi-year projects (under the BRI) in the pipeline are still under consideration and may therefore be susceptible to the risk of another pivot when a new (Philippine) president takes over in 2022.” (*ibid.*)

In August 2018, Philippine Secretary of Finance Carlos Dominguez admitted the incremental flow of Chinese public sector investments. He said that there had been “roadblocks” on the flow of Chinese Official Development Assistance (ODA), particularly Beijing’s hesitation to co-finance certain projects with other lenders and use of renminbi in ODA disbursement instead of dollar (*The Philippine Star*, 14 November 2018). He also revealed that ODA flow from China was delayed because of the reorganization of the Chinese government in early 2018 (*ibid.*). Prior to President Xi Jinping’s November 20, 2019 state visit, the country’s economic managers disclosed that among the 10 big-ticket Chinese-funded projects in the country, the Philippines and China have concluded only one loan agreement – the US\$62.09 million Chico River Pump Project (*ibid.*).

Publicly acknowledging the snail-pace implementation of Chinese-funded infrastructure projects, Budget Secretary Benjamin Diokno said “that the visit of the head of state of China will put pressure on the speedy implementation of all these projects.” (*ibid.*) He explained that the delay in the implementation of Chinese-funded projects is due to the Philippines’ lack of experience in certain technology such as the

construction of railroads, the competitions among regional-local elite over train stops, the negotiation to settle differences between Manila and Beijing on co-financing options, Renminbi usage, and labor-sourcing requirements (Ordaniel and Camba, 2018). Secretary Diokno added that President Xi's visit to Manila would "(hopefully) put pressure on their bureaucracy to speed up the process." (*GMA News*, 14 November 2018)

However, the Nomura Research Institute believes that China-funded projects in the Philippines were delayed not only because of technical issues. The delay was also caused by growing domestic political struggles in the Philippines, possible change in Philippine administration by 2022, and developments related to the South China Sea dispute (*The Manila Times*, 18 April 2018). There is currently public mobilization and oppositions against Chinese infrastructure projects that stems from the widespread public fear of China as a security threat that have often outweighed the economic benefits of Chinese public investments (Ordaniel and Camba, 2018). The Chinese are also hesitant to bring in huge infrastructure projects in the country because these "projects would also hinge on the developments in the South China Sea claims, which will depend on the next administration's stance (vis-à-vis China)." (*The Manila Times*, 18 April 2018)

Interestingly, despite the Philippine-China rapprochement, there is still a lingering public fear about the possible security implications of large-scale Chinese infrastructure construction projects in the country. Some Filipino government officials are also skeptical about the viability of these long infrastructure projects given the geopolitical risk because of the competing territorial claims in the South China Sea (Paracuelles, 2018). The Nomura Institute keenly observed: "Even today, amid President Duterte's high popularity ratings, there are growing concerns about the mismatch between the speed with which China has built structures on disputed islands and how little progress has actually been

made on infrastructure projects or the FDI inflows that the Philippines receive from China so far.” (*The Manila Times*, 18 April 2018)

11. The Long-term Cost of Appeasement

China has not only failed to deliver the economic rewards for the Duterte Administration’s appeasement policy. Moreover, facilitating China’s efforts to project its maritime power in the Western Pacific is adversely affecting the Philippines’ territorial and long-term strategic and economic interests as an archipelagic state. The Duterte Administration’s appeasement policy on China does not only cost the Philippines its territorial rights in the South China Sea and the trust and confidence of its traditional allies and security partners. By appeasing an expansionist power, the Philippines becomes complicit in China’s long-term strategy of maritime expansion aimed to ease the U.S. out of East Asia. It also upsets the present balance of power in the region, and more significantly, erodes Southeast Asia’s maritime order. The Duterte Administration’s appeasement policy on China has the following far-reaching implications:

- 1) *Preempting the formation of an international coalition that can advance the 2016 UNCLOS Award versus China’s maritime expansion* — The PCA award produced the basis and motivation for cooperation among states that are threatened by China’s maritime expansion and consequently, are supportive of international law. Before 12 July 2016, the maxim of “to each his own” hindered these states from engaging in robust cooperation to constrain China’s maritime expansion. With the PCA’s ruling that China’s nine-dash line is invalid, littoral states like the Philippines, Malaysia, Indonesia, and Vietnam can join forces and lawfully align themselves with major

naval powers like the United States, Japan, Australia, and India to defend their EEZ against Chinese encroachment, and rationalize the effort to uphold international law. If cooperation among these states before the ruling could easily be interpreted as taking sides and ganging up on China, now it can be regarded as a collective effort by the international community to defend the rules-based international order against an aggressive and expansionist power. However, by appeasing China, the Philippines has lost any motivation and the moral high ground to form and lead this coalition of states. Instead, it subscribes to China's preferred solutions to the South China Sea imbroglio – bilateral negotiations and joint development.

- 2) *Widening the cleavage within ASEAN* — As a regional association of middle and small powers in Southeast Asia, the ASEAN has the potential to constrain China from expanding into the South China Sea and unravelling the regional maritime order. Since 2003, China has not only prevented ASEAN from effectively embedding it to the association's way of managing security issues by stonewalling the Southeast Asian states' efforts to negotiate a multilateral and legally binding Code of Conduct (COC). More importantly, it has also effectively neutralized the regional organization by creating divisions within ASEAN by slicing its member states one by one. Called the "salami strategy", this involves offering each claimant state a joint development venture as a means of resolving the South China Sea dispute. This is an important component of China's diplomatic initiative of "setting aside disputes and pursuing joint development" with a claimant state on the disputed maritime territories that from China's perspective actually belong to it. By accepting China's offer of joint development, the Philippines has effectively widened the divisions within ASEAN and has effectively weakened this regional association.

3) *Emboldening China's expansion into the South China Sea leading to the unravelling of Southeast Asia's maritime order* — From 2011 to 2016, the Aquino Administration pursued a balancing policy on China as it promoted closer security cooperation with the U.S. The most salient component of this balancing policy on China is the signing of the EDCA, which provides American forward-deployed forces strategic rotational presence in Philippine territory, as well as extensive access to Philippine military facilities. The agreement has been forged to strategically constrain China that has stepped up its territorial foothold in the South China Sea. The Aquino Administration also filed a claim against China in the PCA. President Duterte is undoing President Aquino's geopolitical agenda of balancing China's expansive claim in the South China Sea. He distances his country from its long-standing treaty ally while moving closer to a regional power bent on effecting a territorial revision in East Asia. He has also set aside the 2016 UNCLOS decision on the South China Sea dispute. His maritime security policy is aimed at appeasing China, in contrast to President Aquino's balancing strategy. The Duterte Administration is convinced that its appeasement policy on China is worth pursuing because it makes the country a beneficiary of the latter's emergence as a global economic power.

China effectively changed Philippine foreign policy because it found an effective tool to drive a wedge between countries and within countries that it sees as having impact on its core interests such as Taiwan, Tibet, and the South China Sea. Through BRI, China was able to undermine U.S.-led bilateral alliances in East Asia and the Southeast Asian maritime order so as to empower it to create new power relationships and arrangements that exclude the United States. Relevant to the South China Sea dispute, the BRI enabled China to foster greater stability in its bilateral relations with the disputant

countries. This became evident, as China was able to influence Philippine domestic politics in 2016, veer the country away from its main strategic ally, the United States, and alter its balancing policy on China's expansionist agenda in the South China Sea. China's ability to change the Philippines' foreign policy related to the South China Sea dispute is emboldening this emergent power to expand to the South China Sea and in the process, relegate Southeast Asia's global, open, and liberal maritime order to the dustbin of history.

12. Conclusion

President Duterte's appeasement policy is undoing President Aquino's geopolitical agenda of balancing China's expansive claim in the South China Sea. He distances his country from its long-standing treaty ally, while cozying up to a regional power bent on effecting a territorial revision in the East Asia. He has also set aside the 2016 UNCLOS decision on the South China Sea dispute. His maritime security policy is designed to appease China, in contrast to President Aquino's balancing strategy.

Evidently, the Duterte Administration is convinced that its appeasement policy on China is worth pursuing because it makes the Philippines a beneficiary of the latter's emergence as a global economic power. However, China has not reciprocated the latter's appeasement policy as it has delayed the funding of various infrastructure projects under the Philippine government's Build, Build, Build program. By appeasing an expansionist power, however, the Philippine government colludes with China in its long-term strategy of maritime expansion aimed to ease the U.S. out of East Asia. This will upset the current balance of power in the region. Furthermore, by being complicit in China's moves to project its maritime power in the Western Pacific,

particularly in Southeast Asia's maritime commons, the Philippines puts at risk its territorial, strategic, and economic interests as an archipelagic state in the Indo-Pacific. More significantly, the Philippines' efforts to appease China embolden the latter to pursue its expansionist agenda in the South China Sea and, in the process, make Southeast Asia's global, open, and liberal maritime order a thing of the past.

Notes

+ This is a longer and theoretical version of a paper that was presented in the international conference on "Multipolarism in Asia: Issues and Challenges" at the Institute for Defense Studies and Analyses (IDSA), New Delhi, India, 26-28 March 2019.

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1. The term appeasement has acquired a derogatory overtone both in common parlance and historical scholarship as it supposedly symbolizes the sacrifice of principle (such as sovereignty or independence) for the expedience of placating an expansionist power by the status quo states. However, if properly conducted, appeasement is regarded as an integral part of the Balance of Power process as it is aimed to maintain order and reduce the incidence of great power conflict and rivalry by accommodating the interests of emerging powers to facilitate the peaceful transformation of the international system. See: Graham Evans and Jeffrey Newham, *The dictionary of world politics: A reference guide to concepts, ideas, and institution* (London: Harvester Wheatsheaf, 1992), pp. 16-17.
2. Small or minor powers are generally small or even medium-sized states whose territory, population and resource base make it difficult for them to defend themselves against external military attacks or other forms of big power intervention. To insure their security, this type of states is generally compelled to adjust its bilateral relations with the big powers and to deal with changes in the regional balance of power. There is no general pattern of behavior on how small powers relate with the big or major powers. Rather, each of these states maintains a specific pattern of relation with the major or big powers, each has been affected differently by changes in the latter policies, and each has responded in various ways. See: Laura Neack, *The new foreign policy: U.S. and comparative foreign policy in the 21st century* (Maryland: Rowman and Littlefield Publishers, 2003). pp. 108-159.
3. Peter Dutton, “A maritime or continental order for Southeast Asia and the South China Sea?” Address at Chatham House, London, U.K., 16 February 2016, p. 5. The idea of a global, open, and liberal maritime order is based on the ocean-related legal doctrine that “the high sea like the air is common to all humanity (*Maris Communem Usus Omnibus Hominibus ut Aris*).” This principle states that the right to exclusive control of sea cannot

be authorized nor accepted by the international community. Parts of the seas, considered as the high seas, cannot be included in the territorial sea or in the internal waters of a state. The high seas may be used freely by ships of all nations. See: Seiya Eifuku, "Projection of maritime interests", *Maintaining maritime order in the Asia-Pacific* (Tokyo, Japan: Urban Connections, 2018), p. 138.

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China's Infrastructure Projects in South Asia under BRI: An Appraisal

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Abstract

The Belt and Road Initiative (BRI) is one of the most ambitious projects of China. Through it, as being argued by a few scholars, China may create a new world order dominating over the new trade routes and sea lanes which it is in the process of building. This project is spread across different regions and sub-regions of the world. In South Asia, except India and Bhutan, all other countries are party to the BRI. Under this, China has developed or engaged in developing infrastructures and water projects in the BRI deal signatory countries. Observing the character of the Chinese projects, some commentators argue that it may, gradually, push the BRI member countries into a “debt-trap”. This paper takes stock of the BRI projects in South Asia, notably water-related projects, and examines the “debt- trap” argument.

Keywords: *BRI, debt-trap, hydroelectric projects, infrastructure, South Asia*

1. Introduction

The Belt and Road Initiative (BRI) is an ambitious project adopted by the Chinese government under President Xi Jinping. It was conceived in 2013 when Xi Jinping visited the Central Asian state of Kazakhstan, and subsequently to Indonesia in Southeast Asia where he raised the initiative of jointly building the Silk Road Economic Belt and the 21st-Century Maritime Silk Road (State Council, People's Republic of China, 2015). On his call many countries from different parts of the world have become party to the BRI. At present, under this initiative, China is developing infrastructures and making investments in about 152 countries. It is estimated that China has inked 173 deals on the BRI with 125 countries and 29 international organizations (*The Straits Times*, 25 April 2019). The total trade volume between China and the countries participating in BRI exceeded US\$6 trillion Dollars in 2018. So far, China has chalked up around US\$80 billion dollars in the form of direct foreign investment in the BRI partner countries (*ibid.*). From South Asia, Bangladesh, Nepal, Sri Lanka, Pakistan, Afghanistan and Maldives have signed Memorandum of Understanding (MoUs) with China on BRI.

In May 2017 China conducted the first BRI forum, and the second was held in April 2019. Opening the meeting in 2017, Xi Jinping termed the BRI as “a project of the century” (Xinhua, 14 May 2017). In that inaugural speech he said “We [China] will actively promote supply-side structural reform to achieve sustainable development, inject strong impetus into the Belt and Road Initiative and create new opportunities for global development” (*ibid.*). The target to complete the BRI projects is 2049, which will mark 100 years of the setting up of the People's Republic of China.

Despite the projected potentials, there are many fears about the BRI which the critics have highlighted. Politically, the opposition parties in the South Asian countries have opposed many of the BRI-related

projects because of their potential to push the country into a debt; however, the moment such parties come into power they start following the writings on the walls. Best example is Pakistan's Pakistan-Tehrik-i-Insaf (PTI) under Imran Khan. During its days in opposition, it was critical to many ongoing projects under the BRI in Pakistan. During the election rallies PTI made promises to the voters that once in power the party will review the BRI-related projects. However, except some initial noises, Prime Minister Imran Khan's government is following the trail.

Besides looking at other infrastructure projects, this paper highlights the hydroelectric and other water-related projects China has undertaken and developed or is in the process of building in the South Asia's BRI partner countries. In this paper, I argue that despite the corruption and "debt-trap" arguments, the BRI signatory countries from South Asia are inclined towards China and engaging with it to develop infrastructure projects in their respective countries. There are two reasons for this: first, they have a desire for economic growth and are ready to pay any price for it; second, some of them want to move away from their traditional overdependence on the regional power – India.

2. China's Engagement in South Asia under the BRI

Since its inception, India has raised its objections on the BRI. India did not participate in the first BRI forum in Beijing which was held from 14-16 May 2017. On the issue of the participation in the first BRI forum the Ministry of External Affairs, Government of India spokesperson said:

We had received formal invitation to participate in the 6 separate forums that China is organizing as part of the Belt and Road Forum being held in Beijing on May 14-16, 2017.

We are of firm belief that connectivity initiatives must be based on universally recognized international norms, good governance, rule of law, openness, transparency and equality. Connectivity initiatives must follow principles of financial responsibility to avoid projects that would create unsustainable debt burden for communities; balanced ecological and environmental protection and preservation standards; transparent assessment of project costs; and skill and technology transfer to help long term running and maintenance of the assets created by local communities. Connectivity projects must be pursued in a manner that respects sovereignty and territorial integrity.

(Ministry of External Affairs, Government of India, 2017)

Another reason for India's non-participation in the BRI forum is its political tussle and contest with China in Asia. However, as except India and Bhutan, all other South Asian countries are party to the BRI, it is obvious for India to keep an eye on the Beijing-led project.

In South Asia, the China-Pakistan Economic Corridor (CPEC) is one of the flagship projects under the BRI. Pakistan and China agreed on the CPEC in 2013. Under it, China agreed to collaborate with Pakistan in developing infrastructure projects, building industries, improving livelihood, providing socio-economic development, prosperity and bringing security in regions falling under CPEC (Ministry of Planning Development and Reforms, Government of Pakistan, 2017). On the future of the CPEC, in 2013, the Chinese Foreign Ministry spokesperson Hua Chunying said that "China is ready to work with Pakistan to step up the planning and building of the grand project of China-Pakistan economic corridor and make it a new highlight of bilateral cooperation. We believe that the success of the project will contribute to China-Pakistan cooperation and regional development." (Permanent Mission of the People's Republic of China to the UN, 2013). Explaining the

CPEC's role in the regional connectivity, Mushahid Hussain, chairman of the Pakistan-China Institute, told *China Daily* that the CPEC "will play a crucial role in regional integration of the "Greater South Asia", which includes China, Iran, Afghanistan and stretches all the way to Myanmar. These countries will connect through cooperation in energy and economy" (*China Daily*, 17 February 2014).

In May 2015, Xi Jinping, during his visit to Pakistan, pledged for an investment of around US\$46 billion. Of that, US\$11 billion was for infrastructure and US\$35 billion was to be spend on energy projects (Salman, 2015). Later in 2017, Pakistan and China signed an agreement in which they agreed on a common long-term plan for the development of the CPEC. The investment amount was increased to about US\$62 billion (Ministry of Planning Development and Reforms, Government of Pakistan, 2017).

In October 2019 during the visit of Imran Khan to Beijing Pakistan emphasised that the CPEC is a transformational project. China and Pakistan agreed to establish a CPEC authority to oversee the expeditious implementation of the projects under it. Pakistan and China maintained that the second phase of CPEC will promote industrial and socio-economic development in Pakistan (Ministry of Foreign Affairs, People's Republic of China, 2019). Pakistan also underlined that the facilities developed at Gwadar Port would turn it into a trade and logistical hub for the region (*ibid.*).

Some of the Chinese projects under CPEC in Gilgit Baltistan in northern Pakistan, which India considers as an "occupied" territory. Expressing objections to the spread of the BRI in that area, the spokesperson from India's Ministry of External Affairs said, "Regarding the so-called 'China-Pakistan Economic Corridor', which is being projected as the flagship project of the BRI/OBOR, the international community is aware of India's position. No country can accept a project

that ignores its core concerns on sovereignty and territorial integrity.” (Ministry of External Affairs, Government of India, 2017) This concern, as India thinks, is contrary to what Xi Jinping said in the inaugural speech of the BRI forum in 2017:

The pursuit of the Belt and Road Initiative requires a peaceful and stable environment. We should foster a new type of international relations featuring win-win cooperation; and we should forge partnerships of dialogue with no confrontation and of friendship rather than alliance. All countries should respect each other's sovereignty, dignity and territorial integrity, each other's development paths and social systems, and each other's core interests and major concerns.

(Xinhua, 14 May 2017)

Afghanistan joined the BRI in 2016. Since then it has shown interest in becoming a part of the CPEC. Soon after Afghanistan's entry into the BRI, the first Chinese cargo train carrying goods valued at \$20 million arrived in the northern Afghan port city of Hairatan (Zia, 2018). Subsequently, direct flight between Kabul and Urumqi, which was closed in 2012, was resumed. It was closed at the end of 2012. Now there is one flight in a week from Kabul to Urumqi, the capital of Xinjiang Uygur Autonomous Region, and vice versa (*ibid.*). As estimated and expected, through such connectivity project, Afghanistan would have opportunity to export goods such as rugs, dried fruits, vegetables and much more to Central Asia, West Asia, and China (Hussainy, 2019). However, unlike other BRI countries of the region, Chinese investments in Afghanistan is limited. The biggest Chinese investment in Afghanistan is in Aynak copper mines which has not gained speed yet (Pantucci, 2018). Another major project China has in the country is of refinery oil plant on Amu Darya oil field. Other than

them, China is also involved in developing infrastructures such as hostel, repairing roads and training people to develop human resources in Afghanistan.

In June 2019, Xi Jinping met his Afghanistan counterpart, Ashraf Ghani in Beijing where Xi said that “China is willing to deepen the mutually beneficial cooperation with Afghanistan in various sectors within the framework of the Belt and Road Initiative, steadily promote practical cooperation in economy and trade, and support the two countries’ enterprises to strengthen cooperation based on the principles of mutual benefit and win-win outcomes” (Xinhua, 14 June 2019). He added “China supports Afghanistan and Pakistan to improve relations, enhance mutual trust and carry out cooperation, and is ready to further promote the China-Afghanistan-Pakistan trilateral cooperation” (*ibid.*). To this, Ghani thanked China for its role in Afghanistan’s peace process and in safeguarding regional peace and stability (*ibid.*). He further said that “Afghanistan is committed to fighting, side by side with China, against the "three forces" including the ETIM (East Turkistan Islamic Movement)” (*ibid.*).

Bangladesh became a part of the BRI in 2016. Since then it has received enormous Chinese funds for various infrastructure projects in the country. In November 2016, Xi Jinping visited Bangladesh during which the two countries inked a total of 40 agreements and MoUs worth more than US\$25 billion, though the government of Bangladesh has not revealed the figure officially. Out of the total 40 agreements and MoUs, 27 involved the two governments. Of 27, 15 are agreements and MoUs and 12 are for loan and mutual agreements. Chinese state-owned and private entities signed 13 agreements mostly with Bangladeshi private enterprises.

It is estimated that under the BRI projects, Bangladesh has received about US\$26 billion for BRI projects and another US\$14 billion for joint

venture project. Bangladesh is one of the six economic corridors through which the BRI projects will pass. It also falls in the route of one of the two maritime corridors proposed under the BRI. The road project corridor, as projected, starts at Kunming passes through Myanmar, then enters Indian north-east and through Bangladesh, and terminates in Kolkata (*The Daily Star*, 2019). After signing the BRI bilateral trade between China and Bangladesh has jumped 16.8 percent year-on-year to US\$18.74 billion in 2018. China mainly exports diesel oil, cotton, chemicals, construction machinery, manufacturing equipment, steel, cement and household appliances to Bangladesh. Chinese-made passenger vehicles and trucks have gained popularity in Bangladesh (*China Daily*, 5 July 2019). On the other hand, Bangladesh exports jute and garment products, aquatic products, leather, tea, pottery and porcelain products. According to the Ministry of Commerce, Government of Bangladesh data Chinese companies had signed US\$45.9 billion worth of contracted projects in areas such as building bridges, power stations, hospitals and transportation facilities in Bangladesh by the end of 2018 and have completed projects worth US\$22.56 billion (*ibid.*).

In 2017, Nepal signed a MoU on the Belt and Road Initiative. The press release of the signing of the MoU said that Nepal “seeks to strengthen cooperation in connectivity sectors including in transit transport, logistics systems, transport networks and related infrastructure development such as railways, roads, civil aviation, power grids, information and communication” (Ministry of Foreign Affairs, Government of Nepal, 2017).

The signing of the MoU was followed by a large Chinese investment in the country. In 2018, Nepal and China signed eight cooperation deals worth US\$2.4 billion. In April 2019, Nepal and China signed the Transit Transport Agreement during Nepalese President

Vidya Bhandari's visit to Beijing. Under this agreement, China granted access to Nepal to four Chinese seaports in Shenzhen, Lianyungang, Zhanjiang and Tianjin and three dry ports in Lanzhou, Lhasa and Shigatse. At that time, China has also made a commitment to extend the Lahasa-Xigatse railway to the Gyirong Port in China by 2020 and assist in repairing Nepal's Araniko and Syabrubesi-Rasuwegadhi highways. Buoyed by the BRI and post-BRI agreements, at present, China is the second largest trading partner of Nepal and it is the largest source of foreign direct investment in Nepal.

Sri Lanka signed MoU for BRI in 2015. Since then, China's investment in the country has increased further. Under the BRI project, Sri Lanka has secured more than US\$8 billion of financing from China. The Colombo International Financial City which was earlier known as the Colombo Port City, is an instrumental part the BRI. This project aims at building a new city and financial centre along the existing Colombo coastline (Wijayasiri and Senaratne, 2018). Colombo port will be expanded and modernised.

Under BRI China has also funded the construction of airports in Sri Lanka such as the Mattila Rajapaksa International Airport (MRIA), 241 km south-east of Colombo. The MRIA is the second international airport in Sri Lanka (*ibid.*). Besides, in the war-ravaged northern areas of Sri Lanka Railway Beijing Engineering Group Co. Ltd. won a more than US\$300 million contract to build about 40,000 houses in Jaffna. Also, China is in the process of negotiations to make an investment of around US\$30-40 million in Sri Lanka's tea plantation sector (Ramachandran, 2018).

In 2014, Maldives became a party to the BRI. In 2016, to develop infrastructure facilities for tourism, the Feydhoo Finolhu Island near Malé was given on a lease to China by former president of the country Abdulla Yameen's (2014-2018) government for four years at a price of

US\$50 million. Later, in 2017, Beijing and Malé signed a free trade agreement that would allow zero tariffs on over 90 per cent of goods in bilateral trade. This in turn would improve the country's aquatic exports, which had been affected by the European Union's removal of the Maldives from the Generalized System of Preferences countries list in 2013 (*Nikkei Asian Review*, 8 December 2017). China has taken up many projects in Maldives (*Maldives Independent*, 14 July 2018). One of the projects is the China-Maldives Friendship Bridge. Another project is the upgrade and expansion of the Velena International Airport while a third is the Hulhumalé Phase II housing project currently under construction, where 16 buildings will be constructed. A fourth project is the development of a link road between the Hulhule and Hulhumalé (*ibid.*).

In 2018 Yameen lost the presidential elections to Ibrahim Mohammed Solih. The new government has been critical of the Chinese infrastructure projects in the Maldives. Such projects are cited as reasons for Maldives falling into debt trap. Since the coming of the new government works have been stopped on the Chinese-funded infrastructure projects in Maldives.

3. China's Investment in South Asian Water Infrastructures

Besides roads and ports, China has effectively invested in the hydroelectricity power projects and water treatment plants in the BRI partner countries from South Asia. Such projects have better irrigation facilities and improved the drinking water problems in some of these countries.

In Pakistan, China is involved in building multipurpose hydroelectric projects under the CPEC. In 2017, Pakistan and China signed a MoU in which they agreed for "Indus Cascade" project (Gupta, 2017) which will generate hydroelectricity that will try to address

Pakistan's growing electricity demands. The two countries agreed on projects such as: Bunji Dam in Gilgit, Dasu Dam in Kohistan district in Khyber Pakhtunkhwa province, Patan Dam also in Kohistan in Khyber Pakhtunkhwa province, and Thakot Dam in tribal town in Khyber Pakhtunkhwa. The two sides also agreed on Diamer-Bhasha project but due to strings of conditions by China, Pakistan backtracked and withdrew from the agreement on this project. China wanted to own this project. Differences erupted between them over the operation and maintenance costs. China also expressed a desire to build another operational dam in the region. These conditions for the project as Water and Power Development Authority chairman Muzammil Hussain said were "not doable and against our interests" (*South China Morning Post*, 16 November 2017). Now, due to debt-ridden precarious economic situation, Pakistan is building this project through crowd funding seeking donations from its citizens and people working in foreign countries.

Not only in hydroelectricity sectors, China has also invested in the other water sectors of the country under the CPEC. With an agreement to carry out joint study to cooperate in agriculture sector between Pakistan and China, the latter has shown interest in improving irrigation system in Pakistan. In 2018, Pakistan and China talked about signing of a legal framework agreement under the CPEC with an aim to bring Chinese investment into the agriculture sector of Pakistan. Under the arrangement, Pakistan would keep the required quantity of the products and the surplus would be exported to China (*The Express Tribune*, 16 October 2018). During the visit of the Pakistani prime minister Imran Khan to Beijing in October 2019, the two countries agreed to carry out a joint study to find out feasibility of cooperation in some of the agricultural projects (Ministry of Foreign Affairs, People's Republic of China, 2019). In the agriculture sector the most important is of irrigation

which is a problem for Pakistan because of declining availability of waters. China is already assisting Pakistan in developing irrigation sector. The Chinese ambassador to Pakistan Yao Jing said that “China seeks to contribute to the overall development of Balochistan’s mining, agriculture, fisheries and water sectors.” (*Dawn*, 9 November 2019). Chinese companies are working to strengthen the irrigation sector of Balochistan (*ibid.*).

China is also helping Pakistan to develop sustainable water projects in its cities to address their drinking water problems. In July 2019, China handed over five ready-to-use solar-powered tube wells to Quetta’s Water and Sanitation Authority (WASA). Such tube well programmes have already been started in different parts of Balochistan, especially in southwest Gwadar city (*Xinhua*, 22 July 2019). China has also built two desalination plants and wastewater treatment plant in Gwadar to address water availability issues for the residents of the city.

Earlier, in June 2019 a Chinese company showed readiness to invest US\$3 billion in the clean drinking water and sanitation system in Lahore. The name of the company has not been disclosed, as negotiation is in the initial stages (*The Express Tribune*, 23 June 2019). The Asia Infrastructure Investment Bank which was set up in 2013 on the initiative from China with a headquarter in Beijing is considering a proposal to make an investment in Lahore Waste Water Management project and Karachi Water and Sewerage Service project (*Business Standard*, 2019).

Much before Afghanistan became a party to the BRI, in 2012 China has aided in the repair work for the Parwan Irrigation System. The contract to this project was given to Jiangxi Water and Hydropower Construction Company. This project has enhanced local energy supply and irrigation, and benefited around 100,000 people and 27,000 hectares of land. People were also rehabilitated under this project which was

started in December 2010 and finished in June 2012 (Embassy of China in Afghanistan, 30 September 2012).

In Bangladesh, China has built eight friendship bridges, including the US\$3.7 billion road and rail bridge across the Padma River (Ramachandran, 2019). In June 2014, the Bangladeshi government awarded a US\$1.55 billion contract to the China Major Bridge Engineering Company Limited to build the core structure of the Padma Bridge project (Xinhua, 10 May 2018). They are working on the ninth bridge. All these bridges will enhance trade and connectivity within the country.

Further, China Communications Constructions Company is helping to build Karnaphuli river tunnel in Bangladesh. This tunnel will be 3.5 kilometres long under the river connecting Chittagong city to the other side of Karnaphuli River, and indirectly connects the city with other parts of the country through the Dhaka-Chittagong-Cox's Bazar highways (*Dhaka Tribune*, 11 February 2019). Its foundation stone was laid by Bangladesh's prime minister Sheikh Hasina and Chinese president Xi Jinping on October 14, 2016. On 5 December 2017 the construction work commenced, and it is likely to be completed by 2022 (*ibid.*). However, one of the major problems of the tunnel is siltation on the bed of the river Karnaphuli which threatens proper operational activities at Chittagong port. To tackle this problem of siltation, there is a plan to construct a tunnel crossing the river Karnaphuli, instead of building another bridge over the river (*ibid.*).

Bangladesh does not have water availability problem; however, it has an issue of water quality. A large quantity of Bangladesh ground water and surface waters are polluted. To address this issue, China has ventured into the water treatment sector of Bangladesh. On April 12, 2019 China CAMC Engineering Co, a subsidiary of China National Machinery Industry Corporation (Sinomach), signed an agreement with

Gandharbpur Water Treatment SNC (Bangladesh Branch) to build a water treatment plant in Dhaka. It is estimated that this will produce 500,000 cubic meters of clean water daily (Sinomach, 2019). It will take about 42 months to get complete and cost around US\$66.42 million (*ibid.*). Other Chinese company, China Harbour Engineering Company Ltd. (CHEC), a subsidiary of China Communications Construction, is building surface water treatment plant in Khulna (*China Daily*, 5 April 2017).

Earlier in August 2015, Hydro China Corporation was given Engineering Procurement and Construction contract for the Dasherbandi Sewage Treatment Plant project with the Dhaka Water Supply & Sewerage Authority. Its value amounted to US\$280 million (*China Daily*, 12 December 2018). On November 21, 2016, the two parties signed a supplementary contract for the project. On May 8, 2017, the main contract and loan agreement came into effect (*ibid.*). The project officially started on August 1, 2017, with a contract period of 36 months. It is expected to eliminate pollution from Balu river and provide 50,000 cubic metres of clean waters every day (*ibid.*).

Nepal is one of the water-rich countries of the world with a potential to generate around 83,000 Mega Watts (MW) of hydroelectricity. India is the highest investor in the Nepal's hydropower sector, but China is making its way. Post-BRI signing, in November 2017, the Nepalese government under Sher Bhadur Deuba had cancelled US\$2.5 billion deal with China's Gezhouba Group to build Budhi Gandaki Hydroelectric Project (Swain, 2018). On this issue, the current Prime Minister of Nepal Khadga Prasad Sharma Oli then said: "Political prejudice or pressure from rival companies may have been instrumental in scrapping of the project. But for us, hydropower is a main focus and come what may, we will revive the Budhi Gandaki project." (Chowdhury, 2018) Keeping his words, seven months after coming back in power, in September 2018

K.P. Oli's government awarded this project to the same Chinese company to develop the 1200 MW project (*News18*, 4 September 2018). Nepal had also invited the Chinese state-run Three Gorges Corporation to build a dam on river Seti in Western Nepal. However, it did not materialise. The Chinese firm wanted 75% stake in this project (Chellaney, 2017). In 2018 the negotiations between the Chinese and Nepalese failed; as a result, China pulled out from this project.

In June 2018 during Oli's visit to China, China and Nepal expressed "willingness to speed up the development of the three North-South Economic Corridors in Nepal, namely Koshi Economic Corridor, Gandaki Economic Corridor and Karnali Economic Corridor in order to create jobs and improve local livelihood, and stimulate economic growth and development in those areas" (Ministry of Foreign Affairs, People's Republic of China, 2018). In 2019 during the visit of the Chinese President to Nepal, the two countries reiterated the MoU they signed in 2018 over further cooperation on hydropower sector.

In June 2019, Chinese company Sinohydro Corporation Limited was employed to complete the remaining works related to tunnel of Melamchi Water Supply Project, Nepal's largest water supply project. Earlier the project was with an Italian contractor Cooperativa Muratori e Cementisti di Ravenna. This project aims to supply 170 million litres of fresh water per day to capital Kathmandu. Once fully operationalised Melamchi project is expected to fulfill the existing water demands of Kathmandu. Melamchi project is one of the oldest under-construction projects whose implementation has been delayed due to a number of factors including local people's obstructions, massive earthquake in 2015 and dispute between the board and the previous contractors (Xinhua, 30 September 2019). Sinohydro has been involved in other Nepalese projects as well. It has jointly developed 50MW Upper Marsyangdi Hydropower Project with Nepali company Sagarmatha

Power Company. The Sinohydro is also a contractor for the under-construction 456MW Upper Tamakoshi hydroelectricity project, the largest domestically funded hydel project in Nepal and 140MW proposed Tanahu project (*ibid.*).

China is also building a tunnel for water diversion in Nepal under the BRI. This project will transfer water from the Bheri River to the Babai River and provide irrigation for 51,000 hectares of farmland in central and western Nepal (*China Daily*, 19 April 2019).

In Sri Lanka, the Power Construction Corporation of China (POWERCHINA) is building a “South-to-North Water Diversion Project”. The Moragahakanda (M) and Kaluganga (K) dams projects undertaken by POWERCHINA’s Sinohydro Bureau 14 Co are important to conserve water in Sri Lanka (*China Daily*, 14 November 2018). Engineering Procurement and Construction contract for this project was signed in June 2012 between Sinohydro Bureau 14 Company with Sri Lanka for the M Dam. It is funded by China Development Bank and the government of Sri Lanka. K dam that was founded in 2014 channels water to M dam and increase the irrigation capacity of the Mahaweli River in central Sri Lanka (*ibid.*).

Besides, in August 2019, Chinese firm Gezhouba Group Co Ltd won a tender to build the main civil works, which includes a dam, of the Moragolla Hydro Power Plant. It is a part of the Green Power Development and Energy Efficiency Improvement Investment Programme. This dam will be on the Mahaweli River, and is located in Ethgala, Kandy. For this project the Asian Development Bank will be providing US\$113.86 million – about US\$10 million is to be spent by the Sri Lankan government (*Steelguru*, 2019).

In Maldives, to alleviate water crisis in Malé, after the desalination plant was destroyed in fire in 2014, the Chinese government helped it. Soon after the news of fire spread, a Chinese Navy submarine rescue

ship named Changxing Island which could produce over 70 tons of desalted water every day arrived in Malé in December 2014. It was loaded with nearly 700 tons of fresh water and started to supply water to the Maldivian people through its own sea water desalination facilities. Later, two Ilyushin Il-76 aircrafts of the Chinese Air Force loaded with 40 tons of drinking water arrived in the Maldives. The Chinese government and China-funded enterprises in Sri Lanka and the Maldives airlifted another 65 tons of drinking water to the Maldives through civil aviation flights (*ReliefWeb*, 8 December 2014). Help also poured in from India and Bangladesh. Later, to repair the plant China donated US\$500,000.

All such Chinese investments in the hydel projects, water treatment plants, irrigation etc. are not necessarily a part of the BRI-led investments; however, most of such investments have come after the countries become a part of the BRI or expressed willingness to join it. Like other infrastructure projects, Chinese investments in the hydroelectric and other water projects also put burden on the borrowing countries, as they have to pay higher rate of interests. This opens a debate on “debt trap”.

4. The “Debt Trap” Argument

As Chinese investments under BRI is increasing, there is a fear that the receiving countries will find themselves in a debt problem. There is also argument that China is engaged in a debt diplomacy through which it is pushing the BRI member countries into debt to occupy politically predatory position. The case of Hambantota project, discussed below, and of Maldives say a lot about such intentions clearly. Besides, “debt-trap” corruption charges have also been levelled against the Chinese companies.

In Pakistan it is being argued by some scholars, mainly social scientists, that China is using similar tactics which were used centuries back by the East India Company to colonize India. There is also a fear expressed that Pakistan would be caught in the Chinese debt trap due to CPEC-related loans whose rate of interests are relatively higher than most of the other donating institutions such as the World Bank (Haq, 2017). For example, there is a likelihood that the construction cost of the “Indus cascade” projects is going to be around US\$98 billion which Pakistan has to borrow. The interest on this borrowing will accumulate at US\$5 billion per year. So, after 20 years, the taxpayers would have to pay around US\$200 billion (Abbas, 2017). However, the government of Pakistan does not buy such arguments.

When in opposition, the PTI had raised a number of objections against the projects under the CPEC. One such project is the 27.1 kilometres long China-funded Orange Line Metro Train project in Lahore (PTI, 4 March 2019). The PTI criticized it as a waste of public money with insinuation that corruption was rife in this and many other CPEC projects. After coming into power, the PTI government expressed a desire to review all CPEC projects; however, Beijing was ready to do so only for those which have not yet started.

On the development front, one of the early tests for Imran Khan was revamping of colonial-era rail line project linking Karachi to Peshawar. This is a US\$8.2 billion-dollar project which the government had to think over due to debt concerns and terms of financing (*The Straits Times*, 30 September 2018). Later, after a re-think, the amount for the Karachi-Peshawar project was slashed by US\$2 billion from US\$8.2 billion to US\$6.2 billion. Also, to revamp the 1,872 km rail line project, the government of Pakistan explored funding options that “depart from the traditional BRI lending model – whereby host nations take on Chinese debt to finance construction of infrastructure – and has invited

Saudi Arabia and other countries to invest" (*ibid.*).

In South Asia, Bangladesh is the second-biggest receiver of Chinese investment, after Pakistan. In April 2019 Speaking to the *South China Morning Post* ahead of the second Belt and Road Forum in Beijing, Bangladesh Minister of State for Foreign Affairs Mohammed Shahriar said that Bangladesh "never will" ask China for more loans. He said any amount of debt can be "dangerous" for countries not achieving high economic growth (*South China Morning Post*, 23 April 2019). Zahid Hussain, lead economist of the World Bank's Dhaka office, points that "The loans granted to Bangladesh by China so far account for just 6% of the total debt ... There is not enough information as to the grounds on which the loans have been granted" (*DW*, 11 July 2019). Chinese investments bring both risks and opportunities. However, there are some who remain worried due to China's growing economic influence over Bangladesh (*ibid.*).

As Sri Lanka has borrowed large amounts from China in recent years, to pay the debt, as being maintained by many political commentators, it gave Hambantota port and around 15,000 acres of land around the port to China on a 99-year lease on a debt-equity swap. While handing over the port, Sri Lanka made China accept a provision that Hambantota cannot be used for military purposes (Weerakoon and Jayasuriya, 2019). In this exercise, a Chinese company – China Merchants Port Holding – Sri Lanka received US\$292 million out of a US\$1.12 billion deal. The US\$1.5 billion Hambantota port was launched in 2010 but was incurring losses due to lack of commercial activity (Reuters, 10 December 2017).

After Mahinda Rajapaksa was elected president in 2005, there was renewed interest in the project. After many other countries such as India refused to be a part of this project, Rajapaksa lured the Chinese investment to complete the incipient stages of the project. The first phase

of the Hambantota Port project was built through a US\$307 million loan from the Export-Import Bank of China (Exim Bank) at 6.3% interest which was very high (*Ship Technology*, 2018). The Sri Lankan Ports Authority began devising what officials believed was a careful and economically sound plan in 2007. It called for a limited opening for business in 2010 (Abi-Habib, 2018). Over the years the Hambantota project was constructed and renegotiated with China Harbor Engineering Company, one of Beijing's largest state-owned enterprises. Although tens of thousands of ships pass by along this shipping lane, the port drew only 34 ships in 2012 (*ibid.*).

The Hambantota project is marked with corruption. *The New York Times* investigative story shows that large payments from the Chinese port construction fund flowed directly to campaign aides and activities for Rajapaksa, during the 2015 presidential elections (*ibid.*). In the final months of Sri Lanka's 2015 election, as the *NYT* report says, officials from the Chinese embassy in Colombo including the ambassador "broke with diplomatic norms and lobbied voters, even caddies at Colombo's premier golf course, to support Rajapaksa over the opposition, which was threatening to tear up economic agreements with the Chinese government" (*ibid.*). The report claims that at least US\$7.6 million was dispensed from China Harbor's account at Standard Chartered Bank to affiliates of Rajapaksa's campaign (*ibid.*). Also, as the report says, 10 days before the polls "around US \$3.7 million was distributed in checks [cheques]: US \$678,000 to print campaign T-shirts and other promotional material and US \$297,000 to buy supporters gifts, including women's saris. Another US \$38,000 was paid to a popular Buddhist monk who was supporting Mr. Rajapaksa's electoral bid, while two checks [cheques] totalling US \$1.7 million were delivered by volunteers to Temple Trees, his official residence. Most of the payments were from a subaccount controlled by China Harbor, named "HPDP Phase 2,"

shorthand for Hambantota Port Development Project.” (*ibid.*)

Despite all such efforts, Rajapaksa lost the elections, and President Maithripala Sirisena, assumed office with a mandate to scrutinize Sri Lanka's financial deals under BRI: “It also faced a daunting amount of debt: Under Mr. Rajapaksa, the country's debt had increased threefold, to US \$44.8 billion when he left office. And for 2015 alone, US \$4.68 billion payment was due at year's end.” (*ibid.*) Conversely, on this issue of debt-equity swap, Dushini Weerakoon and Sisira Jayasuriya write that it is not correct to say that the Hambantota port was ceded to China because Sri Lanka faced problems in paying back Chinese loans. They write:

Sri Lanka's debt repayment problems had very little to do with Chinese loans. Chinese loans comprise about 10 per cent of Sri Lanka's total foreign debt. Of this debt, over 60 per cent was lent to Sri Lanka on concessional terms that, while not as generous as those from Japan – Sri Lanka's largest bilateral source of loans – were not really excessive (typically at fixed rates of 2 per cent, with other fees of 0.5 per cent and average maturity of 15 to 20 years). The remaining 40 per cent of non-concessionary loans from China comprise only 20 per cent of Sri Lanka's total debt from such borrowings. The rest was borrowed from international capital markets in the form of sovereign bonds, term financing facilities and foreign holdings of gilt-edged securities.

(Weerakoon and Jayasuriya, 2019)

In the case of the Maldives, China is accused of putting the country into severe “debt-trap” by investing in the projects and lending money to the country on higher interest rates. Few days after Solih took over, former president and the speaker of the Maldivian parliament,

Mohammed Nasheed claimed that the Chinese Ambassador to the Maldives, Zhang Lizhong, handed the government an invoice of US\$3.2 billion (*News18*, 23 November 2018). This is being denied by China which, however, maintained that the amount of debt is nearer to US\$1.5 billion (*ibid.*). In July 2019, Chinese ambassador to Maldives Zhang Lizhong, citing figures from the Chinese central bank, said that the debt owed to China was US\$1.5 billion out of a total debt of US\$3.2 billion, and the bulk of the cost was grant aid from China (*Maldives Independent*, 22 July 2019). According to the Maldivian Central Bank, the Chinese debt includes “guaranteed debt” of US\$900 million. Abdulla Yameen provided sovereign guarantees for US\$1.36 billion worth of loans taken by 23 state-owned enterprises and one private company (*ibid.*). It was also reported that the Solih government would pull out from the Free Trade Agreement (FTA) with China which was signed by Yameen. Nasheed said: “The trade imbalance between China and the Maldives is so huge that nobody would think of an FTA between such parties ... China is not buying anything from us. It is a one-way treaty.” (Reuters, 19 November 2018)

However, after few months of assuming office, the Solih government began engagement with China on the issue of investments and infrastructure developments. In September 2019, Maldivian foreign minister Abdulla Shahid was in Beijing where he met the Chinese officials and talked about cooperation between China and Maldives on all fronts.

5. Conclusion

For the success of the BRI, China is making large investments in the infrastructures in South Asia. As mentioned in this paper, with the help of China, the South Asian BRI countries have developed several

infrastructures in their respective countries. Among others, one of the important sectors is water where China is making big investments. Some of these investments, as critics find, may lead these countries into “debt-trap”. However, despite such arguments the South Asian countries are actively participating in the BRI programme. They feel that the Chinese money is essential to develop infrastructure projects in their respective countries.

Besides debt trap, another criticism of this BRI-led infrastructure building in South Asia is massive corruption. The case of Hambantota port was exposed by *The New York Times*. This worries the Chinese leadership. In one of his speeches Xi Jinping said that: “We will also strengthen international cooperation on anticorruption in order to build the Belt and Road Initiative with integrity.” (Abi-Habib, 2018). Due to corruption charges, in 2018 a Chinese company – China Harbour Engineering – has been banned from any future contract in Bangladesh. This company was accused of attempting to pay bribe to an official at the ministry of roads, stuffing US\$100,000 into a box of tea. Earlier in 2009 China Harbour’s parent company, China Communications Construction Company, was banned for eight years from bidding on any World Bank projects because of corrupt practices in the Philippines (*ibid.*).

Finally, though it has not been touched in this paper, the growing presence of China and growing investment under the BRI is somehow related to the growing differences between India and its South Asian neighbouring countries. Due to political tensions with India, Pakistan depends a lot on China for political help. This makes the Chinese bargain their economic deals by providing political support. Also, debt-ridden Pakistan needs someone to overcome its financial crisis, and China is providing that much needed oxygen to it. Although Bangladesh has a good relationship with India, it also needs Chinese money to

develop infrastructure. Bangladesh is properly balancing both India and China. Nepal under the Oli government is inviting China to make investments in its infrastructure. The economic blockade of Nepal carried out by India in 2015-16, though the government of India denies, has made the Himalayan country get much closer to China. Under Abdulla Yameen, Maldives maintained distance from India and invited China to make huge investments in the country. After Solih came into power in September 2018, he vowed to review and renegotiate some deals; however, he has not.

Acknowledgment: The author is thankful to the anonymous reviewers whose comments have improved this paper.

Note

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Rivalry for Global Dominance

Toward an Explanation of U.S.-China Trade Disputes: Entrepreneurial Innovation, Protectionism and the Struggle for Hegemony in the Global Economy

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Abstract

The paper puts forward an international development model based on entrepreneurial innovation and learning to explain the origin of recent U.S.-China Trade disputes. It argues that Schumpeterian innovation initiates a wave of “creative response” in an economy and widens income and productivity gaps between this economy and the rest of the world. Equipped with advanced military weapons and technological skills, the advanced nation (first mover) calls for free trade with an attempt to enter overseas markets. Preventing the collapse of their economies, governments of developing economies (latecomers) imposes tariff and other means to limit import of foreign goods. This is the beginning of international conflict. Taking the advantages of cheap labor and resources in developing areas, transnational corporations from the advanced nation enter developing economies in the form of foreign direct investment. They soon penetrate and destroy traditional industries

of developing economies. Being weak in technologies and resources, developing economies have no choice but to follow the leader and are content to be a follower. Hence, the world enters into a state of cooperation and harmony. At the same time, foreign direct investment entering developing areas provides opportunities for latecomer firms to learn and catch up. Through learning and imitation from transnational firms, latecomer firms are able to produce and sell imitative and improved products at lower prices. As international markets are flooded with cheap and improved goods, profit margins in the international market decline. Seeing that latecomer economies are able to catch up and threaten its supreme global position, the advanced nation reverts its free trade strategies and calls for trade protection. The tension between two economic camps (the first mover and latecomer economies) increases. This dilemma will not be resolved until another wave of Schumpeterian innovation emerges to redefine the international division of labor and world economic order. This model is illustrated by US-China trade relationship since 1979 and allows us to understand the recent US-China trade disputes.

Keywords: *international development, US-China trade disputes, entrepreneurial innovation, learning and catching up, protectionism*

1. The US-China Trade Disputes

The great power competition with China is “a fight with a really different civilization and a different ideology ... it’s also striking that it’s the first time that we will have a great power competitor that is not Caucasian.”

Dr. Kiron Skinner, Director of Policy Planning at the US State Department

Source: *The Washington Post* (4 May 2019)

“If both sides treat their trade dispute purely on its own merits, their trade negotiators will be able to resolve it. But if either side uses trade rules to keep the other down, then the dispute will not be resolved.”

Lee Hsien Loong, Prime Minister of Singapore

Source: *Channel News Asia* (31 May 2019)

After Deng Xiaoping’s open-door policy in 1979, China and the United States have gone through a relatively harmonious trade relationship for a period of time. However, after more than 40 years of economic reform, China becomes the second largest economy in the world and rises as a global superpower. The United States (hereafter U.S.) is well aware of China’s threats. Clashes between two nations begin.

Since January 2018, China and the U.S. have engaged in a trade war involving the mutual imposition of tariffs. In particular, the U.S. President Donald Trump (hereafter as Trump) wants to fix China’s “longtime abuse of the broken international system and unfair practices.”¹ Furthermore, in April 2018, the U.S. complained to the World Trade Organization (WTO) that China has severely violated intellectual property rights. Relying on Section 301 of the Trade Act of 1974, the U.S. claims that Chinese laws undermine intellectual property rights by forcing foreign companies in the joint ventures to give the Chinese firms access and permission to use, copy and modify American technologies. Trump also considers China’s plan of “Made in China 2025” as a severe threat to the U.S. economy and national security, therefore imposed tariff and other regulations on Chinese goods, in an attempt to curb China’s expansion. However, China argues that U.S. trade policies are typical unilateralism, protectionism and bullying. China argues that the U.S. government is a clear violation of the basic WTO principle of most-favored-nation treatment as well as the basic spirit and principles of international law (*China Daily*, 13 July 2018).

Effort on cooling down the trade disputes between the two nations failed. The trade war has escalated on 5 May 2019. The Trump administration raised the tariffs of 10% levied on US\$200 billion worth of Chinese goods to 25% on 10 May 2019. China retaliates by raising tariffs on \$60 billion worth of U.S. goods on 1 June 2019 (*BBC*, 14 May 2019; see also Appendix 1).

Apart from tariff, the U.S. also sanctioned on China's information and communication technology. On 15 May 2019, Trump issued the Executive Order which gave the government power to restrict any transactions with "foreign adversaries" that involved information and communications technology (*South China Morning Post*, 16 May 2019). Trump emphasized that these adversaries posed "unacceptable risks" to national security. On the same day, the U.S. Department of Commerce added Huawei and 70 "affiliates" to its "entity list" under the Export Administration Regulations. This restricts U.S. companies from doing business with Huawei without a government license (*ibid.*).

Responding to the U.S.'s offensive moves, the Beijing government states that China will defense its legitimate rights and interests at all costs. He warns the U.S. government not to go further down the wrong path to jeopardize China-US relations (*South China Morning Post*, 21 May 2019).

Literatures on international trade disputes are not lacking. When international economic relation is viewed in terms of trade, mainstream neoclassical studies have utilized the Neo-Ricardian theory of comparative advantage. While this neoclassical theory has contributed to our understanding of international trade and development, it neglects the important fact that entrepreneurs or governments can alter the given resource situation of an economy and hence its comparative advantage. In this sense, Porter (1990: 65) is right to contend that "the principle of comparative advantage ... fails to capture the determinants of economic

success in the modern world economy”. He recommends using the concept of “competitive advantage” which emphasizes on organizational learning, creative thinking and knowledge. More crucially, the theory of comparative advantage ignores political, cultural or social factors in trades. Huntington (1993; 1997) argues that the US-China conflicts represent a clash of civilizations. Zhang Lin, a Beijing-based political economy analyst comments that “the growing conflict between Beijing and Washington is very little to do with tariffs”. Instead, it is “a clash of civilizations and ideologies” (*South China Morning Post*, 15 October 2018). The U.S. and China are now struggling for hegemony in global affairs.

Given that there was very little research incorporating international trade, technology transfer, and politics in the world development, this paper attempts to fill the gap. It will formulate a model of international development which incorporates entrepreneurial innovation, learning, technology transfers and protectionism associated with the struggling for hegemony between the world’s two superpowers. The model allows us to understand the US-China trade war in broader international political economy perspective.

2. Toward a Model of International Development: Entrepreneurial Innovation, Protectionism and Struggling for Hegemony

Based on Cheah and Yu (1996: 241-266), our model starts with two types of entrepreneurship, namely Schumpeterian and adaptive². Schumpeterian innovation is extraordinary. It imposes a “creative destruction” to the economy (Schumpeter, 1934/1961: 81-86). Adaptive entrepreneurs attempt to exploit opportunities in the economy. Their activities bring about a change *within* the system.

2.1. Schumpeterian and Adaptive Entrepreneurship

According to Schumpeter (1934/1961), entrepreneurs bring about technological breakthroughs and exert a disturbing force on an economy. Schumpeterian entrepreneurship encompasses three essential characteristics.

First, it can always be understood *ex post*; but it can practically never be understood *ex ante*; that is to say, it cannot be predicted by applying the ordinary rules of inference from the pre-existing facts. Secondly, it shapes the whole course of subsequent events and their long-run outcome. It changes social and economic situations for good and creates situations from which there is no bridge to those situations that might have emerged in its absence. Thirdly, the frequency of its occurrence has something to do with the quality of the personnel available in the society, with relative quality of personnel and with individual decisions, actions and patterns of behaviors (Schumpeter, 1947: 150).

Schumpeter's mode of entrepreneurs is very rare in economic history. Most entrepreneurs are adaptive or imitative but their contributions in economic development should not be ignored. Baumol (1968: 85) argues that imitative entrepreneurship deserves a place alongside innovative entrepreneurship in the front rank of contributors to an economy's prosperity. Imitation is a clever competitive strategy involving investment, creativity and insight (Bolton, 1993). Imitative entrepreneurs exploit the success of others. They invent neither products nor services, but rather perfect and position them. Imitation adds some product attributes so that the product differs slightly from the original and fits in a slightly different market. That is, imitators supplement on what is still lacking in the markets. Drucker (1985: 203-207) correctly points out that imitators do not proceed by taking away customers from

the pioneers who have first introduced a new product. Instead, they serve the markets which the pioneers have created but have not yet adequately serviced.

The two modes of entrepreneurship, namely Schumpeterian and adaptive, exert different impacts on international development. They are associated with what Schumpeter (1947) referred to as creative and adaptive responses in economic history.

2.2. Entrepreneurial Innovation and Two Types of Economic Responses

A central aspect of dynamic competition process in international development is that some firms in advanced nations deliberately strive to be pioneers in technological innovations, while others attempt to catch up by imitating the success of the leaders. In other words, adaptive response follows creative response. Once a new possibility is tried, imitators will arise. They perceive the advantages of new combination and are eager to share in those advantages. These imitators do not have the will or drive to overcome the social resistance to innovation themselves but are ready to adopt new methods promptly as soon as the initial resistance has been overcome by the genuine innovator. It is in this way that an innovation achieves widespread adoption in the system. Some kinds of subsidiary innovations may be derived from the initial breakthrough (Cauthorn, 1989: 14). Schumpeter (1934/1961: 228) summarized the relationship between the two responses as follows:

If one or a few have advanced with success many of the difficulties disappear. Others can then follow these pioneers, as they will clearly do under the stimulus of the success now attainable. Their success again makes it easier, through the increasingly complete removal of the obstacles ... for more people to follow suit, until finally the

innovation becomes familiar and the acceptance of it a matter of free choice.

Schumpeter's two types of response can be modified to explain the dynamic global development process. This paper argues that during the international development process, creative response in the Western society is brought about by Schumpeterian entrepreneurship, while adaptive response is associated with adaptive or imitative entrepreneurship in latecomer economies. The dynamic development model is explained below.

2.3. The Dynamic International Development Process

Our paper confines to the international relationship between a first mover in the West and a follower in the East. Assume that initially extraordinary discovery or Schumpeterian innovation (creative response) occurs in a Western society such as the U.S. and hence makes this nation economically and technologically more advanced than other economies. We would like to examine the development path of a latecomer economy and the resulting pattern of international relationship.

2.3.1. Technological breakthrough in a Western society

Schumpeterian entrepreneurship initiates a creative response in an economy and widens the income and productivity gaps between this economy and other developing economies. In other words, developing economies are made to lag behind the advanced nation due to Schumpeterian innovation and become a latecomer. The advanced nation, as a first mover, with its advanced technology and high production productivity will explore and penetrate foreign markets. At the initial stage of international trade, only final goods are exported to developing economies. To ensure a smooth international investment,

business people from the advanced economy call for free trade and government assistance during their exploration of overseas markets. Advanced technological skills and superior products of the advanced nation soon penetrate and destroy traditional industries of developing economies. Preventing the collapse of their economies, the government of latecomer economies introduce tariff and other means to limit the import of foreign goods. This is the beginning of international conflict. Being weak in both military powers and technological capabilities, developing economies cannot prevent the inflows of cheap and superior foreign goods. They lose their bargaining power and even their taxation sovereignties³. Furthermore, taking the advantages of cheap labor in latecomer economies, multinational corporations from the advanced economy enter latecomer economies in the form of foreign direct investment. Though political conflict occurs at this stage of development, international relationship is still harmonious in economic sense because each nation fits well in the international division of labor. During that stage, the world economy enters a state of cooperation and harmony which is initiated by Schumpeterian innovation in the Western society, and prolonged by the imitative follower in latecomer economies. Carlos Escudé's Peripheral Realism thesis on foreign policy further illuminates our argument.⁴ Escudé (2015: 26-27) stresses "the differences in functions engendered by power differentials between nations". He argues that the world order as a whole is hierarchical. Superpowers are rule-makers who set the rules of world order. The United States is an example. On the other hand, the peripheral states such as Asian developing nations or Latin American nations are rule-takers. Developing economies accept the rules as long as the rules do not damage their economic interests (Escudé, 2015: 27). It is crucial to know that rule-takers can emerge as rule-makers as their economic and

political powers grow. In development economics, this is referred to as catching-up.

2.3.2. Catching up in latecomer economies

Under the impact of foreign goods and technologies, traditional handicraft activities of the latecomer economies go through drastic transformations. Interestingly, transnational enterprises from the advanced nation make huge profit from foreign direct investments; at the same time, they also provide huge profit opportunities for latecomer firms. It is often possible that, through learning, imitation and subsidies from their governments, latecomer firms can catch up with the Western developed countries (Yu, 1997). Catching up is possible because: (a) The productivity of developed countries diminishes. In other words, productivity cannot be increased dramatically beyond the threshold unless there is technological breakthrough. (b) As the developed countries put huge investment on specific production plants and technologies, it is economically impractical to switch to a new, though efficient, production method. That is because production and development is path dependent. (c) As a follower, it is easier for latecomer firms or countries to adjust certain advanced production technology. Also, they can avoid making the same mistakes by the developed countries (Dore, 1973: 68; Abramovitz 1988: 337; Ames and Rosenberg 1963: 18).

Learning from the first mover, latecomer firms are able to produce and sell imitative and inferior products at lower prices initially and then improved products later. As international markets are flooded with cheap and improved goods, profit margins decline. The world economy will subsequently adjust downward. The latecomer economies, now with new production capacity, gains more political bargaining power.⁵ The tension between two economic camps (leaders and followers) increases.

Previous harmonious economic relationship vanishes. Encountering economic threats from the followers, the advanced economy undertakes protection policies. In the global scene, free trade view gives way to new protectionism. This dilemma will not be resolved until a new wave of creative response emerges. In the next section, we shall adopt our model to explain the US-China trade conflict.

3. The US-China Trade Conflict

This paper uses the U.S. as an illustration of the first mover and China as an Asian latecomer economy. Our story starts at the time when China is one of the poorest nations in the world after the Cultural Revolution while the U.S. has been a dominant player in world's affairs. Moreover, after the fall of the Soviet Union in 1991, the U.S. became the world's only superpower (Escudé, 2015: 24). It goes no further to say that economic power between the U.S. and China contrasts sharply at the beginning.

3.1. China in the Early 1980s

China under Mao Zedong's leadership still remained, both economically and intellectually, in extremely backward conditions. At the end of the Cultural Revolution, China was one of the poorest nations in the world. Learning from mistakes, Deng Xiaoping embarked on a Four Modernizations Program in order to revive the economy. Among others, the program attempts to adopt foreign technologies to boost China's productivity, and the use of joint ventures with foreign firms (e.g. the U.S. and Japan) to bring funds and investment to China (Yu, 2014: 613). Foreign direct investment in backward economies is regarded by Marxists as exploitation. However, the Deng's government envisaged that the strategic use of foreign direct investment could help China

modernize by gaining access to foreign technology and capital. Since China “opened” her door in 1979, as a result of some preferential measures, foreign direct investments poured into China to take advantage of cheap labor and rentals.

3.2. The United States as a Superpower in the Global Economy

The U.S. has been the world’s economic and technology powerhouse after Second World War. Since 1984, the U.S. economy entered into one of the longest periods of sustained economic growth (U.S. Department of State, 2019). Specifically, in the 1980s, the U.S. industry has performed well in information and communication technologies. Continuing leadership in the new industries provides U.S. productivity growth and competitiveness in the world market (Committee on Japan, 1997: 50). In particular, Steve Jobs and Bill Gates, two of America’s most brilliant minds, can be regarded as Schumpeterian innovators. The two pioneers in the computer world, together with other techno-entrepreneurs, not only created new industries⁶, but also revolutionized the lifestyle of mankind (*Aljazeera News*, 31 July 2017). As a global leader in the information-related technologies, American firms were eager to export their products for profits. They lobbied their government to open trades with other developing economies, and in particular with China. Some of the U.S. government’s trade strategies included helping China enter WTO so that China would comply with international rules of game and liberalize control over American exports of advanced technologies.

3.2.1. Inducing China to play the international rule of game by helping China enter WTO

When American firms enjoy a clear competitive edge in world markets, they lobby their government to push for free trade (*Financial Times*, 24

June 2019: 17). In order to induce China to open its markets and conduct a freer trade, the U.S. tried to help China enter the WTO so that China would comply the international rule of game. The Clinton administration at the time identified WTO accession as one of the measures available to the U.S. for influencing China's trade and development (Brainard, 2001). The U.S. government finally won legislative approval for China's entry into the WTO in the Congress. China's entry into the WTO had a profound impact on US-China relations for years to come. Specifically, American exports to China increased by 81 percent in the three years after China joined the WTO, compared with 34 percent in the three previous years. As the business environment in China improved, American entrepreneurs explored new opportunities in China. In 2004, Wal-Mart, one of the America's largest corporations, had 6,000 suppliers over the world. Of these, 80 percent came from China. As a result, China emerged from relative economic insignificance nation to become the world's third largest trading nation after the U.S. and Germany in 2005. In 1978, the total value of China's trade was only US\$20 billion, ranking 30th in the world. However, China's trade rose to US\$3.87 trillion in 2005 (Wang, 2013).

3.2.2. Liberalizing control over American exports of advanced technology

The US-China economic relations at the time were also facilitated by the steady liberalizing of U.S. controls over American exports of advanced technology. In 1980, American products exported to China were re-grouped from Category Y (the Warsaw Treaty countries) to Category P (new trading partners with the U.S.), then to Category V (American allies). The change allowed additional exports to China. A three-tiered system of export licenses further streamlined the licensing process, placing 75 percent of export license applications in a "green zone" under

the authority of the U.S. Department of Commerce (Wang, 2013). In the second half of the decade, finished manufactures and technologically advanced products began to enter the China market. The U.S. was one of the largest investors in China, with about \$3 billion in assets by 1985. American firms entered China by forming joint ventures with Chinese firms or government agencies. Early entrants into China included giants such as AT&T, American Motors, American Express, Gillette, Kodak, to name a few. Trades in the 1980s were enthusiastic on both sides. Their commercial relationship grew 44 percent per year (*ibid.*). In the 1990s, trade developments were heavily influenced by the stunning performance of the information technology sector in the U.S. According to Information Technology Association of America (1996), information technology became America's number one export. It was obvious that US's IT industries increasingly dominated economic performance all over the globe (Brainard, 2001).

3.3. China's Adaptive Response: Learning from and Imitating Foreign Multinational Firms

Foreign direct investment is useful for latecomer economies to catch up with first mover economies. As multinational firms from advanced economies take the advantage of cheaper resources in the developing economies and invest there, local firms in latecomer economies learn their skills and imitate their products. According to their abilities to absorb foreign technologies, latecomer firms modify and gradually create some new designs. From a large pool of knowledge, they adopt foreign technology and improve on it. Later, some latecomer firms may spend money on R&D and move away from pure copying. By trial and error, eventually some firms establish their own brands. More importantly, by selling improved designs at lower prices, local producers can even threaten the original suppliers from advanced countries. They

can compete in world markets. Of course, the success depends on the absorptive capacity of the nation.⁷ This argument correctly explains China's development.⁸ According to a report in London (Economist Intelligence Unit, 1 August 2002), China was once seen as little more than a vast sweatshop, cheap low-tech production center. However, that perception is changing. As multinationals relocated both factories and research and development (R&D) to China, Chinese firms strove to develop home-grown products. Gradually, China has become a world center for high-tech manufacturing. Chinese firms have been associated with industrial value chain by the most well-known foreign technology brands, including Microsoft, Intel and Lucent of the US (*Financial Times*, 19 April 2002). The rapid shift of global manufacturing capacity to China has prompted commentators to predict the emergence of a new workshop for the world. However, few have noticed a newer but equally pronounced migration of foreign research and development operations to the world's most populous nation.⁹ As *Financial Times* (19 April 2002) reports:

The importance of this trend, evident not only in information technology but in automation, supplies a potent riposte to sceptics who have argued that China was destined to become a giant sweatshop, productive but low tech. And although much of the cutting-edge work is confined to the labs of multinational firms, the people executing it are almost exclusively Chinese. Over time, ideas and skills would be expected to flow to local companies.

In summary, in the early days, products from China are regarded as cheap, low-quality, imitative versions of original branded products. China strove to catch up with the U.S. economy. After learning and innovation, latecomer firms in China modify, improve and design new

products for exports. Meanwhile, China's relationship with U.S. at that time can be said to be harmonious. During the first decade of the 21st century, the bilateral relationship between China and the U.S. expanded at all levels, notably in communications and crisis management. Both countries have attached great political importance to their economic relations. From the Chinese government's standpoint, bilateral trade and foreign investment were crucial for China's modernization. For the U.S., while strengthening its trade with China, its strategies were also subjected to national security and moral constraints. Despite some fictions, the two governments have emphasized their economic collaboration and mutual benefits, and trade relations expanded rapidly, producing the world's most robust trade relationship (Wang, 2013).

3.4. China's Rise as a Global Superpower

As a capable learner, after pursuing a series of trade, technology and development policies, China has become a world's workshop, first in labor-intensive goods, and then high value added and technology-intensive products. China has transformed itself from being seen as "the world's factory" to a home of technology innovation, with some industries having leapfrogged the West.

In terms of industrial technologies, Americans cannot ignore China anymore. In certain high-tech industries such as nuclear reactors and high-speed rail, China is moving aggressively ahead. In some areas such as advanced coal technologies, alternative energy vehicles, renewable energy, supercomputing, China is already outpacing U.S. efforts. In IT sectors, China is surging ahead in e-commerce and Fintech. Specifically, China is a leader in mobile payment. Chinese consumers go beyond debit cards to new, cashless ways to buy. They are adopting mobile payment (via QR code and phones) at a rapid pace, going from £24 million of transactions per year in 2012 to £9.8 trillion in 2016. The

cashless payment system also means that Chinese consumers now sell their own products online. Furthermore, China is currently the second largest investor in artificial intelligence enterprises after the U.S. (*The Telegraph*, 16 November 2018). Obviously, the U.S. must innovate or put itself at risk of falling behind (Aston, 2010).

With technological capabilities, China attempts to expand its influence in global affairs. In particular, China helps developing nations build infrastructure in order to extend China's influences in these regions. In 2013, the Chinese government initiated "One Belt One Road" project and the Asian Infrastructure Investment Bank for strategic global expansion. The two projects serve as a vehicle for creating a new global economic and political order.

3.5. The Struggle for Hegemony: Competition between the United States and China

After the Cold War ended, the US became the sole superpower. However, China emerges as one of the global superpowers too after 40 years of economic reform. The two giants are struggling for world dominance. The U.S.-China relationship has entered a new era that is marked by intense confrontation and competition rather than by coordination and cooperation.

3.5.1. The U.S.'s view

There is a growing consensus in the U.S. that Americans have facilitated China's growth by allowing their manufacturers to invest in China, and it is time for America to wake up. They cannot afford to remain defensive when competing with China. Moreover, they believe that China has taken advantage of the U.S. for too long and that China has overtaken the U.S. in areas of advanced technology, such as artificial

intelligence and some military technologies, through secret means. To many Americans, Chinese firms “steal intellectual property, from corn seeds to computer technology” (Council on Foreign Affairs, 14 May 2019). Some politicians in the U.S. call for efforts to hold the Chinese Government accountable for intellectual property theft, counterfeit goods and acts of economic sabotage. Such views were seen in Trump’s foreign policies on China. In particular, Trump administration’s National Security Strategy now identified China as a competitor, and Chinese global influence as a challenge that must be prioritized (*ibid.*). On 4 April 2018, Trump announced that “war was lost many years ago by the foolish, or incompetent, people who represented the U.S.... Now we have a trade deficit of \$500 billion a year, with intellectual property theft of another \$300 billion. We cannot let this continue” (*ibid.*). Americans and the Trump government claim that China, instead of opening up and becoming more like the U.S., has held back in terms of political openness, and hence represents a challenge to American values and leadership (*Channel News Asia*, 31 May 2019).

3.5.2. *China’s view*

China believes that the U.S. government is trying to “thwart China’s legitimate ambitions” and “no matter what they (Chinese) do or concede on individual issues, the U.S. will never be satisfied” (*Channel News Asia*, 31 May 2019). In China’s view, when American firms enjoy a clear competitive edge in the world markets, they will lobby their government to push for free trade. When the U.S. loses its competitive advantage, it returns to tariffs and protectionism in the name of “fair trade” (*Financial Times*, 24 June 2019: 17).

In response to Trump administration’s initiation of a tariff war, Zhang Qingli, Vice Chairman of the Committee of the Chinese People’s Political Consultative Conference said that “China never wants a trade

war with anybody, not to mention the U.S., who has been a long term strategic partner, but we also do not fear such a war.... The U.S. side has disregarded a consensus with China after multiple rounds of consultations, insisting on waging a trade war against China and continuing to escalate it” (*Express News*, 23 October 2018).

4. The Showdown: Trump’s Offensive Strategies and China’s Retaliation

As a result, tariff and trade wars between the world’s two superpowers formally started on March 22, 2018, with the Trump administration investigated the possibility to apply tariffs on US\$50–60 billion worth of Chinese goods including aircraft parts, batteries, flat-panel televisions, medical devices, satellites and weapons. On 2 April 2018, China responded by imposing tariffs on 128 products imported from the U.S., including aluminum, airplanes, cars, pork, soybeans, fruits, nuts and steel pipes. (For a chronology of the US-China Trade War, 2018-2019, please refer to Appendix 1).

Apart from trade, conflicts “have built up between the two nations over issues including cyber-espionage, 5G technology, freedom of navigation, human rights” (*Channel News Asia*, 31 May 2019). On 15 May 2019, Trump signed an executive order, which sought to restrict the export of U.S. information and communications technology to “foreign adversaries” on national security grounds. The order was meant to support the U.S. allegations of espionage via Chinese telecommunications firms. Specifically, on mobile phone industry, on 15 May 2019, Trump issued the Executive Order on Securing the Information and Communications Technology and Services Supply Chain, which gives the government power to restrict any transactions with “foreign adversaries” that involve information and communications

technology. Trump made no specific reference to China, Huawei, or any other party, but emphasized that these adversaries posed “unacceptable risks” to national security. On the same day, the U.S. Department of Commerce added Huawei and 70 “affiliates” to its list under the Export Administration Regulations. This restricts U.S. firms from doing business with Huawei without a government license. Some U.S.-based companies immediately stopped their supplies to Huawei in order to comply with the regulation. For example, Google removed its ability to certify future devices and updates for its Android operating systems from Huawei (*South China Morning Post*, 21 May 2019).

Responding to the U.S. moves, Chinese envoy to the European Union (EU) stated that Beijing will not “sit idly by” as U.S. undermines “Chinese companies’ legitimate rights and interests”. China warns the U.S. “not to go further down the wrong path, to avoid further disturbances to China-US relations” (*ibid.*).

It remains to speculate what will happen to the trade war in the future. Our model suggests that the U.S.-China conflict and trade disputes will proceed until another wave of Schumpeterian innovation emerges to make many trade protection policies ineffective. New technologies will once again widen economic and productivity gaps between first mover and follower economies. It will also redefine international division of labor. As it happens, the world economy re-enters into a state of cooperation and harmony.

5. Concluding Remark: Innovation as the Determinant of Future World Economic Leader

The paper suggests an international development model which incorporates entrepreneurial innovation, protectionism and world politics. The model is used to explain the U.S.-China competition in last

decades and recent trade disputes in particular. This paper begins by pointing out that after the Cultural Revolution, China was one of the poorest nations in the world. On the other hand, Schumpeterian entrepreneurs in IT industry created a creative response in the U.S. and make the U.S. an economic and technology leader in the world. Equipped with excellent technological capabilities, American entrepreneurs explored profit opportunities in China and entered China in the form of exports and foreign direct investment. Given poor resources and technology capabilities, China accepted the U.S.'s rule of game and opened its markets to Americans. As a result, both nations gain in trade. The U.S.-China relationship at the time was in harmony. As multinational firms from the U.S. invested in China in the form of foreign direct investment, China's latecomer firms were able to learn from them. Chinese manufacturers went on to master high-tech industries from the West. In other words, China embarked on a phase of adaptive response, encompassing imitation, product improvement and mass production. After more than 40 years of economic reforms and learning, China eventually emerged as a global superpower. It begins to pose a challenge to the U.S.'s dominance. In order to curb China's rise, the U.S. government exercises a series of trade protection policies on China. Hence, final showdown between the two superpowers occurs. Our model suggests that the U.S.-China conflict and trade disputes will continue until another wave of Schumpeterian innovation emerges to make trade protection policies ineffective. Technological breakthrough will once again widen income and productivity gaps between first mover and latecomer economies. New technologies will also redefine international division of labor. As it happens, the global economy re-enters into a state of cooperation and harmony. Our theory concludes that innovation is the determinant of future leader in the world.

Acknowledgment

I thank the two anonymous referees of this journal for their constructive comments. Any error that remains is mine.

Appendix 1 Chronology of the US-China Trade War, 2018-19

- On March 22, 2018, the Trump administration investigated the possibility to apply tariffs on US\$50–60 billion worth of Chinese goods including aircraft parts, batteries, flat-panel televisions, medical devices, satellites and weapons. Trump stated that the proposed tariffs were a response to the unfair trade practices of China over the years, including theft of U.S. intellectual property.
- On April 2, 2018, China responded by imposing tariffs on 128 products imported from the U.S., including aluminum, airplanes, cars, pork, soybeans, fruits, nuts and steel pipes.
- On May 29, 2018, the U.S. announced that it would impose a 25% tariff on \$50 billion of Chinese goods with “industrially significant technology”. It also planned to impose investment restrictions and enhanced export controls on certain Chinese individuals and organizations to prevent them from acquiring U.S. technology.
- On June 15, 2018, Trump declared that the US would impose a 25% tariff on \$50 billion of Chinese exports, of which \$34 billion would start July 6, 2018. China imposed retaliatory tariffs on U.S. goods of a similar value. On June 19, 2018, China retaliated and stated that the United States had launched a trade war. China vowed to retaliate with additional tariffs on American goods worth \$60 billion annually.
- On August 8, 2018, the U.S. finalized a list of 279 Chinese goods, worth \$16 billion, to be subject to a 25% tariff from August 23, 2018. In response, China imposed 25% tariffs on \$16 billion of imports

from the U.S., which was implemented in parallel with the U.S. tariffs on August 23, 2018.

- On September 17, 2018, the U.S. announced that its 10% tariff on \$200 billion worth of Chinese goods would begin on September 24, 2018, and will increase to 25% by the end of the year. They also threatened tariffs on an additional \$267 billion worth of imports if China retaliated, which China promptly did on September 18, 2018, with 10% tariffs on \$60 billion of U.S. imports.
- On May 5, 2019, Trump stated that the previous tariffs of 10% levied in \$200 billion worth of Chinese goods would be raised to 25% on May 10, 2019.
- On May 15, 2019, Trump signed an executive order, which sought to restrict the export of U.S. information and communications technology to “foreign adversaries” under national security grounds. The order did not make any references to specific companies or nations, but it was heavily implied that the order was meant to support United States allegations of espionage via Chinese telecommunications firms.
- On June 1, 2019, China will raise tariffs on \$60 billion worth of U.S. goods.

Sources: *The New York Times* (5 July 2018); *CNBC* (12 December 2018); *CNBC* (5 May 2019) and Crowley (2019).

Notes

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1. Trump's press conference at the White House on 7 November 2018. See *Economic Times* (8 November 2018), "Donald Trump says China no longer in race to supersede US as top economic power", <https://economic-times.indiatimes.com/news/international/world-news/donald-trump-says-china-no-longer-in-race-to-supersede-us-as-top-economic-power/articleshow/66545223.cms>, accessed on 26 June 2019.
2. Instead of "adaptive entrepreneur", Cheah and Yu (1996) uses the term "Austrian entrepreneur".
3. This is the case in the late Ch'ing Dynasty in imperial China.
4. Mainstream scholars in international relations look at the world order from the superpower's perspective. In other words, the superpower is the center of the world order and all other nations are peripheries. However, Escudé (2015) looks at the world order from the periphery perspective.
5. For instance, today, Malaysia would confront face-to-face with Britain or USA in many international affairs.

6. Personal computers can be said to appear in the 1970s, shortly after the development of the microprocessor chip. The Apple I came out in 1976, and the Apple II in 1977. Then in 1982 came the IBM PC. By introducing a powerful PC, IBM gave personal computers real credibility. During the 1980s, Intel released a 32-bit processor which had more than a million transistors on a single chip, a clock speed of 25 MHz and a 4-gigabyte memory space. Hard disks, which really did not exist in the personal computer marketplace in 1980, became inexpensive and ubiquitous. By the end of the 1980s, PCs were widely adopted (Brain, 2006).
7. See Cohen and Levinthal (1990) for the concept of absorptive capacity.
8. Admittedly, at the beginning, most joint ventures were rent-seeking activities pursued by the government officials either at the township or provincial level. However, the most important fact is that Chinese people have had the opportunities to learn from overseas companies.
9. For example, Alcatel, the telecommunications company, joined forces in 2003 with a Chinese venture capital fund, New Margin ventures, to invest US\$18 million to support innovation in telecom engineering. Alcatel expects to spend around 15 per cent of its worldwide R&D budget in Shanghai. On this investment, Ron Spithill, the executive vice-president of Alcatel remarks that “China has long been a recipient of telecom technology, very soon it will be a source of innovative technology.” (*Financial Times*, 19 April 2002).

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The Influence of China in Hollywood Environment

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Abstract

Film as an entertainment and learning tool is so effective that many filmmakers around the world have included certain elements in their homemade films such as a moral message to educate as well as communicate the culture of a state. Films in Hollywood are used by the People's Republic of China to form Chinese image worldwide. This study discusses how the People's Republic of China through the Dalian Wanda Group real estate entrepreneur Wang Jianlin helped Hollywood to rise from its downturn. Culture is expected to be a bridge between the People's Republic of China and the United States of America. Also discussed is how audiences and also mass media have responded to the phenomenon that occurs between the People's Republic of China and Hollywood affair using many aspects (culture, business, and public diplomacy) and many elements (cultural, media, governmental, and public diplomacy). Yet China is not used to utilize the maximum potential of movie as soft power.

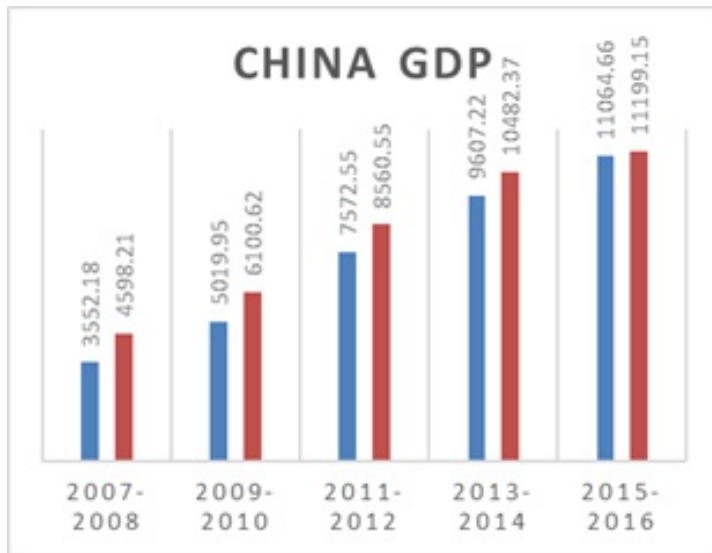
Keywords: *Hollywood, China, culture, business to business, public diplomacy*

1. Introduction

China and the United States are two big countries. History shows that diplomatic relations between China and the United States was unsuccessful in 1784 due to China's refusal to cooperate with the United States (US Department of State, 2017).

China with its economic system has experienced in rapid growth. According to the International Monetary Fund (IMF), China's economic growth reached an average of 10% per year over the past 30 years, and even faster to reach 11.4% in 2005 compared to the GDP growth of 10.1% in 2004. The increase in China's economic growth can be seen in Figure 1 about nominal Chinese GDP in 2006-2016 (*Trading Economics*, 2016).

Figure 1 China's Economic Growth, 2006-2016



Source: *tradingeconomics.com*.

There are so many industries run by China that spread into all fields to support the country. For example, the mining and foundry industries (iron ore, steel, aluminum), textiles and apparel, petroleum, cement, chemicals, fertilizers, consumer goods (footwear, toys, electronics), food & beverages, transportation equipment (motorized vehicles), and telecommunications (satellite) (Menafn, 2015).

China has bilateral relations in the exports sector with the United States, Hong Kong, Japan and South Korea, and in the imports sector with South Korea, Japan, Taiwan, the United States, Australia and Germany (CIA, 2016). However, the development of the Chinese economy is not only limited to commodity goods. China has also begun to explore the world of entertainment (cinema & movies), such as Hollywood in the United States. Initially, China severely limited the development and screening of Hollywood films in the country to protect its own films. However, all that has changed since China realized that Hollywood is a very promising field of cooperation and investment (Eka, 2015).

Hollywood was originally a simple community in 1870 and was incorporated into a municipality in 1903 and combined with the city of Los Angeles in 1910 (*Los Angeles Herald*, 15 November 1903). After this merge, the leading film industry emerged, and eventually became the most recognizable film industry in the world (Auditor's Office of Los Angeles, California, 1913). In 1912, a large motion picture company made a production near Los Angeles (Jacobs, 1939: 85).

When Hollywood was increasingly dominant in the mid-1980s, the Chinese government continued to maintain, foster and strengthen its own film industry. China is very strict in selecting Hollywood films that may air in the country (*Kompas*, 24 May 2016). Films originating from Hollywood production must comply with Chinese government standards where films that enter China must comply with the rules of the Chinese

Censorship Agency by considering Chinese audiences (Kokas, 2017). The standard examples are: not vulgar, at least containing a Chinese actor or actress, at least having one or more Chinese crew, even if possible with a Chinese background (place) – but these are only a small part of the examples. These are due to the fact that since the beginning film has become an important part of society, namely media for education and entertainment (*CNN Indonesia*, 7 December 2016).

Film is divided into two types, Box Office films and Blockbuster films. In the United States the designation of Box Office was originally a term used for ticket sales boxes in theater buildings, cinemas, or other entertainment venues (*Collins Dictionary*, 2018).

Currently the term Box Office in Hollywood is the term for successful films that have income above the budget that has been spent during film making, in just a few days or a few weeks of screening the film through ticket sales; the more films are in demand, the greater the income (Nurfadillah, 2018).

For the Blockbuster designation, this is a designation that was first used in 1942 to describe a very large bomb explosion and the term for something very expensive, effective, successful or perhaps wasteful (*Merriam-Webster*, 2018). Blockbuster in this case, namely film or mass media, is something that is very popular and very successful in terms of income with large budgets or big results in the Box Office. It can be said that Blockbuster films are a narrowing of the category of the Box Office film (Pittman, 2018).

From the point of view of communication studies The world of cinema is an effort of communication. Film is also an effective communication medium due to the fact that it has the two aspects – audio and visual – in its production. Whether it is a drama-themed film, or one on history or nationalism, it certainly contains those aspects (Said, 1991: 44).

Film is also expected to become a bridge of culture and style between China and the United States. Lindsey Conner, a US Entertainment lawyer, herself is the leader of Phelps & Philips, a media and entertainment practitioner based in Manhattan. With the opening of the door to collaboration between the Chinese and Hollywood industries, Conner ensured that there would be more Chinese people investing in Hollywood and vice versa. These investments will involve finance, distribution and production. Meanwhile, from Hollywood itself it is clear that China is a lucrative market for “throwing” their latest films because China is the latest market in the world and the opportunity to grow there is huge (Eka, 2015).

Initially film was made only for education and entertainment but, because of the many interests of certain parties film became a field to convey a message both implicitly and explicitly. These days there are already many production houses owned by Hollywood that have been acquired and have short and long-term contracts with several large companies owned by China.

China has a big market but the most important thing is that China has huge capital so that the acquisition of a famous production house in Hollywood can be controlled by China. According to Li Rigang, head of China Media Capital (CMC) – a private equity company that partners with Warner Bros., Dream Works, and Imax, China’s main capital comes from the Dalian Wanda Group which is actually a real estate company that is trying to transform into an international-level entertainment company in China and expanding its business to the United States, especially in Hollywood (Fannin, 2017).

China is very interested in Hollywood and vice versa. In addition to having a strong culture, China has a market for Hollywood cinema and also has the Qiangdao Movie Metropolis which was founded by

Wang Jianlin from Dalian Wanda Group (*Sindo News*, 2018). In addition to getting the Hollywood market, it also gets a place to advance Hollywood cinema (*QINGDAO(nese)*, n.d.). According to Wang Jianlin, the acquisition of Hollywood is expected to advance the technology and quality of Chinese cinema (*Sindo News*, 2016).

Hollywood is already on its edge towards financial downfall, so the arrival of China's acquisitions and investments is the right step to save the Hollywood itself. For the name as famous as Hollywood is making a profitable business for China, whereas consumers for Hollywood from China are pretty much (Tartaglione, 2017).

Hollywood is a place of duel and struggle for China and the United States, through films produced by Hollywood with Chinese interference as investors, and of course it is expected to be a bridge of culture and style between China and the United States. However, through a Legendary Entertainment film such as *The Great Wall*, China is considered to be indirectly exporting culture, rather than importing culture from the United States (Hoskin, 2017).

In this article, we will discuss China using Hollywood as a land to expand its cultural influence. Through the role of the Dalian Wanda Group company, China began to make unexpected moves.

2. Literature and Methodology

Communication is crucial and important in dealing with others. No one has never communicated with others, both verbal and non-verbal communication (Nasrullah, 2012).

Culture is values that are recognized directly and indirectly that occur in the subconscious of individuals which are passed on from generation to generation (*ibid.*: 15). Culture has its own characteristics historically which can be seen from the symbols that appear. These

symbols have meaning, namely, a system of human communication concepts that contain meaning that continues to grow with the development of human knowledge (Hofstede as cited in Nasrullah, 2012: 16).

In every country there must be a culture that existed since the beginning of the state's formation. Through culture, people in a country have something that can maintain their identity. Culture is something that is inherited from the family from generation to generation. Culture includes many things, namely clothing, buildings, values, political systems, religious systems, languages, and works of art (Tubbs and Moss, 2008).

To be said literally, cinema (film) comes from the word *cinematographie* which means *cinema* (motion), *tho* or *phytos* (light) and *graphie* or *graph* (writing, images, images). So that film can be interpreted as painting motion with lights (*Sekolah Pendidikan*, 2017) using a special tool, and usually the tool used is a camera.

According to John Storey (2008) in his book entitled *Cultural theory and popular culture*, pop culture occurs because of the process of urbanization where the movement of people from villages to urban areas is very high when the industrial revolution takes place. The industrial revolution makes everything easy to produce something. It is due to this process of urbanization that pop culture (popular culture) is also called mass culture.

Language and thought patterns that are part of Chinese culture are symbols of communication brought into Hollywood that are poured into film artwork. Since Chinese companies have invested heavily in Hollywood, Hollywood cinema has grown so much and has taken examples from China (Kokas, 2017).

Business to Business (B to B) is a form of business cooperation from a company to another company by making an agreement but not

necessarily moving in the same field. Like a Chinese company that is engaged in real estate, Dalian Wanda Group, is helping Hollywood in the field of film art by collaborating to help Hollywood market its films to Chinese territory because China is a big market for Hollywood (Eka, 2015).

Vincent Mosco stated that political economy from a media, in this case film, is a representation of power or domination that is shown to dominate a particular group, namely the audience. Updated technology and the ability to influence audiences by media companies through new media tools (such as social networking and blogging, films) to reject business and government power (Mosco, 2009: 24).

Today's political power has affected the media. The media are now unwittingly including political elements to strengthen a particular group because of the influence of globalization (*ibid.*: 105).

China in this theory has become a primary stakeholder in the media, namely Hollywood. China as the biggest investor has the power to control Hollywood films funded by Chinese companies. Changes that occur in Hollywood regulations are so real that 10 years ago the United States government banned foreign companies from owning companies from the United States.

Diplomacy is certainly carried out by each state to reach agreement in a policy with other countries. Own diplomacy according to Eytan Gilboa (2001) using media channels is the most effective way because it can reach and influence the public directly through messages conveyed because the mass media is mainly more focused on certain events (Gilboa, 2001: 6). The importance of mass media's role in diplomacy cannot be denied due to the fact that mass media can be used as a tool for political campaign (or perhaps propaganda) but the media is a stand-alone "actor".

According to Louise Diamond and John McDonald (1996), in addition to public diplomacy in general, there are 9 multi-track diplomacy as a system for creating peace between countries.

There is also a theory about multi-track diplomacy which separates nine different tracks of diplomacy depending on the actor and context. These are: (1) Government, (2) Professionals, (3) Business, (4) Private Citizen, (5) Research, Training and Education, (6) Peace Activism, (7) Religion, (8) Funding and (9) Media and Public Opinion (Diamond and McDonald, 1996).

Tracks 1, 3, 8, and 9 are the suitable tracks that can reflect the system used in the collaboration formed between China and Hollywood. The Chinese government has provisions or foreign policy to build peace with other countries which will be explained in the discussion.

The first track “Government, or Peacemaking through Diplomacy” explains how China and the United States collaborated through Hollywood. Through President Xi Jinping’s foreign policy, relations between China and the United States, especially in Hollywood, have become more flexible.

The third track “Business, or Peacemaking through Commerce” explains how China helped revive Hollywood cinema with a large investment by taking over Legendary Entertainment and AMC Entertainment Holdings which became a subsidiary of Dalian Wanda Group. In addition to the Dalian Wanda Group company, another company Tencent (giant Internet company from China), WeChat application and mobile video game *Honor of Kings* have already purchased a portion of shares from Skydance Media which produces famous film such as *Mission Impossible* and *Terminator* films (VOA Indonesia, 2018).

The eighth track “Funding, or Peacemaking through Providing Resources” explains how Wang Jianlin provided financial assistance to Hollywood through buying Legendary Entertainment and AMC Entertainment Holdings which managed to become a company that had more income than before being taken over by Wang Jianlin.

The ninth track “Communications and the Media, or Peacemaking through Information” explains how China took over Hollywood to create a new image of China in the eyes of the world. China changed the world view of its country through Hollywood cinema.

3. Analysis

3.1. Culture

China is one of the countries in the eastern part of the world while the United States is on one of the continents in the western region of the world. China and the United States have different views partly due to cultural differences.

The culture brought by China into Hollywood is so visible because China wants its state roots to be unforgettable in other countries. Nevertheless, China’s presence is still so significant in helping Hollywood (Robinson, 2016).

According to Johanes Herlijanto from the Department of International Relations, Bina Nusantara University, Jakarta, the cultural differences between China and the United States have made them who they are now. China from its inception was already aware of the purpose and direction to be addressed by the government in contrast to the United States which followed developments from private entrepreneurs. China is an autocratic-monolithic country that has only one major party, the Chinese Communist Party. Every right of its citizens to create and develop works of art is severely restricted so that it remains in line with

the Chinese government and that affects the amount of Chinese widescreen film production (Herlijanto, 2018). The cultural gap between the two countries shows huge contrast, which is also what makes an initial problem in China and Hollywood relations.

Leaders in each country certainly have cultural differences and different ways to lead their respective countries. According to René Pattiradjawane, president of Indonesia's Center for Chinese Studies, China has planned to realize the "China Dream" where China through President Xi Jinping wants to be the center of all countries in the world. China is so limiting and even curbing the creativity and opinion of its people that the government holds full power without any contribution from the people (Pattiradjawane, 2018).

There are several films that are banned from entering China through a special body that selects Hollywood films such as the *Avatar* movie. *Avatar* is prohibited from circulating in China because the film has a storyline that the government avoided telling its people – the problem of the region, namely describing visualizations of land rights, land colonization, land tenure. This is due to the large number of areas belonging to the people (in the form of land ownership) which are acquired by the government with a "profit change" where the proceeds from the sale are given higher than the actual price (*ibid.*).

Film is an entertainment product that has a great demand in China since the first time film was used as a government tool to "instill" perceptions that must be followed by every citizen. Hollywood cinema is so tightly selected by the Chinese government in order that it does not interfere with people's perceptions and views of the government (*ibid.*). It is so clear that Chinese government wants to utilize pop culture as their own culture (perception towards country) barrier to uphold the people's morale.

According to René Pattiradjawane, for every freedom that the people want to achieve some particular thing must pass selection in the political and economic fields of a country. Films are like coins that have two sides: they can be used for learning and can also serve as tools for certain groups.

The occurrence of cultural and technological exchanges between China and Hollywood is just a myth. Wang Jianlin hopes that passing in the wake of the Qingdao Movie Metropolis of China can take the knowledge and technology of Hollywood filmmakers. However, it is all just the ideals of the Dalian Wanda Group. If the Chinese government does not approve a proposal, there will be no second chance to discuss the same thing (*ibid.*).

What actually happened is that the process that was passed by Dalian Wanda Group owner of Legendary Entertainment in Hollywood was quite long. The limited creativity of the Chinese people has caused Hollywood to remain the largest source of film production in the world (*ibid.*).

Although China has a super-fast computer named Tianhe-1A and Tianhe-2 which helped Dreamworks in the making of such animated films, not many people know this. Competition between China and Japan (through the Sony Pictures company) in Hollywood has been fierce as the owner of the largest capital that can influence culture and technology in Hollywood (*ibid.*).

Hollywood films are “admired” because no one yet can compete with the United States film industry – if we compare it to another film industry, for example, that of the United Kingdom which produces the television series and film *Mr. Bean* or its predecessor, Charlie Chaplin Films, which makes silent films where players only communicate and express themselves through body language (*ibid.*). According to René Pattiradjawane, the audience in China did not understand what the silent

actors mentioned above wanted to say. However, the reality is Charlie Chaplin is one of the ten film actors whom the audience like most (*China Daily*, 2014). Charlie Chaplin made cultural differences become invisible because he only used body language to convey messages.

The major directors of Chinese films such as Zhang Yimou and Chen Kaige have limitations in freedom within China, and they are only allowed to make colossal themed films based on Chinese history alone. The directors cannot think freely and have their imaginations to create a story just like the director and filmmaker of *Star Wars* or *The Avengers* (Pattiradjawane, 2018).

According to cultural theory, here the Chinese government retains its national roots because it limits the influence from outside its country which can change the views or perceptions of its people. On the other hand, China is not the only country that helps develop Hollywood (*ibid.*).

China through the Dalian Wanda Group company is just one actor who has a large capital supporting Hollywood. There is a cultural mix between China and Japan in Hollywood where these two countries are big Hollywood funding sources (*ibid.*).

3.2. Business to Business Aspects

In carrying out relations of cooperation, both bilateral and multilateral relations must consider the economic field. According to René Pattiradjawane, there are two types of economic policy, namely: hard economy and soft economy.

In China, hard economy in this case refers to a new policy made during the era of President Xi Jinping, the One Belt, One Road (OBOR) which includes bilateral relations between China and the United States and other countries in Asia and Europe. Hollywood is one example of soft economy, namely through the film industry (*ibid.*).

Wang Jianlin's Dalian Wanda Group is a large-scale company that has businesses in various fields. Atletico Madrid football club, Shanghai Disneyland, and merchandise are just a few examples of Dalian Wanda Group's sources of income (*South China Morning Post*, 12 July 2017).

Table 1 Dalian Wanda Group Assets

Date	Target	Price (US\$ billion)
May '12	AMC (cinema chain)	2.6
Jun '12	Sunseeker (motor yacht builder)	0.41
Jun '14	Edificio España (a building in Madrid)	0.36
Feb '15	Infront Sports & Media	1.2
Jun '15	Hoyts Cinema	0.37
Aug '15	World Triathlon Corp	0.65
Jan '16	Legendary Entertainment	3.5

Source: *South China Morning Post*, 12 July 2017.

The business carried out by Dalian Wanda Group which is less popular to the people is only the Shanghai Disneyland. Due to poor maintenance, there were not many people in Shanghai who went to visit the amusement park (Pattiradjawane, 2018).

The Dalian Wanda Group company does not have a factory and only works in the service sector. Wang Jianlin through Dalian Wanda Group has a dream to bring together various industries. For example, the famous actor Leonardo DiCaprio, who played in the film *The Revenant* produced by Legendary Entertainment, has been used as an advertising model since he won the Oscar for the first time because of the film (*ibid.*).

Even though Dalian Wanda Group's revenue source is large and has a share in building China's state economy, the government still limits its operation. Wanda company earns approximately 400 billion USD only from businesses in the property sector, and this does not include the entertainment sector such as Legendary Entertainment and the AMC Entertainment Holdings cinema network. The Chinese government feels threatened by the amount of income from the Dalian Wanda Group company because of the amount of Chinese state money circulating if calculated amounting to 23 trillion USD (*ibid.*).

China prioritizes state revenues from state-owned enterprises so that state businesses remain strong and are not rivaled by private-owned companies. By contrast, in the United States private companies control the country's economy so that it can change government policies (*ibid.*).

Since President Xi Jinping's leadership China has limited and curbed the movement of the private sector in investing abroad. Wanda company since 2016 after acquiring Legendary Entertainment and the AMC Entertainment Holdings cinema network cannot expand further overseas (*ibid.*).

China's domestic problem is how the government controls the money that comes out of its country. Before President Xi Jinping came to power, there was cooperation between China's political elite and private companies so that private entrepreneurs such as Wang Jianlin could expand their business overseas freely (*ibid.*).

Initially, Wang Jianlin saw Hollywood as a “fertile” and pure “field” of business only for the sake of his company with a company in Hollywood. However, since the new policy implemented by President Xi Jinping, Wang Jianlin may only carry out domestic activities due the cases involving money laundering (*Variety*, 2017).

What the state of China has done in recent years has been carried out by the state of Japan for the past 20 years. China is studying the Japanese state slowly but is sure to enter the biggest film industry in the world, Hollywood (Pattiradjawane, 2018).

Japan with Sony Pictures entered Hollywood in the event of a deficit in the country. Japan has already read Hollywood developments compared to China (*ibid.*).

In the Hollywood film industry merch sales must also be included such as t-shirts, dolls, and others. The Chinese state made it an opportunity to become the place to produce the merchandise which will be sold in theaters where the film was aired (*ibid.*).

Today’s films do not use ribbons like in the old days. Today’s films use hard disks as data storage media before they are distributed to cinemas who work together to show the film. The occurrence of duplicate films is due to the ease of access to distribute films illegally (*ibid.*).

If calculated carefully China is causing quite a lot of disadvantage to some parties because of the violation of copyright issues. In the field of cinema, many Hollywood films that have just aired are already on Chinese websites even though China limits its citizen’s Internet use. In the field of merchandise, many are also remade merch that are sold very cheaply compared to buying at Disneyland (the original distributor) for example. As René Pattiradjawane said:

“*Apa yang di jual China, pasti laku. Apa yang di beli China, pasti ludes. Premis nya kira-kira begitu.*” (What China sells, certainly sold. What China bought, certainly sold out. That is about the premise.)
(*ibid.*)

According to the theory of business to business with the concept of media politics, there is certainly little impact from the entry of China into Hollywood. China through film director Zhang Yimou in collaboration with the Hollywood production team filmed *The Great Wall* to tell the background or history of the founding of the Great Wall in China (*ibid.*).

In the Hollywood film industry, China cannot yet become the center. Apart from still interfering from other countries, Hollywood is a closed industry that is rather difficult to “go” to other countries except for business or investment (because Hollywood is on the stock exchange), not to say acquiring or taking over Hollywood companies like Dalian Wanda Group does.

3.3. Public Diplomacy

China made various efforts to control the existing industries in the world, including the film industry. The biggest film industry in the world is in the United States, namely Hollywood.

If viewed from various perspectives, the image of the state of China has not changed at all. China and the United States remain two countries that need each other. China has capital and markets for the United States while the United States has film media to be used as soft economy media or soft power by China (Kokas, 2017).

From China’s perspective we need to look at Xi Jinping’s foreign policy which aims for: (1) Peaceful Development (with short- and long-term goals, thus achieving the China Dream); (2) New Model

of Major Country Relations (enabling every country to participate with equal chance in open-market and achieve multilateral relationship); (3) Neighborhood Diplomacy (there is no such term as one-size-fits-all policy; the approach will be different for every single country); (4) Cooperation with Developing Countries (the OBOR policy); and (5) Multilateral Relations (with a fair system in rights and responsibilities, respecting the sovereignty and diversity between country that are interconnected) (Swaine, 2015).

China sees the Hollywood film industry as a place of business that is tempting if it is seen for the long term because everybody needs entertainment. China through its media and private companies before President Xi Jinping's government was so free in carrying out overseas activities that it could cooperate with Hollywood (Pattiradjawane, 2018).

The Chinese government in addition to limiting the production of films in China also limits those who will be involved in foreign films. Original Chinese actors and actresses are hard to find in Hollywood films. Most of them are only Chinese descendants (from Hong Kong and Taiwan) but are not citizens of the original Chinese People's Republic (*ibid.*).

China does not have a special funding team or group to give Hollywood because of a lack of sensitivity to the film industry. China is a Communist state that does not understand the meaning of soft power that is loved by everyone. China is accustomed to following rules and making rules that make its citizens not to fight or oppose policies made by the Head of State (*ibid.*).

According to the theory of public diplomacy with multi-track diplomacy, bilateral relations between China and the United States can be considered successful because not a few private companies from each country invest in each other. The goal of China in going to Hollywood is only for profit in the economic field (business expansion) alone.

Likewise, the United States has come to China to look for land and labor, where factories will be built for private companies from the United States (*ibid.*).

The Chinese aspects of Hollywood cinema are limited to the setting of the scene, the storyline and the typical Chinese food. The lack of freedom from government policies causes citizens to be less educated in other industries (e.g. film industry).

There is no freedom in expression and making a work of art because of the policies of President Xi Jinping who only wants to implement hard economy through One Belt, One Road (OBOR). If examined further, soft power or soft economy will be easier to control because the occurrence is not explicit or can be run covertly (Herlijanto, 2018; Pattiradjawane, 2018).

Contrary to the core of track 9, audience are not allowed to express themselves (giving criticism or giving advice to the government) through mass media such as films and even the Internet in China is so different from the Internet in general. The government does not let the public know the latest information from foreign mass media that talks about their country. Communication is done only in one direction, only from the government to the people.

From the results of the research evaluation, it can be seen that the entry of Chinese culture to Hollywood film industry has four main elements which have the following evidence:

(1) Cultural elements

This can be shown through the film *The Great Wall* (2016) which was produced by Legendary Entertainment with the colossal genre (history) clearly portraying the development of Chinese weapons as compared to countries in Europe. There are mercenaries from Europe who try to find out the secrets of China's gunpowder. In this case the

fourth foreign policy of President Xi Jinping namely Cooperation with Developing Countries shows how he becomes the center of OBOR (One Belt, One Road) through the commodities possessed by his country. In addition, according to President Xi Jinping's first foreign policy, Peaceful Development, he will also prioritize culture in cooperation (bilateral or multilateral).

(2) *Media elements*

Film in this case is used as a tool for promotion by China, as in the movie *Transformers: Age of Extinction* (2014) where there is one Chinese actress, Li Bingbing, who is the leader of the KSI factory in Beijing, there are conversations and writings in Chinese, set in Beijing. There is a battle between the Autobots and Decepticons, there is milk from China that was drunk by Joshua Joyce (Stanley Tucci), the owner of KSI Industries above the apartment building. In the second film, *Independence Day: Resurgence (ID 2)* (2016) there is one Chinese actress, Angelababy (lieutenant and pilot tug), and there is a Weibo application from China that is used by the son of the former President of the United States (President Whitmore) to communicate with his girlfriend, a spacecraft pilot on duty at the earth defense headquarters on the moon, in accordance with President Xi Jinping's second foreign policy, the New Model of Major Country Relations.

(3) *Governmental elements*

In the context of government, China's policy prohibits the entry of the *Avatar* movie (2009) because the film has an issue that the Chinese government does not want to inform its people. This clearly shows that information even from a fiction movie is carefully controlled by the government.

(4) Public diplomacy elements

China according to President Xi Jinping can put forward the country's position in other countries. It is explained in the third foreign policy of President Xi Jinping, namely Neighborhood Diplomacy that there are no one-size-fits-all, equal-based dialogue, and friendly consultation designation in conducting bilateral relations; each state has its own advantages and interests in various fields.

The Chinese state through the foreign policy of President Xi Jinping can in such a way regulate bilateral and multilateral relations with other countries – through film, especially, even though there is a special sensor body that filters films that enter the country.

China already knows how important it is to participate in the soft economy through film in Hollywood. On the other hand, China also continues to prioritize its hard economy through OBOR (One Belt, One Road) which invites other countries to combine economic power with China as its center (China Dream).

According to an analysis of the discussion on Culture, Business to Business, and Public Diplomacy and a collection of evidence for the focus of research, China prioritizes culture in bilateral and multilateral relations. Culture is represented through promotions of Hollywood films as its media. China wants the public to know how much Chinese influence is in Hollywood and the world.

In running the government, China pretty much hides issues from its people so that through the Chinese censorship body it can filter out all information that will be wide-spread in its country through Hollywood films. President Xi Jinping's policy also balances the development of his country (its people) even with limited access.

4. Conclusion

Culture in a country is the result of customs that are passed down from generation to generation. Likewise, since the beginning of the Communist Party's rule till the leadership of President Xi Jinping, the thickness of Communist Party's rule in the state of China makes the people confined with limited access to the outside world.

In the aspect of Business to Business using the concept of political economy of the media, it is explained that through a private company from China, Dalian Wanda Group, China succeeded in entering the film industry. Wang Jianlin could acquire Legendary Entertainment and the AMC Entertainment Holdings cinema network that became a subsidiary of Dalian Wanda Group, making the government curb private companies from growing and developing more than the Chinese State-Owned Enterprises.

In the theory of Public Diplomacy that uses nine tracks in achieving peace between countries it is explained that only tracks 1 and 3 are in accordance with the facts that occur because in track 8 (funding) this is not done by the state of China in carrying out bilateral relations with the United States. Likewise, with track 9, mass media, namely film used as a tool to express public opinion does not materialize in China. Film is only used by China as a form of public opinion.

The conclusion that can be taken based on the results of this study is that China is not merely in control of its economic power, but is still rigid in using soft power or soft economy because it is accustomed to form cooperative relations between countries formally and depending on the country's economic and political strength. Here the United States has a role to show China how to manage the entertainment industry that is always interesting and enjoyed but on the other hand can also be controlled.

Notes

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Money and Finance

Dynamic Relationship between Yuan-Dollar Exchange Rate and Malaysian Macroeconomic Variables in Pre- and Post- Exchange Rate Reform Periods in China

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Abstract

This study investigates the impact of changes in the Yuan-Dollar exchange rate (CNYUSD) on Malaysia's macroeconomic variables during China's pre- and post-exchange rate reform periods. Using data from 1988 Q1 to 2017 Q2, our results show: firstly, changes in CNYUSD influence Malaysia's macroeconomic indicators in the post-exchange rate reform period, and an appreciation in CNYUSD leads to an expansion in real GDP and price level; secondly, positive impact on real GDP and price level lasts for one-year horizon; lastly, the variance decomposition yields consistent results with the impulse response function. As a policy suggestion, the Malaysian government should improve the competitiveness of the export sector in order to reap the benefit of Chinese Yuan appreciation through the aggregate demand channel.

Keywords: *Renminbi, China's exchange rate, Malaysian currency, macroeconomic indicators*

1. Introduction

Owing to the macroeconomic performance of the Chinese economy, as McKinnon and Schnabl (2003) point out, the Chinese Yuan has a stabilizing influence on the East Asian economies during the Asian Financial Crisis in the 1990s. The trade channel or the aggregate demand channel mentioned by Ibrahim (2007), apart from investment one, is considered as the primary transmission mechanism for the effect of the Chinese Yuan exchange rate changes on the economies of other countries.

As China rises in economic power, it seems inevitable that its currency will also rise in importance as well. This is evident by several studies such as Zhang and Fung (2006). They found that an appreciation of the Chinese Yuan would have a notable effect on the trade balance of the ASEAN countries. Feng and Alon (2007) found that there is no difference between the impacts of Yuan appreciation and depreciation on the price adjustment of the ASEAN economies. Ahmed (2011) and Thorbecke and Smith (2010) support the view that changes in exchange rates throughout Asian supply chain countries exert an essential effect on exports. Wang *et al.* (2012), using panel cointegration, find out that a real appreciation of Yuan has no overall long-run effect, but it has a significant effect in the short run.

Due to the trade-oriented development pattern, the ASEAN economies are highly dependent on international trade in their economic performance. Besides, the synchronized character of the business cycle in East Asia, due to the regional economic integration, makes the growth rates of the regional economies highly correlated (McKinnon and

Schnabl, 2003). This implies that these economies are exposed to any trade-related external shocks such as the shock in foreign exchange rates.

McKinnon and Schnabl (2003) insist that pegging to the Dollar benefits the East Asian Dollar bloc as a whole, but it also constitutes an instability source for the economies within the bloc. Some literature argues that the economy that treats the U.S. Dollar as an anchor currency, like Malaysia, may be vulnerable in the face of the shocks in a third currency such as the Yen-Dollar rate (Rajan, 2002; McKinnon and Schnabl, 2003; Ibrahim 2007).

The surrounding countries of China, especially the developing countries, begin to have a concern about the impact of the Chinese Yuan's exchange rate on their economies. Due to the high trade volume with China, Malaysia is one of them who has a close trade tie with China. As China's largest trade partner in ASEAN and the third largest trade partner in Asia, Malaysia has significantly benefited from its trade tie with China. However, the competition imposed by China's strong international trade growth, such as the low value of Chinese Yuan against the U.S. Dollar, also constitutes a real challenge to Malaysia's manufactured exports.

Therefore, it is interesting to examine the impact of Chinese Yuan changes on Malaysian macroeconomic performance. Specifically, this study examines the impact of Chinese Yuan appreciation on real GDP, price level and money supply in the Malaysian economy. Notably, the present findings on the impact of Chinese Yuan changes on macroeconomic indicators mostly focus on developed countries. Therefore, the results may not be generalized to developing countries such as Malaysia, due to their different economic structure and government regulations. To the best of our knowledge, Ibrahim (2007) pioneers in examining the impact of foreign currency changes on

Malaysian macroeconomic indicators. However, the study focuses on the role of Japanese Yen instead of Chinese Yuan.

Given the increasing role of China in the world economy and the close trade tie with Malaysia, it is crucial to understand the impact of Chinese Yuan changes on Malaysia's macroeconomic indicators. Therefore, this study contributes to the existing literature by examining the dynamic relationship between Chinese Yuan-Dollar and Malaysian macroeconomic variables in pre- and post-exchange rate reform in China. The findings are significant because it provides direction to the policymakers on whether China is the engine for growth or an economic threat to Malaysia.

The remainder of this paper is structured as follows. Section 2 reviews the related literature. Section 2.1 shows the theoretical framework of this study. Section 3 outlines the data and methodology. Section 4 and 5 present the results. Section 6 discusses the findings of this study. The last section concludes this paper with the key findings.

2. Literature Review

The United States is perceived to be the largest economy in the world, and therefore the movement in the U.S. Dollar is believed to have a significant impact on the economic performance for the rest of the world. However, the role of China in influencing countries' macroeconomic performance is increasing since China moved to a managed float currency regime in July 2005. As such, the movement of Chinese Yuan (Renminbi) is found to have a significant impact on the currencies for the rest of the world, especially Asian currencies (Shu, Chow and Chan, 2007; Fratzscher and Mehl, 2011; Henning, 2012; Subramanian and Kessler, 2012). In this regard, it can be argued that changes (appreciation or depreciation) in the Chinese Yuan will have an

impact on the countries' macroeconomic performance.

Given that the scope of this study is to evaluate the impact of Chinese Yuan's exchange rate changes on the economies of other countries, therefore the role of U.S. Dollar in affecting countries' economic performance will not be highlighted here but is well documented in the literature (Liu, Spiegel and Tai, 2016; Avdjiev, Bruno, Koch and Shin, 2018; Shousha, 2019).

To date, numerous studies have examined the impact of Chinese Yuan changes on countries' macroeconomic performance (Fair, 2010; Xing, 2010; Li and Xu, 2011; Mattoo, Mishra and Subramanian, 2012; Yang, Zhang and Tokgoz, 2012; Zhang, 2012; Chow, 2014; Meng, 2015; Shu, He and Cheng, 2015; Schnabl and Spantig, 2016; Cuevas, 2017). By and large, the empirical study demonstrates that changes in Chinese Yuan will have a significant impact on the performance of macroeconomic indicators of a country.

Specifically, Fair (2010) employs a multi-country macro-econometric model to examine the macroeconomic effect of a Chinese Yuan appreciation against the U.S. Dollar for the U.S. economy. The study found that the positive impact of Chinese Yuan appreciation on U.S. output and employment is modest, partly due to the adverse effect from a decline in Chinese output and an increase in U.S. import prices. To support, Xing (2010) estimates the pass-through effects of the Chinese Yuan exchange rates on the prices of U.S. imports from China. The study found that a 1% nominal appreciation of the Chinese Yuan would result in a 0.23% increase in the prices of the U.S. imports in the short run and 0.47% in the long run. Moreover, changes in Chinese Yuan is found to have a bearing on the U.S. trade deficit with China (Zhang, 2012). As such, the simulations based on an MC macro-econometric model (Fair model) show that Chinese Yuan appreciation improves current account in China but deteriorates in the U.S.

Consequently, Chinese Yuan appreciation worsens the trade imbalances between China and the U.S., leading to a higher trade deficit in the U.S.

Subsequently, changes in Chinese Yuan is found to affect the performance of the export sector for competitor countries. As such, Mattoo, Mishra and Subramanian (2012) examine the spillover effect of China's exchange rate changes on exports of competitor countries in third markets. The paper develops an identification strategy in which competition between China and its developing country competitors in specific products and destinations plays a vital role. The study exploits the variation – afforded by disaggregated trade data – across exporters, importers, product, and time to estimate the spillover effect. Findings show that a 10 per cent appreciation of China's real exchange rate boosts on average a developing country's export of a typical 4-digit HS product category to third markets by about 1.5-2 per cent. Moreover, the magnitude of the spillover effect varies systematically with product characteristics.

In a later study, Meng (2015) provides a comprehensive analysis of the economic impact of Chinese Yuan changes on the country's export performance. By covering more countries in the analysis, the results from GTAP model show that a 10% appreciation in Chinese Yuan would lead to a decline in export for Australia (0.606%), Hong Kong (0.584%), Japan (1.478%), Korea (0.591%), Taiwan (0.584%), India (0.869%), Mexico (0.883%) and U.S. (1.14%). The decline in exports in those countries indicates that they have a significant amount of exports to China. Subsequently, when China's demand for import decreases (due to the import-export linkage), the countries have a high exporting volume to China will experience a significant decline in their export performance. Conversely, Chinese Yuan appreciation is found to improve the export performance for Malaysia (0.046%), Singapore (0.082%) and Vietnam (0.191%). This is because these countries are

China's competitors in the exportation market, and therefore an appreciation in Chinese Yuan makes the Chinese export become expensive and thus gives these countries a price advantage. Subsequently, this improves the export of these countries.

The literature mentioned above shows that changes in Chinese Yuan would influence the country output level, employment rate, trade performance (import and export) and current account balance. Furthermore, changes in Chinese Yuan is also found to have an impact on currency movement for the rest of the world (Chow, 2014; Shu, He and Cheng, 2015; Schnabl and Spantig, 2016). Specifically, the role of Chinese Yuan in affecting Asian currencies has increased after the global financial crisis, and it is found to exert either higher or a similar impact as the U.S. Dollar (Chow, 2014). Notably, not only the onshore Chinese Yuan market but the offshore Chinese Yuan market is also found to have a growing influence on the Asian currencies (Shu, He and Cheng, 2015).

In the case of Malaysia, to the best of our knowledge, Ibrahim (2007) pioneers in examining the impact of foreign currency changes on Malaysia's macroeconomic performance. Specifically, the study employs Vector Autoregressive (VAR) model in quantifying the impact of the Japanese Yen exchange rate on Malaysia's macroeconomic indicators, namely real output, price level and monetary aggregate. Results suggest that variations in the Yen-Dollar rate have significant influences on Malaysia's macroeconomic variables. Specifically, the Yen-Dollar depreciation leads to a contraction in real GDP and money supply in Malaysia.

Recently, China has emerged as the largest trading partner of Malaysia. Hence, it can be expected that changes in the Chinese Yuan would influence the Malaysia's macroeconomic performance through various channels such as aggregate demand and foreign direct

investment channel. Therefore, a detailed study on the impact of Chinese Yuan changes on Malaysia's macroeconomic indicators is needed. This is important because it can provide input to the Malaysian authority on whether China is the engine of growth or an economic threat to Malaysia.

Based on the studies as mentioned earlier, two research gaps can be identified. Firstly, the study on the impact of Chinese Yuan changes on Malaysia's macroeconomic indicators is limited. Most of the studies focuses on developed countries, and less attention has been paid to developing countries, especially Malaysia. The present findings based on developed countries may not be generalized to Malaysia due to their different economic structures and government regulations. Secondly, the current study by Meng (2015) provides insight into the nexus between Chinese Yuan changes and Malaysia's export performance. However, results based on a single macroeconomic indicator may not be able to represent the overall macroeconomic performance of the nation, and therefore more macroeconomic indicators should be considered.

Thus, this study aims to fill in those gaps by examining the dynamic relationship between Chinese Yuan-Dollar and Malaysian macroeconomic variables. Specifically, this study employs the framework proposed by Ibrahim (2007) in examining the impact of Chinese Yuan changes on Malaysia real output, price level and monetary aggregate.

2.1. Theoretical Framework

The exchange rate is defined as Dollar per Chinese Yuan (CNYUSD). Therefore an increase in the exchange rate indicates appreciation in the Chinese Yuan. Thus, a positive variation of the CNYUSD represents an appreciation of the Yuan currency. As mentioned earlier, changes in the

CNYUSD will affect Malaysia's macroeconomic performance. Hence, it can be hypothesized that:

H1: There is a positive shock in CNYUSD which will have an expansionary effect on GDP.

H2: There is a positive shock in CNYUSD which will have an expansionary effect on the CPI.

H3: There is a positive shock in CNYUSD which will have an expansionary effect on the M3.

Hypothesis 1 and 2 are used to illustrate the aggregate demand channel of CNYUSD changes. Malaysia is one of China's competitors in the exportation market. An appreciation in the Chinese currency makes the Chinese export more expensive and therefore gives Malaysia a price advantage, subsequently, positively affect exports and aggregate demand, leading to expansion in domestic real output and prices (Ibrahim, 2007; Meng, 2015). Thus, a positive shock in CNYUSD is expected to exert upward pressure on Malaysia's output and price level.

Next, hypothesis 3 illustrates that foreign direct investment (FDI) channel of CNYUSD changes. As such, an appreciation in CNYUSD makes China's investment in foreign countries more profitable as Yuan-denominated assets become cheaper, thereby leading to an increase in FDI (Buckley *et al.*, 2007; Li and Rengifo, 2018). The influx of FDI would increase the net foreign asset received by a country, and subsequently increases the monetary aggregate in the economy. Therefore, a positive shock in CNYUSD is expected to accelerate the money supply in the Malaysian economy.

3. Data and Methodology

3.1. Data

The data period selected was from 1988 Q1 to 2017 Q2. The study employs the framework provided by Ibrahim (2007) in examining the dynamic relationship between Chinese Yuan and Malaysia's macroeconomic indicators. In this regard, this study uses two types of the exchange rate, namely Chinese Yuan to U.S. Dollar exchange rate (CNYUSD) and Ringgit Malaysia to U.S. Dollar exchange rate (MYRUSD) to analyse the impacts of exchange rates of both foreign currency and domestic currency on the performance of the Malaysian economy.

Three domestic variables are considered in the analysis, namely real output (GDP), consumer price index (CPI), and money supply (M3). The inclusion of the variables enables the study to examine the influences of Chinese Yuan on the goods and money markets. Moreover, Ibrahim (2007) used money supply M1, and this study uses M3 to capture a broader aspect of the money market. In further analysis, the sample period is divided into pre- and post-exchange rate reform in China. This seeks to ascertain the impacts of CNYUSD on Malaysian macroeconomic variables in different exchange rate regimes. The variables used are shown in Table 1.

3.2. Unit Root Test

A unit root test is used to examine whether a time series is stationary or non-stationary using the autoregressive model. The economic time series must be stationary in a VAR framework. A differencing method is commonly used in order to eliminate the non-stationary trend in time series data, which has a non-stationary sequence. In order to establish sequence stationarity, standard unit root tests will be performed.

Table 1 List of Variables

Variables	Description	Unit of measurement
CNYUSD	Chinese Yuan to U.S. Dollar exchange rate	Exchange rate
MYRUSD	Ringgit Malaysia to U.S. Dollar exchange rate	Exchange rate
GDP	Real Gross Domestic Product	MYR million
CPI	Consumer Price Index	Price index
M3	M3 Money Supply	MYR million

Notes: All data are retrieved from Thomson Reuter DataStream. Data period: 1988 Q1 to 2017 Q2.

The tests which shall be employed include the Augmented Dickey-Fuller (ADF) test, Phillips-Perron (PP) test, and Kwiatkowski-Phillips-Schmidt-Shin (KPSS) test in order to improve the credibility of the empirical findings. These tests are further explained below.

3.2.1. Augmented Dickey-Fuller (ADF) test

The Augmented Dickey-Fuller (ADF) test is an extension of the Dickey-Fuller test which is used to test the unit root of a series by adding lagged terms of dependent variables to ensure that error terms are not correlated. Furthermore, by adding the lagged difference term of variable y_t , the ADF test enables higher-order serial correlation to be avoided.

The ADF test equation can be explained below:

$$\Delta y_t = \psi y_{t-1} + \sum_{i=1}^p \alpha_i \Delta y_{t-i} + u_t \quad (1)$$

The test for stationarity can be further explained based on the hypothesis below:

$$H_0 : \psi = 0$$

$$H_1 : \psi < 0$$

The test statistic refers to

$$DF = \frac{\hat{\gamma}}{SE(\hat{\gamma})} \sim \tau \quad \text{distribution} \quad (2)$$

H_0 is rejected if the computed $DF >$ Mackinnon critical value and the series y_t is integrated into the order of 0. In choosing the appropriate lag length of the unit root test, the value that minimizes the information criteria such as Akaike Information Criteria (AIC) is as below:

$$AIC = n \sum \tilde{\varepsilon}_t^2 + 2m \quad (3)$$

Also, Schwarz's Bayesian Information Criteria (BIC) (as below)

$$BIC = n \sum \tilde{\varepsilon}_t^2 + m \ln n \quad (4)$$

where ε_t is the residual of the unit root test regression and m is the parameter in the test regression, including a constant, is used.

3.2.2. Phillips-Perron (PP) test

The Phillips-Perron (PP) test is also used to test for the unit root of the series. The PP test equation is:

$$\Delta y_t = \mu + \beta t + \gamma y_{t-1} + \varepsilon_t \quad (5)$$

The hypothesis to be tested is

$H_0 : \gamma = 0$ (The series needs to be differenced in order to make it stationary)

$H_1 : \gamma < 0$ (The series is stationary and need not be differenced)

3.2.3. Kwiatkowski-Phillips-Schmidt-Shin (KPSS) test

However, the power of ADF and PP tests is low if the root is close to a non-stationary boundary. In order to confirm the result of the unit root test, stationarity tests have also been carried out. In this instance, the KPSS test by Kwiatowski, Phillips, Schmidt, and Shin (1992) is used.

To further explain the KPSS test, it could be argued that KPSS is another unit root test with time trend, t , where:

$$y_t = \mu + \beta t + \varphi \sum_{i=1}^t \varepsilon_{t-1} + u_t \quad (6)$$

where μ is constant, u_t is a stationary process and the past error $\varepsilon_{t-1} \sim \text{i.i.d}(0,1)$.

Under the null hypothesis, the series y_t is assumed to be stationary. On the contrary, under the alternative hypothesis, y_t is non-stationary, so that by default under the null the series will appear stationary:

$H_0 : y_t \sim I(0)$

$H_1 : y_t \sim I(1)$

The nonlinearity and structural breaks may influence the stationarity properties of a series. However, the traditional unit root tests (ADF, PP and KPSS) are unable to cater for both conditions, and therefore the Ender and Lee (2012) FADF test and Perron and Vogelsang (1992) ADF-SB test will be used to ensure the robustness of the unit root test results. The Ender and Lee (2012) FADF is used to cater for nonlinearity

in a series. While Perron and Vogelsang (1992) ADF-SB test is to incorporate structural change in testing the unit root for a series, both tests have been widely used in economic research in ensuring the robustness of traditional unit root test results (Furuoka, 2014; 2015; 2016a; 2016b; 2016c).

3.3. Vector Autoregressive (VAR)

Vector autoregressive model VAR (p) is an extension of the univariate autoregressive model to model multivariate time series model. In the case where the k variables are not co-integrated, a VAR model with lag p is defined as

$$y_t = c + A_1 y_{t-1} + A_2 y_{t-2} + \cdots + A_p y_{t-p} + \varepsilon_t \quad (7)$$

where y_t is defined as $(y_{1,t}, y_{2,t}, y_{k,t})$ of $k \times 1$ vector, each c is a $k \times 1$ vector of constant (intercept), each A_i is a $k \times k$ coefficient matrix, and ε_i is $k \times 1$ error terms vector.

The lag length for the VAR(p) model may be determined by using model selection. However, the method may not be adequate in the presence of moving average error terms (Cheung and Lai, 1993). Therefore, this study follows the suggestion by Hall (1989) and Johansen (1992) in specifying the lag length such that the VAR residuals are serially uncorrelated.

4. Results

4.1. Descriptive Statistics

Table 2 presents the descriptive statistics of all the series. It can be observed that MYRUSD exhibits a higher standard deviation than

CNYUSD. This implies that MYRUSD is highly volatile as relative to CNYUSD. Moreover, M3 is highly volatile with higher standard deviation as compared to GDP.

Table 2 Descriptive Statistics

Variables	Mean	Std. Dev.	Skewness	Kurtosis	Jarque-Bera	Observation
CNYUSD	0.151	0.040	1.675	5.384	83.148(0.000)	118
MYRUSD	0.314	0.055	0.311	1.652	10.841(0.004)	118
GDP	134596	89377	0.584	2.095	10.744(0.005)	118
CPI	84.164	18.602	0.064	1.925	5.763(0.056)	118
M3	671784	498562	0.660	2.164	12.013(0.002)	118

Notes: GDP and M3 are in MYR million. Data period: 1988 Q1 to 2017 Q2.

4.2. Unit Root and Stationarity Test Results

Table 3 presents the unit root and stationarity test results for all of the series. Before the unit root test is conducted, all series are transformed into a natural logarithm. Both ADF and PP test has shown that all series become stationary after taking the first difference. As for the KPSS test, all series reject the null hypothesis. Hence, they are stationary after taking the first difference. The unit root and stationary tests show consistent results regardless of the series being the test with a trend or without a trend. Therefore, it can be concluded that all the series are integrated of order one or $I(1)$.

Since all the series are integrated of the order one, it is interesting to examine the long-run relationship among the series. Therefore, the test for cointegration has been conducted. In testing for cointegration, this paper uses the Johansen and Juselius (1990) procedure. This procedure is a multivariate cointegration analysis, in which it allows one to test for

Table 3 Unit Root and Stationarity Test Results

Variable	Level		First Difference	
	without trend	with trend	without trend	with trend
ADF Test				
LCNYUSD	-2.75(0)	-2.18(0)	-10.24(0)***	-10.61(0)***
LMYRUSD	-1.49(1)	-2.07(1)	-8.78(0)***	-8.75(0)***
LGDP	-2.51(5)	-1.93(5)	-6.38(4)***	-6.89(4)***
LCPI	-1.65(0)	-1.96(0)	9.50(0)***	-9.64(0)***
LM3	-4.01(1)***	-1.51(1)	-	-8.07(0)***
PP Test				
LCNYUSD	-2.75[0]	-2.19[4]	-10.24[2]***	-10.62[3]***
LMYRUSD	-1.18[0]	-1.85[1]	-8.70[5]***	-8.66[5]***
LGDP	-2.61[7]	-2.35[7]	-10.58[8]***	-11.66[7]***
LCPI	-1.77[5]	-1.94[3]	-9.43[3]***	-9.58[5]***
LM3	-4.15[6]***	-1.22[6]	-	-8.14[5]***
KPSS Test				
LCNYUSD	2.98[0]**	0.28[9]**	0.63[0]	0.13[3]
LMYRUSD	0.65[9]**	0.16[9]**	0.08[2]	0.09[2]
LGDP	1.28[9]**	0.26[9]**	0.46[7]	0.05[7]
LCPI	1.27[9]**	0.24[9]**	0.29[2]	0.09[5]
LM3	1.25[9]**	0.25[9]**	0.71[8]	0.11[6]

Notes: The asterisks *** and ** denote statistical significance at 1% and 5% level respectively. The optimal lag length selected for ADF is based on SIC. The optimal lag length selected for PP and KPSS is based on Newey-West Bandwidth. Figures in () indicate optimal lag length chosen. Figures in [] indicate optimal bandwidth is chosen. Ln denotes all series having transformed to the natural logarithm.

the number of the cointegrating vector that might exist. Before the test for cointegration, a vector autoregression model (VAR) in level form is conducted to determine the appropriate lag length. Referring to the suggestion by Hall (1989) and Johansen (1992), this study specifies the lag length to be three and sufficient to mitigate the problem of autocorrelation (*p-value of LM test is 0.362*).

As observed from Table 4 and Table 5, both FADF and ADF-SB test yield consistent results as the traditional unit root tests. As such, all the series are found to become stationary after taking the first difference. Thus, it can be concluded that all the series are integrated of order one.

Table 6 shows the Johansen cointegration test. The estimated results show that the null hypothesis of the non-cointegrating vector is rejected at the 1 % significance level at the first rank. This indicates the presence of one cointegrating relationship, suggesting a long-run equilibrium relationship between the series.

4.3. VAR Results Based on the Full Sample Period (1988Q1 to 2017Q2)

As noted by Engle and Granger (1987) and Selover and Round (1996), a vector error correction model or an unrestricted VAR in levels can be applied if the series are cointegrated. In this analysis, VAR in levels form will be estimated instead of VECM. This is because: (1) there is no guarantee that imposing cointegrating restriction can be a reliable basis for making inferences, which is right in the case of imposing inappropriate cointegrating relationships (Faust and Leeper, 1997; Ibrahim, 2007); (2) Ramaswamy and Sløk (1998) and Ibrahim (2007) state that the impulse response functions generated from a VECM tend to imply that the effects of shocks are permanent. While the impulse response function from an unrestricted VAR provides insight into

Table 4 Ender and Lee (2012) Flexible Fourier Form and Dickey-Fuller-type Unit Root Tests

Variables	Level	First difference
LnGDP	-1.539	-15.511***
LnM1	-2.124	-6.986*
LnCPI	-0.779	-8.508***
LnMYRUSD	-1.254	-7.359***
LnCPYUSD	-2.155	-8.068***

Notes: The 1%, 5% and 10% critical values for FADF test are 10.35, 7.58 and 6.35, respectively (Ender and Lee, 2012). The asterisks ***, ** and * denote statistical significance at 1%, 5% and 10% level respectively.

Table 5 Perron and Vogelsang (1992) ADF-SB Test

Variables	Without trend	Breakpoint	With trend	Breakpoint
LnGDP	-2.242	2009Q2	-5.678	1992Q2
ΔLnGDP	-17.174***	1998Q1	-17.117***	1998Q1
LnM1	-2.392	1999Q1	-3.394	1997Q4
ΔLnM1	-8.059***	1998Q1	-8.005***	1998Q1
LnCPI	-2.242	2004Q3	-3.514	1991Q4
ΔLnCPI	-10.332***	2008Q3	-10.251***	2008Q3
LnMYRUSD	-4.377	1997Q2	-4.706	1997Q2
ΔLnMYRUSD	-8.834***	1997Q3	-8.729***	1997Q3
LnCPYUSD	-3.993	1989Q4	-4.464	1994Q1
ΔLnCNYUSD	-13.587***	1994Q2	-13.232***	1994Q2

Notes: Critical values are based on Furuoka (2016a). The asterisks ***, ** and * denote statistical significance at 1%, 5% and 10% level respectively.

Table 6 Johansen Cointegration Test

Hypothesized number of CE	Trace statistics	5 % Critical value	Prob
None*	85.471	69.818	0.002
At most 1	36.457	47.856	0.374
At most 2	17.429	29.797	0.608
At most 3	7.169	15.494	0.558
At most 4	1.405	3.841	0.236

Note: The Johansen tests are based on a model with an only intercept but no trend in the cointegrating equation.

whether the effects of shocks are permanent or temporary. Thus, unrestricted VAR (level VAR) remains appropriate and is employed in this study.

As mentioned above, lag three will be employed in estimating the VAR. From the VAR, impulse response function and variance decomposition will be conducted as bases for inferences. As noted by Sims (1980), this study employs the Cholesky factorization to identify shocks in the system. This option imposes an ordering of variables in the VAR system and attributes the effect of any common component to the variable that appears first in the VAR system. Hence, the method is sensitive to the ordering of the variable. Therefore, this study follows the suggestion from Ibrahim (2007) and orders the variables in the following way: LCNYUSD, LMYRUSD, LGDP, LCPI, LM3.

As a variable from the external sector, the Chinese Yuan is reasonably the most exogenous of all the variables. The Malaysian Ringgit is stabilized against the U.S. Dollar. Hence it can be placed before the domestic variables. Next, real GDP and price level are sluggish to adjust and, therefore, should be treated as more exogenous than money supply.

Table 7 Residual Correlations Matrix of VAR Model

	LCNYUSD	LMYRUSD	LGDP	LCPI	LM3
LCNYUSD	1.000				
LMYRUSD	0.101	1.000			
LGDP	0.009	0.102	1.000		
LCPI	0.136	-0.060	0.108	1.000	
LM3	0.110	0.105	0.093	-0.001	1.000

Table 7 shows the contemporaneous correlations among the shocks in the VAR. Notably, all the correlations are low, and therefore our preferred ordering is not a cause for concern. As a robustness check, this study employs the generalized impulses in generating the impulse response functions, in which the function constructs an orthogonal set of innovations that do not depend on the VAR ordering (Pesaran and Shin, 1998). This study presents the impulse response function based on the preferred ordering. However, the results are the same when the impulse response function is generated based on generalized impulses.

Figure 1 to 6 show the impulse response function. As observed, all the three Malaysian macroeconomic indicators, namely LGDP, LCPI and LM3 response positively concerning LCNYUSD appreciation (Figure 1, 3 and 5 respectively). However, the impact of the LCNYUSD appreciation on all the three macroeconomic indicators is insignificant in both short and longer horizons as the confidence interval contains the value of zero.

On the appreciation of shock from LMYRUSD, Figure 2 shows that Malaysia's output (LGDP) increases significantly in response to LMYRUSD appreciation shock at quarter three and six. Hence, the significant effect is felt in less than one year and becomes apparent in

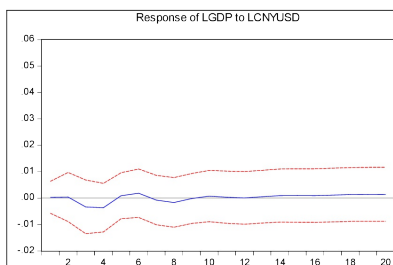


Figure 1 Response of LGDP to LCNYUSD

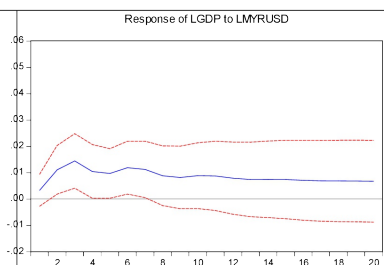


Figure 2 Response of LGDP to LMYRUSD

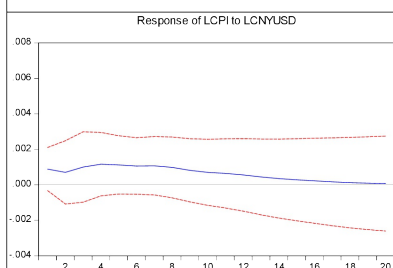


Figure 3 Response of LCPI to LCNYUSD

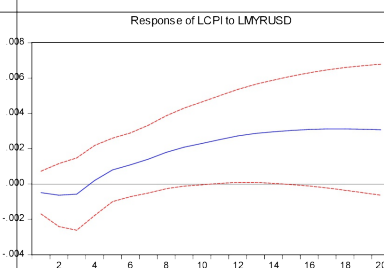


Figure 4 Response of LCPI to LMYRUSD

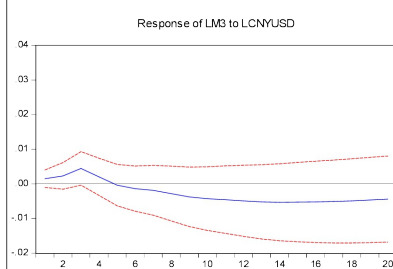


Figure 5 Response of LM3 to LCNYUSD

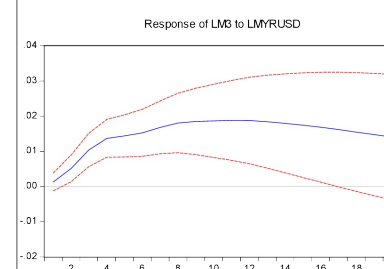


Figure 6 Response of LM3 to LMYRUSD

Notes: The impulse response function is based on the following order: LCNYRUSD LMYRUSD LGDP LCPI LM3. Robustness check using generalized impulse yields same results but are not reported here to conserve space. They are available upon request.

the second year. Therefore, it can be observed that Ringgit appreciation shocks do not seem to exert a permanent expansionary effect on real output. This result concurs with earlier findings by Upadhyaya (1999) and Ibrahim (2007).

Next, the LMYRUSD appreciation shock is found to have no impact on the price level in short and longer horizons (Figure 4). However, M3 increases significantly in response to LMYRUSD appreciation shocks at 3-quarter to 16-quarter horizons (Figure 6). The significant effect is felt in less than one year and lasts until five years. Appreciation in LMYRUSD makes the Ringgit-denominated assets attractive, thereby leading to an increase in FDI and net foreign assets received, subsequently, increases the monetary aggregate in the economy.

Next, Table 8 illustrates how much of the forecast error variance of each of the domestic variables can be explained by exogenous shocks to the other variables. It can be observed that the dominant role of explaining the variation of LGDP, LCPI and LM1 in both short and the longer horizon is LMYRUSD changes while Chinese Yuan is found to have a limited impact on the variation of Malaysia's macroeconomic indicators.

Table 8 Variance Decompositions (Full sample period: 1988Q1 to 2017Q2)

Period	VDC of <i>LGDP</i>		VDC of <i>LCPI</i>		VDC of <i>LM1</i>	
	<i>LCNYUSD</i>	<i>LMYRUSD</i>	<i>LCNYUSD</i>	<i>LMYRUSD</i>	<i>LCNYUSD</i>	<i>LMYRUSD</i>
4	0.738	13.575	2.856	0.785	3.273	33.597
8	0.603	16.712	4.354	4.299	1.696	51.908
12	0.475	17.012	3.713	11.668	2.432	55.292
16	0.433	16.831	2.787	17.914	3.088	53.573
20	0.452	16.631	2.135	21.480	3.306	50.574

Note: Cholesky Ordering: LCNYRUSD LMYRUSD LGDP LCPI LM3.

As such, after 20-quarter horizon, the Ringgit fluctuation accounts for about 16%, 21% and 50% of the variation in LGDP, LCPI and LM3 respectively, while Yuan fluctuation only explains 0.5%, 2.1% and 3.3% of the variation in LGDP, LCPI and LM3 respectively. These results confirm the findings from the impulse response function above, in which changes in MYRUSD is essential in affecting the macroeconomic indicators as opposed to changes in Chinese Yuan.

Hence, the analysis based on the full sample period (1988Q1 to 2017Q2) demonstrates that Chinese Yuan changes have a negligible impact on the Malaysian macroeconomic performance while fluctuation in the Ringgit Malaysia plays the dominant role in affecting the real GDP and M3 in both short and longer horizons, respectively.

However, the full sample period involves a series of event that affects the currency movement of Chinese Yuan and Ringgit Malaysia. For instance, both Chinese Yuan and Ringgit Malaysia were pegged to the U.S. Dollar in the aftermath of the 1997 Asian Financial Crisis and de-pegged in July 2005. Moreover, China was having exchange rate reform in a particular period and moved to a managed float regime in July 2005. Given all these events, it can be argued that the analysis based on the full sample period is fundamentally inaccurate as the estimation results may be affected by the exchange rate policy in a particular period. In other words, the role of Chinese Yuan in affecting Malaysia macroeconomic indicators may be hindered by the exchange rate policy. Therefore, a further analysis which splits the sample period into pre- and post-exchange rate reform in China is motivated.

5. Further Analysis (Pre-and Post-Exchange Rate Reform in China)

As mentioned earlier, the full data period used in the analysis earlier covers several strategic time points, which are essential in the roadmap

of China's exchange rate reform agenda. Partially because of the worsening situation of inflation, the official Chinese Yuan exchange rate was sharply cut in 1994. With the coming of the Asian crisis, the Chinese Yuan was deliberately pegged to the US dollar within a narrow range from 1997 until July 2005.¹ The dummy variable is used to take into account the structural break observed from 1994Q1 to 2005Q3.

In other words, data from 1994Q1 to 2005Q2 will not be included in the analysis. According to the likelihood ratio test, the result implies that the dummy variable is significant in the unrestricted VAR model². For this purpose, two VAR models have been estimated for pre- and post-exchange rate reform in China.

Moreover, the lag length specified for the VAR model in pre- and post-exchange rate reform is one and two, respectively, which is sufficient to render error terms serially uncorrelated. Furthermore, with the findings of cointegration in pre- and post-exchange rate reform period³, a level VAR model will be estimated for the two periods. Similarly, this study reports the impulse response functions and variance decomposition of the three domestic variables to innovations in the two exchange rates for pre- and post-exchange rate reform period.

Panel A shows the impulse responses from the first VAR model (Pre-reform). Notably, in the pre-exchange rate reform period, both LCNYUSD and LMYRUSD appreciation shocks are found to have an insignificant impact on the three macroeconomic indicators. This may be due to insufficient sample size in the pre-reform period⁴. Therefore, it is reasonable that no significant results can be obtained. However, the variance decomposition from Table 9 Panel A shows that fluctuation in LCNYUSD is essential in influencing the variation in real output, price level and monetary condition as compared to the fluctuation in LMYRUSD.

Panel A: Impulse Response Function for the Pre-Exchange Rate Reform Period (1988Q1 to 1993Q4)

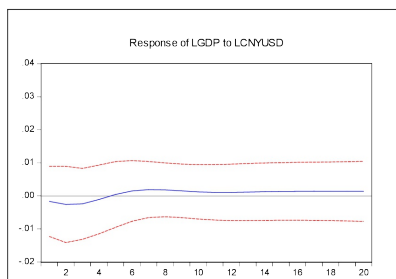


Figure 7 Response of LGDP to LCNYUSD

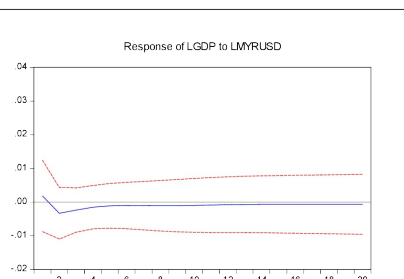


Figure 8 Response of LGDP to LMYRUSD

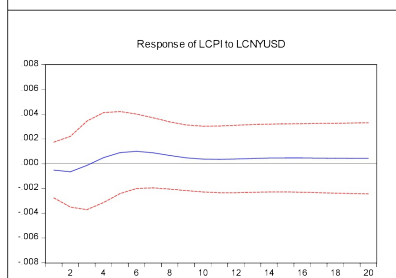


Figure 9 Response of LCPI to LCNYUSD

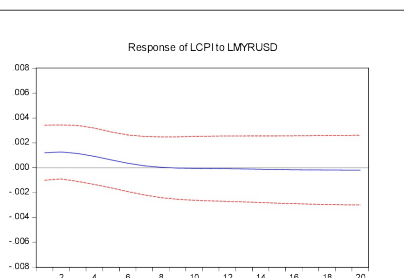


Figure 10 Response of LCPI to LMYRUSD

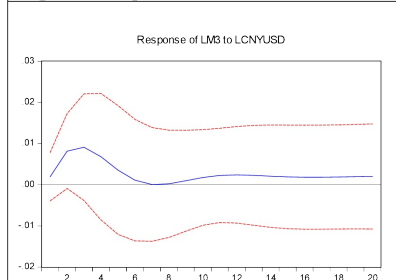


Figure 11 Response of LM3 to LCNYUSD

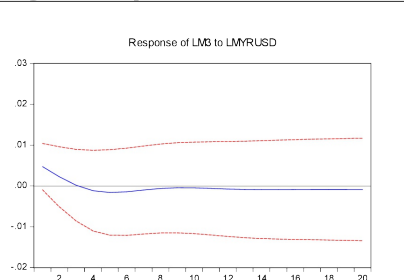


Figure 12 Response of LM3 to LMYRUSD

Notes: The impulse response function is based on the following order: LCNYRUSD LMYRUSD LGDP LCPI LM3. Robustness check using generalized impulse yields same results but are not reported here to conserve space. They are available upon request.

Panel B: Impulse Response Function for Post-Exchange Rate Reform Period (2005Q3 to 2017Q2)

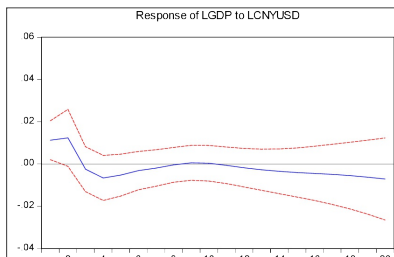


Figure 13 Response of LGDP to LCNYUSD

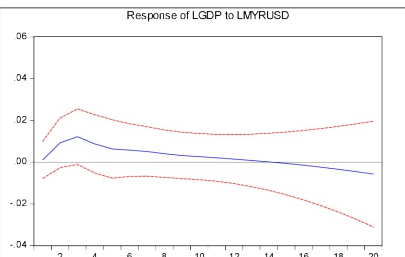


Figure 14 Response of LGDP to LMYRUSD

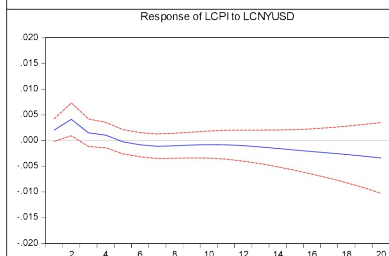


Figure 15 Response of LCPI to LCNYUSD

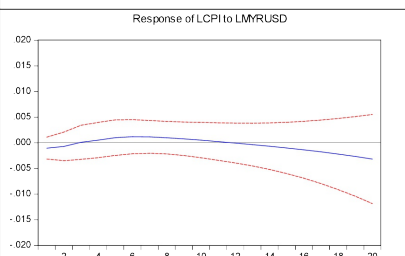


Figure 16 Response of LCPI to LMYRUSD

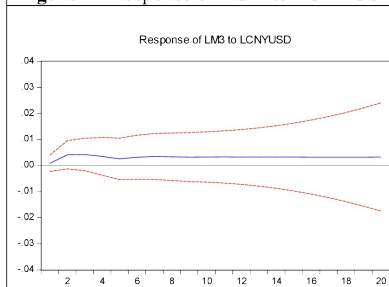


Figure 17 Response of LM3 to LCNYUSD

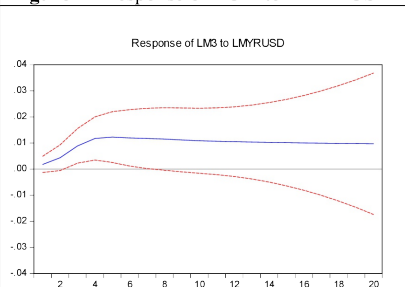


Figure 18 Response of LM3 to LMYRUSD

Notes: The impulse response function is based on the following order: LCNYRUSD LMYRUSD LGDP LCPI LM3. Robustness check using generalized impulse yields same results but are not reported here to conserve space. They are available upon request.

Panel B shows the impulse response function for the post-exchange rate reform period. Notably, LCNYUSD appreciation is found to have an expansionary effect on real output at quarter 1 to 2 (Figure 13). The effect lasts within one year, and therefore it can be concluded that the positive impact of LCNYUSD appreciation on real output is temporary. Thus, hypothesis 1 is supported in which positive shock in LCNYUSD will have an expansionary effect on Malaysia's GDP.

Similarly, price level responds positively and significantly concerning the LCNYUSD appreciation shock at quarter two and the effect becomes insignificant in a longer horizon (Figure 15). Hence, LCNYUSD appreciation shock is also found to have a temporary positive impact on the domestic price level. Thus, hypothesis 2 is supported in which positive shock in CNYUSD will have an expansionary effect on Malaysia's price level. Conversely, LCNYUSD appreciation shock has no significant impact on the monetary aggregate (Figure 17). Thus, hypothesis 3 cannot be accepted.

For the domestic exchange rate, LMYRUSD appreciation shock is only useful in influencing the monetary aggregate at 3-quarter to 5-quarter horizon (Figure 18). For output and price level, the impact of LMYRUSD appreciation shock is found to be insignificant (Figure 14 and Figure 16 respectively).

Next, Table 9 Panel B tabulates the variance decomposition for post-exchange rate reform period. The results concur with the above findings and, more importantly, further emphasize the relative importance of the Chinese Yuan exchange rate for domestic real output and price level. As such, a fraction of forecast error variance in LGDP attributed to innovations in LCNYUSD and LMYRUSD is roughly 12% and 11% respectively at the one-year horizon. Similar to the price level, the Chinese Yuan fluctuations account for about 16% of the variations in

LCPI as compared to only 1% by LMYRUSD at a one-year horizon. Thus, hypothesis 1 and 2 are further supported.

Table 9 Variance Decompositions – Further Analysis

Panel A: Pre-Exchange Rate Reform Period (1988Q1 – 1993Q4)

Period	VDC of <i>LGDP</i>		VDC of <i>LCPI</i>		VDC of <i>LMI</i>	
	<i>LCNYUSD</i>	<i>LMYRUSD</i>	<i>LCNYUSD</i>	<i>LMYRUSD</i>	<i>LCNYUSD</i>	<i>LMYRUSD</i>
4	1.725	2.320	1.416	7.749	18.821	2.736
8	1.987	2.058	3.819	5.512	11.571	1.903
12	1.904	1.809	3.261	4.071	8.892	1.423
16	1.873	1.562	3.023	3.243	7.304	1.188
20	1.876	1.378	2.820	2.708	6.228	1.030

Panel B: Post-Exchange Rate Reform Period (2005Q3 – 2017Q2)

Period	VDC of <i>LGDP</i>		VDC of <i>LCPI</i>		VDC of <i>LMI</i>	
	<i>LCNYUSD</i>	<i>LMYRUSD</i>	<i>LCNYUSD</i>	<i>LMYRUSD</i>	<i>LCNYUSD</i>	<i>LMYRUSD</i>
4	12.621	11.874	16.454	1.255	5.631	27.832
8	10.898	12.448	12.636	3.006	4.267	38.569
12	9.307	11.086	10.041	2.459	4.237	40.736
16	8.982	9.361	9.741	2.522	4.349	41.905
20	9.335	8.436	11.048	5.259	4.501	42.855

Notes: Cholesky Ordering: LCNYRUSD LMYRUSD LGDP LCPI LM3.

6. Discussion

Generally, there are two possible channels on how fluctuation in foreign currencies influences Malaysia's macroeconomic indicators. The first channel is the aggregate demand channel suggested by Ibrahim (2007)

and Meng (2015). In this study, the aggregate demand channel informs that the appreciation of the Chinese Yuan exchange rate would have an expansionary effect on Malaysia's output and price level. As such, appreciation of the Chinese Yuan increases the international competitiveness of China's export competitors and, subsequently, positively affects exports and aggregate demand, leading to an expansion in domestic real output and prices.

Next, the second channel is the foreign direct investment channel mentioned by Buckley *et al.* (2007) and Li and Rengifo (2018). In the context of this study, the channel suggests that an appreciation of the Chinese Yuan exchange rate would have a positive impact on the monetary aggregate in the Malaysian economy. As such, the appreciation of the Chinese Yuan exchange rate increases the profit of Yuan-denominated investment in Malaysia. Hence, there will be an influx of foreign direct investment, which in turn increases the net foreign assets received by Malaysia, and subsequently increases the monetary aggregate in the economy.

Notably, the empirical results show that fluctuation in Chinese Yuan exchange rate has a negligible impact on Malaysia's macroeconomics indicators when the full sample period is used in the analysis. This may be due to the exchange rate reform in China over the period 1994Q1 to 2005Q2, which hinders the role of Chinese Yuan in affecting Malaysia's macroeconomic performance. However, the impact of Chinese Yuan fluctuation on Malaysian macro-economy becomes apparent after splitting the sample period into pre-and post-exchange rate reform.

The post-exchange rate reform reflects the period where China moves to managed float exchange rate regime and, subsequently, increases the role of China in influencing countries' macroeconomic performance through the movement of Chinese Yuan. In conjunction with this, our results show that Chinese Yuan appreciation shock has an

expansionary effect on Malaysia's real output and price level. The results suggest that the aggregate demand channel seem to be operative. This is particularly true in the context of Malaysia, which is one of the export competitors of China. In particular, appreciation of Chinese Yuan would reduce the export competitiveness of China, thereby providing price advantage to Malaysia. Subsequently, Malaysia's export to the rest of the world would increase, leading to higher aggregate demand, output produced and price level in the economy. Empirically, Meng (2015) has proven that Malaysia's export tends to be benefited in response to the appreciation of Chinese Yuan. Moreover, the findings concur with earlier work done by Fair (2010) and Ibrahim (2007) in which fluctuation in foreign currency would have an impact on domestic output and price level.

Next, Chinese Yuan appreciation shock is found to have no impact on the monetary condition in Malaysian economy. The results contradict earlier findings by Ibrahim (2007), in which fluctuation in foreign currency would have a bearing on the Malaysian monetary condition. This can be explained by the ease of doing business in Malaysia as opposed to other countries. In 2017, the ease of doing the business index of Malaysia was 78.11 points, ranked at 23 out of 190 countries in the world (World Bank, 2017). The top five countries which had the least restriction in doing business were New Zealand, Singapore, Denmark, Hong Kong and Korea. Hence, it can be argued that if there is an appreciation in Chinese Yuan against the U.S. Dollar, China's investment in foreign countries becomes more profitable as Yuan-denominated assets become cheaper. As a result, China firms may diversify their investment into countries which has the least restriction in doing business to reap the benefit from Chinese Yuan appreciation. Therefore, instead of Malaysia, the top five countries which have the highest ease of doing business index will be their preferred choice of

investment. Thus, this explains the findings above, in which appreciation shock in Chinese Yuan is found to have no impact on Malaysia's monetary condition.

By and large, our results are in line with the thesis that fluctuations in foreign currencies can have a significant impact on countries' macroeconomic performance. Specifically, this study contributes to the existing literature in revealing the impact of Chinese Yuan appreciation on the performance of Malaysia's macroeconomic indicators. Results indicate that Chinese Yuan appreciation would lead to an increase in real output and price level in the economy. Therefore, this study highlights the importance of China as the engine of growth for the Malaysian economy.

7. Conclusion

This study investigates the impact of changes in the Yuan-Dollar exchange rate (CNYUSD) to Malaysia's macroeconomic variables in pre- and post-Chinese exchange rate reform period. Our result shows that both Chinese Yuan and Ringgit Malaysia appreciation have no impact on Malaysia's macroeconomic variables in pre-exchange rate reform period. This may occur due to insufficient observations in the pre-reform period, in which no inferences can be made.

However, in the post-exchange rate reform period, the impulse response function shows that Chinese Yuan appreciation shock has an expansionary effect on Malaysia's real output and price level. However, the positive impact is found to be temporary and lasts for the 1-year horizon. Moreover, the variance decomposition yields consistent results with impulse response function, in which fluctuation in Chinese Yuan accounts for a more substantial variation in real output and price level for the 1-year horizon. The influence is found to deteriorate in more

periods ahead. Hence, hypothesis 1 and 2 are supported, in which appreciation in Chinese Yuan would result in output expansion and an increase in the price level in the Malaysian economy. The results also support the presence of aggregate demand channel in explaining the influence of Chinese Yuan on domestic macroeconomic variables. Furthermore, the findings concur with the earlier studies by Ibrahim (2007) and Fair (2010), in which changes in foreign currency would have a significant impact on the performance of Malaysia's macroeconomic indicators.

As a policy suggestion, the Malaysian government should improve the competitiveness of the export sector. This would enable the country to reap much of the benefit if there is an appreciation in Chinese Yuan. A competitive export sector, together with Chinese Yuan appreciation, would further enhance the export sales, thereby generating greater aggregate demand and higher economic growth in the country.

Notes

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1. This is in order to resist the depreciation pressures as well as to stabilize the neighbouring economies, especially the ASEAN economies that are important trade partners of China. After 2005, China resumed its so-called managed float system with its exchange rate determined based on market supply and demand to maintain the primary stability. Similar to China, the Malaysian ringgit was also de-pegged from U.S. dollar in July 2005.
2. The p-value for the likelihood ratio test is 0.015. Therefore we reject the null hypothesis of VAR without dummy variable and accept an alternative model which is the VAR with a dummy variable.
3. The cointegration tests will not be reported here to conserve space, but they are available upon request.
4. The sample size for the pre-exchange rate reform is 24 (n=24).

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You've Got Money Left Over: Twin Surpluses of Balance of Payments Accounts in China

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Abstract

This study is devoted to explore empirically China's twin (double) surpluses of Balance of Payments (BoP) for the period 1998-2016. This phenomenon reflects the money China have left over from importing (buying) and exporting (selling) goods and services (as recorded in current account), and between outflow and inflow of financial assets (as recorded in financial account). This study answers the following questions: *Are China's twin surpluses sustainable? What are the macroeconomic variables determining China's twin surpluses?* and *What are their possible transmission channels between current account surplus and financial account surplus?* The time series econometric tests offer that China's twin surpluses phenomenon is considerably sustainable. That is both surpluses will be approaching a zero balance in the long run. Secondly, domestic income, exchange rate, and world income are important macroeconomic variables in explaining the behaviour of China's twin surpluses in the long run, except for domestic, and world interest rates. Lastly, no transmission channel has been found, while China's current account surplus is caused by financial account

surplus, and world interest rate, separately. This study has relevant policy implications, especially on the country's external imbalances.

Keywords: *balance of payments, China, current account, financial account, twin (double) surpluses*

1. Introduction

China is unusual from the economic perspective as a country with the important features of both market economy and planned economy. Since Deng Xiaoping's economic reforms at the end of 1970s, China has been transformed dramatically from a centrally-planned economy into a prosperous market-based nation with several episodes of economic reforms implemented. Among them are, developing Shenzhen as the first "*special economic zone*" in 1980, Renminbi convertibility in 1996, and opening more the country to the world (trade). Table 1 provides some stylized facts (macroeconomic indicators) of China's economy between 1995 and 2014. First of all, the country's standard of living as captured by Gross Domestic Product (GDP) per capita has increased remarkably from an averaged US\$790.55 to US\$5,453.52 between the interval periods of 1995-2000 and 2008-2014. Indeed, China has achieved an extraordinary GDP growth of 9%, 11%, and 9% over the three consecutive periods of 1995-2000, 2001-2007 and 2008-2014 respectively regardless of several "shocks" occurred such as the Asian financial crisis in 1997-1998, and the global financial crisis in 2006-2007.

Also, China's trade performance is considerably outstanding as the statistics reported in Table 1. The country's trade openness (measured by the sum of imports and exports per GDP) has increased from 35.04% to 48.83% during the interval periods of 1995-2000 and 2008-2014

respectively, while their trade values either exports or imports are almost tenfold. As projected, China's exports of goods and services will continue to outweigh imports, and current account (CA) balance will continue to record a surplus (State Administration of Foreign Exchange, China, 2015: 70). More interestingly, International Monetary Fund (IMF) has projected that China's CA balance will be around 0.5% of GDP in 2019, but will enter negative territory in 2022 and stand at -0.2% by 2024.¹

Table 1 Stylized Facts of China Economy (Averaged), 1995-2014

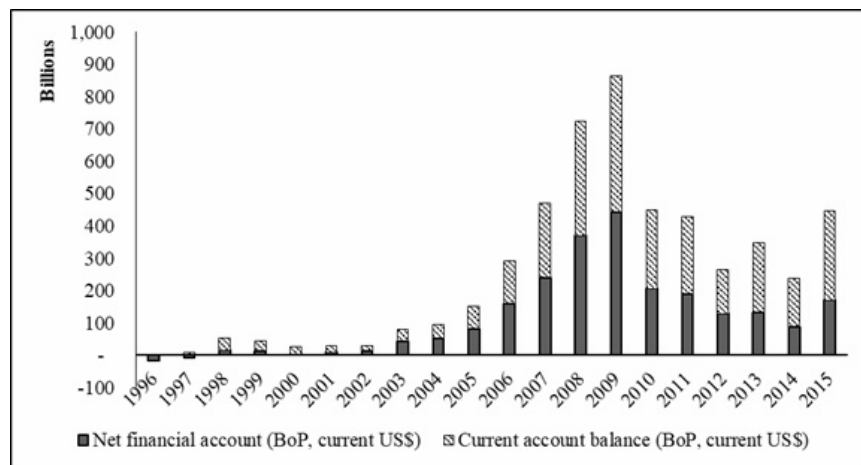
	1995-2000	2001-2007	2008-2014
GDP per capita	790.55US\$	1,637.66US\$	5,453.52US\$
GDP growth	9.01%	10.82%	8.81%
Inflation	4.34%	1.86%	3.02%
Unemployment	3.05%	4.06%	3.97%
Trade openness (% of GDP)	35.04	54.53	48.83
		<u>in US\$ billion</u>	
Exports of goods and services	185.27	655.97	1,894.20
Imports of goods and services	157.54	561.94	1,658.35
Net foreign direct investment	-38.19	-74.77	-165.51
Net portfolio investment	1.58	7.89	-41.25
Total reserves (includes gold)	137.41	716.50	3,107.89

Source: Data from *World Development Indicators*, World Bank (<http://data.worldbank.org>).

After a brief review of China's real sector – goods and services market above – China's financial sector, in particular the net foreign direct investment (FDI) has recorded a notable change between 1995 and 2014, more obviously after China joining WTO in 2001, by huge foreign investments that flowed into China. The net FDI as showed in Table 1 has been doubled from -US\$38.2 billion (1995-2000) to -US\$74.8 billion (2001-2007), and -US\$165.5 billion (2008-2014). Meanwhile, China's FDI outflow is about US\$118.0 billion in 2014, and of this

amount, US\$14.8 billion is along China's "*Belt and Road Initiative*".² On the contrary, the net portfolio investment declines in China since 2006, which may be (partially) associated with the unconventional reform that commercial banks are allowed to set bank deposit and lending rates freely with reference rates set by the People's Bank of China (PBOC), which is crucial for financial liberalization in China.³ According to China's State Administration of Foreign Exchange (2015), financial account (FA)⁴ that covers all transactions associated with changes of ownership in the foreign financial assets and liabilities of an economy will be more volatile as China's economy becomes more open (see, pp. 70-72). Yu (2007) highlights that FA balance is foreseen to increase as a result of the intensified cross-border capital flows.⁵ By the same token, CA balance is assumed to be in deficits, whereas FA in surpluses, as it is considered that foreign savings will lead a developing country like China to have a higher investment rate than what domestic savings itself can do (p. 10). This offsetting phenomenon is assumed to be true. In fact, China is in a position of *twin surpluses* or *double surpluses* (i.e. +CA and +FA) of Balance of Payments (BoP) since 1998, as showed in Figure 1. Both the CA and FA surpluses have increased rapidly, and reached a peak in 2009. Although they have slightly declined then, their surpluses remain "*big*" – around US\$200 billion in CA and more than US\$100 billion in FA. Recent statistics from the World Bank (as the source showed in Figure 1) show that China's (net) FA is in deficits of US\$28 billion and US\$58 billion in 2016 and 2017 respectively.

Figure 1 Current Account and Net Financial Account of China's Balance of Payments (BoP), 1996-2015



Source: Data from *World Development Indicators*, World Bank (<http://data.worldbank.org>).

As noted by Kumhof and Yan (2016), “... *the current account surpluses have contributed to explosive central bank foreign exchange reserve accumulation, to the point that reserves now exceed, often by a wide margin, what is required for liquidity purposes or as an insurance device against sudden reversals in capital inflows*” (p. 187). Deng and Zhang (2007) highlight that continuous twin surpluses of BoP may cause other negative effects such as trade conflicts, pressure of high inflation, and pressure of appreciating Renminbi. Additionally, China’s twin surpluses have created large welfare losses (Yu, 2012). In fact, China *will continue to stay* in twin surpluses, and will not have any change in the short run (Deng and Zhang, 2007; Zheng, 2006). However, in the long run, as Zhang and Tan (2015: 101) document, twin surpluses

experienced in China *will* fade out eventually because of structural changes externally and internally. To be more specific, their prediction is that China's CA and FA will be balanced out because of the new standards of calculation system of IMF as reserve asset item was categorized into FA. China's twin surpluses would vanish in the future due to the certain structural factors that CA surplus will shrink because of liberalization of domestic factors, appreciation of the Renminbi exchange rate, and weak external demand. In fact, FA surplus is likely to decrease because of strong incentives from China's government that encourage domestic enterprises to invest abroad (Zhang and Tan, 2015: 118). China is not alone, indeed twin surpluses phenomenon had also happened in South Korea during the years of 1999-2005 when the country adjusted industrial structure caused by technological development (see, Deng and Zhang, 2007).

Of the literature search, the twin surpluses phenomenon has not been conceptually explored, and empirically examined, in particular for the case of China. This study aims at examining the twin (double) surpluses (that is both current account and financial account surpluses) of China's BoP. More precisely, this study considers the following research questions.

- (i) *Is China's twin surpluses sustainable?* This study answers: the twin surpluses phenomenon in China is either permanent (i.e. always in an imbalance position – surpluses or deficits) or temporary (i.e. approaching a zero balance in the long run). The existing studies (Zheng, 2006; Deng and Zhang, 2007) only describe and summarize the unfavourable effects of twin surpluses. They believe that this phenomenon would be continued, but this projection is lack of empirical support. Perhaps, the question of sustainability of twin surpluses of BoP in China remains puzzling. Zheng's (2006) study

suggests future study to consider a more proper empirical testing on twin surpluses.

- (ii) *What are the macroeconomic factors determining the twin surpluses of China's BoP accounts?* Using general equilibrium perspective of open economy macroeconomics (Brooks and Fausten, 1998), a set of macroeconomic variables has been proposed and tested in association with twin surpluses behaviour in China. It is based on a systematic derivation from the behavioural relations of CA(.) and FA(.). Several studies have looked at the relevant variables determining the twin surpluses in China (Zheng, 2006; Deng and Zhang, 2007; Zhou, 2012; Yu, 2007) – Renminbi exchange rate, price of exports, and imports on CA balance (Zhang and Tan, 2015); and FDI inflow, and reserve asset as the main explanators of twin surpluses (Liu, 2008). However, these variables are being considered as ad hoc because of lacking theoretical foundation.
- (iii) *What are the potential transmission channels from current account (CA) surplus to financial account (FA) surplus?* This question is to find out the causalities between CA balance and FA surplus with a set of macroeconomic variables, in relation to (ii). The identified transmission channel(s) is important to policymakers, especially in reducing the so-called “unfavourable surpluses” in China, as aired by the U.S. As noted by Yiping Huang, “China's large external sector imbalance is a product of incomplete economic reform. The best way to reduce the imbalance is to finish the task of economic reform. The growing risks, including large current account surpluses, suggest that liberalizing factor markets should now be placed at the top of Chinese policymakers' agenda.”⁶

The rest of this study is organized as follows. Section 2 investigates the sustainability of China's twin surpluses behaviour. It covers briefly

the relevant past studies, theoretical (or conceptual) framework, data, testing methods, and empirical results. Similar content applies for the Sections 3 and 4. Section 3 identifies and examines the macroeconomic determinants of China's twin surpluses behaviour from the general equilibrium perspective of open economy macroeconomics. Section 4 is about an empirical investigation of the possible transmission channels of twin surpluses, i.e. from CA to FA via macroeconomic variable as identified in Section 3. Section 5 concludes this study with a brief discussion on policy relevance.

2. Sustainability of China's Twin Surpluses

This section offers an empirical evidence that China's twin surpluses phenomenon is *considerably* sustainable. This finding reflects a phenomenon that the current surpluses recorded by both CA and FA of China's BoP are *temporary* (i.e. in the short run), and a zero balance will be approached over time (i.e. in the long run).

“The sustainability hypothesis defines the condition that CA dynamics are consistent with a country's inter-temporal budget constraint, in the sense that this can be met in the long-run without the need for drastic corrections.”

(Lanzafame, 2014: 1001)

Among the influential works on this (CA) sustainability hypothesis are Hakkio and Rush (1991) and Husted (1992). For a case study of China, Guan (2004) highlights that China's CA is unsustainable because it has been in surpluses for a long time. Aizenman and Sun (2010) have called for reconsidering the arising sustainability issue in China since 1980s, because China's CA surplus (as per GDP) exceeds 10%, and its

relative size to the world economy is getting bigger. Sun (2011) finds no cointegration between real exports and real imports, which suggests that China's CA is unsustainable for the period 1990Q1-2010Q1, but it is sustainable for the sub-period 2005Q2-2010Q1 given the exchange rate regime announced. Tiwari (2011) finds no cointegration between China's real exports and real imports by using Gregory-Hansen (1996) tests for the monthly data of 1992M1-2010M2, but Saikkonen and Lütkepohl (2000) tests suggest cointegration. Xu *et al.* (2013) find that China's CA is weakly sustainable since May 1994⁷ because the estimated coefficient of imports is inelastic (0.7).

Indeed, no empirical study is found for testing the sustainability of twin surpluses of BoP, as well as the FA balance. Zhang and Tan (2015) have *predicted* that China's FA surplus will be narrowing in the long term because of shrinking in FDI inflows, portfolio investment and other investments which bring uncertainty (volatility) to FA position. According to them, China's CA and FA balances will be “*deficitted*” in the long run due to domestic structural reforms, and further liberalization of China's services sector. Recently, China's CA surplus is observed to be declining, while a deficit in FA is forecasted. However, China's twin surpluses will stay longer because the world demand of imports and ability to invest overseas will largely rise when the major foreign markets, i.e. the U.K. and the U.S., recover from the recent global financial crisis.⁸ Perhaps, a persistent twin surpluses behaviour is neither desirable nor sustainable for China as highlighted by Yu (2007: 18), while studies by Yu (2007) and Zhang and Tan (2015) are rather descriptive without offering an empirical evidence of the sustainability of China's twin surpluses.

Theoretically speaking, given a small open two-sector economy of real sector (goods and services) and financial sector (bond and money), an equality of $CA = \Delta F + \Delta IR$ is assumed to hold from the general

equilibrium perspective, where ΔF is changes in the foreign bonds, and ΔIR is changes in international reserves (money market). According to Fausten (1989-1990), CA and FA are interdependent, in which a deficit of one sector's balance is being funded by a surplus acquired in another sector. For example, a CA deficit will be financed by either private and official capital inflows or other transactions in FA at fixed exchange rate parity.⁹ Re-arranging $CA = \Delta F + \Delta IR$ by incorporating twin surpluses, i.e. $+CA$ and $+FA$, a consequent equality reflects either $CA - \Delta F - \Delta IR = 0$, or $CA - FA = 0$. Since this (twin surpluses sustainability) hypothesis remains exploratory, the econometric approaches employed by the well-established CA sustainability hypothesis have been considered by (i) stationarity or $I(0)$ of the sum of CA and FA (per GDP) – if $(CA + FA)/Y$ is stationary or $I(0)$, twin surpluses behaviour is said to be sustainable; otherwise, unsustainable, and (ii) cointegration between CA and FA (as scaled by China's nominal GDP) – if both variables are cointegrated, twin surpluses behaviour is sustainable, or *vice versa*.

The data are obtained from CEIC database for the available observations between 1998Q1 and 2016Q2.^{10,11} For the first approach, Table 2 shows the results of unit root tests – Augmented Dickey-Fuller (ADF) (Dickey and Fuller, 1981), Phillips-Perron (PP) (Phillips and Perron, 1988), and KPSS stationarity tests (Kwiatkowski *et al.*, 1992), as well as unit root tests with structural break. The ADF and PP tests including the tests with structural break (by assuming innovation outlier) fail to reject the null hypothesis of a unit root (unsustainable) at 10% level. Meanwhile, the KPSS and unit root tests with structural break when additive outlier is assumed are inconclusive. In this regard, the second approach is *necessary* and *feasible*. Indeed, both approaches have been employed *interchangeably* in the CA sustainability literature.

Table 2 Unit Root and Stationary Tests for Variable $(CA+FA)/Y$

	ADF	PP	KPSS	Structural break: Innovation outlier	Addictive outlier
Constant	-1.558[4] (0.498)	-2.545[3] (0.109)	0.220[6]	-2.857[10] (0.759) Break Date: 2004Q1	-2.896[10] (0.741) Break Date: 2004Q1
Constant & trend	-1.481[4] (0.827)	-2.510[3] (0.323)	0.218[6]***	-4.682[10] (0.163) Break Date: 2004Q2	-5.090[0]* (0.064) Break Date: 2010Q1
<i>Sustainable?</i>	Not	Not	Inconclusive	Not	Inconclusive

Notes: Asterisks *** and * indicate significance levels at 1%, and 10%, respectively. Figures in parentheses (.) indicate p -value. Figures in square brackets [.] indicate the optimal lag length based on Akaike's information criterion (AIC) for ADF (maximum lag is 12) and bandwidth for PP and KPSS. The critical values for KPSS tests are 0.739 (1%), 0.463 (5%), and 0.347 (10%) for constant, and 0.216 (1%), 0.146 (5%), and 0.119 (10%) for constant and trend. The ADF and PP tests have H_0 : A unit root; while H_0 : (trend) stationary for KPSS test.

Alternatively, the second approach infers that twin surpluses behaviour is sustainable if a cointegrating relation exists between CA and FA. For this (cointegration) method, at least one of the underlying variables must be $I(1)$. If both CA/Y and FA/Y are $I(0)$, no cointegration can be delivered. ADF and unit root tests with structural break suggest $I(1)$ for CA/Y , but PP test shows it to be $I(0)$, while KPSS test is inconclusive. Also, FA/Y is inconclusive between $I(0)$ and $I(1)$.¹² Hence, Autoregressive Distributed Lag (ARDL) bound testing procedure (Pesaran *et al.*, 2001) is employed for testing cointegration. This procedure is feasible irrespective of whether the regressors are $I(0)$, $I(1)$ or a combination of both. It eliminates the pre-testing problems related to standard cointegration analysis which requires the classification of the variables into $I(1)$ and $I(0)$ (Pesaran and Pesaran, 1997: 302-303). An ARDL equation with two variables, let us say y and x , can be written as $\Delta y_t = c + \gamma_0 y_{t-1} + \gamma_1 x_{t-1} + b_1 \Delta y_{t-1} + b_2 \Delta x_{t-1} + u_t$, and it can be estimated by OLS (ordinary least squares) estimator for testing (i.e. rejecting) the null

hypothesis $H_0: \gamma_0 = \gamma_1 = 0$ (no level relationship), against $H_1: \gamma_0 \neq 0, \gamma_1 \neq 0$ (a level relationship). If the computed F -statistic exceeds the 0.10 upper bound of the critical value band $I(1)$, the null hypothesis can be rejected: a cointegrating relation exists. If, the computed F -statistic is below the 0.10 lower bound $I(0)$, no cointegration can be concluded because the null hypothesis cannot be rejected. In the case that the computed F -statistic falls within the 0.10 critical value bands, the cointegration between y and x is inconclusive.

Table 3 reports the results of ARDL bound tests. It is interesting to find that CA/Y and FA/Y are cointegrated since the respective computed F -statistics are above the 0.10 upper band, $I(1)$. The null hypothesis of no cointegration (or unsustainable) can be rejected, suggesting that China's twin surpluses behaviour is *considerably* sustainable. That is the country's CA and FA imbalances (surpluses) will be approaching zero (or toward an equilibrium) in the long run by adjusting (i.e. reduction) their surpluses during the short runs.

Table 3 ARDL Cointegration Approach to Twin Surpluses Sustainability Hypothesis

	<i>F</i> -statistics			Critical values: $I(0)$; $I(1)$		
Lag length:	4	8	12	10%	4.04;	4.78
$F(CA/Y FA/Y)$	29.197***	5.480*	5.480*	5%	4.94;	5.73
$F(FA/Y CA/Y)$	5.261*	41.200***	4.444	1%	6.84;	7.84

Notes: Asterisks *** and * indicate significance levels at 1%, and 10% levels, respectively. The dynamic specification of $ARDL(p, q)$ is suggested by AIC with constant (level) in trend specification.

3. Determination of China's Twin Surpluses Behaviour

This section proposes an empirical framework from general equilibrium perspective of open economy macroeconomics, to understand what are

the macroeconomic variables determining the twin surpluses behaviour, and to examine China's data. Relevant past studies are relatively few, and they are generally descriptive without proper and systematic derivation from a theory in their empirical equation(s). Among them are Deng and Zhang (2007), Yu (2007; 2012; 2015), Yue (2015), and Zhang and Tan (2015). To recall, twin surpluses in BoP are about surplus in CA and FA respectively during the same period. Therefore, a review of those studies examining each behaviour of CA and FA is essential.

Let us look at the determination of CA behaviour. Theoretically, CA is equivalent to savings-investments gap, in which its behaviour can be explained by either the factors which affect exports and imports (i.e. real income, foreign income and real exchange rate) or which affect savings and investments (i.e. real interest rate and real income).¹³ Among the studies, Zhang and Zhang (2015) find that China's CA and its examined determinants, namely secondary industry ratio, domestic income, age profile, male population, consumption and investment, are cointegrated (i.e. existence of a long-run relation) over the period 1980-2012. Secondary industry ratio is found to be the most important factor explaining China's CA behaviour, with estimated coefficient of 0.48. Also, excessive savings variable does cause CA surplus. Another study by Gervais *et al.* (2016) investigates if real exchange rate adjustment helps to re-balance CA by considering 22 emerging-market countries, including China. For China's data, there is no cointegration between CA per GDP and real exchange rate – it is partially explained by fixed exchange regime that has been implemented.¹⁴

For the FA behaviour, it is fundamentally determined by *changes* in nominal interest rates at home country and at foreign country. The former variable is expected to have a positive influence on FA, while the latter is negative (Brooks and Fausten, 1998: 158). Yu (2015) and Yue (2015) have explained that large inflows of foreign capital (i.e. attracted

by government's reckless policies towards FDI) fail to translate CA surplus into capital outflow, which results in a large surplus in China's FA. More precisely, imperfect financial markets in China explain the country's FA surplus. Again, Zhang and Zhang (2015) find that financial openness (i.e. its estimated elasticity, 1.18), secondary industry ratio (0.17), age (0.33), male population ratio (0.11), income (-0.29), consumption (-0.15), and credit to private sector (-0.14) are statistically significant to explain China's FA surplus, except for investment.

By and large, general equilibrium perspective of open economy macroeconomics as in Brooks and Fausten (1998) has offered a theoretical insight on the determination of twin surpluses behaviour via the behavioural relations of $CA(.)$ and $FA(.)$. Given the behaviour relations of demand for exports, $EX(Y^{*+}, e^+)$, and imports demand at home, $IM(Y^+, e^-)$ (where Y^* is world income, e is exchange rate, Y is domestic income (Y), and the superscript '+' and '-' are the expected signs of the respective coefficients, and CA balance (i.e. net exports) is exports minus imports, i.e. $CA=EX(Y^{*+}, e^+)-IM(Y^+, e^-)$ (Brooks and Fausten, 1998: 155), a CA behavioural relation can be expressed as $CA(Y, e^+, Y^{*+})$.^{15,16} For the FA of BoP, which records all transactions of direct investment, portfolio investment, other investment, and reserve assets, its behavioural relation can be expressed as $FA(i^+, i^{*-})$.^{17,18} Hence, twin surpluses that are $+CA(.)$ and $+FA(.)$ can be written as a behavioural relation $CAFA(.)$ as in (1):

$$CAFA(Y, i^+, e^+, Y^{*+}, i^{*-}) \quad (1)$$

This behavioural relation $CAFA(.)$ informs that domestic income (Y), domestic interest rate (i), exchange rate (e), world income (Y^*), and world interest rate (i^*) are the macroeconomic determinants of the twin surpluses behaviour, as in theory. Their expected sign is as

superscripted. The twin surpluses behaviour, more technically the dependent variable, *CAFA* is measured by the sum of CA and FA scaled by GDP. Some variables are transformed into natural logarithm (*ln*), *lnY* and *lnY** – China's and the U.S. (proxies the world) real GDP (in 2010 prices), and *lnREER*, the real effective exchange rate (2010=100).¹⁹ *i* and *i** are home (China) and the U.S. (the world) real interest rates (as % pa) proxied by lending rate. The data are quarterly observations between 1998Q1 and 2016Q2. Since the unit root or stationary tests suggest that the underlying variables are inconclusive between stationary *I*(0) and non-stationary *I*(1) (see, Appendix A), ARDL bound testing approach for cointegration is feasible to be employed in this section, including their long-run (i.e. cointegrating relation) and short-run (i.e. error-correction model) estimates. More technically, an ARDL equation of relation (1) used for OLS estimation can be written as:

$$\begin{aligned} \Delta CAFA_t = & c + \gamma_1 CAFA_{t-1} + \gamma_2 \ln Y_{t-1} + \gamma_3 i_{t-1} + \gamma_4 \ln REER_{t-1} \\ & + \gamma_5 \ln Y^*_{t-1} + \gamma_6 i^*_{t-1} + \sum_{i=1}^p b_{1i} \Delta CAFA_{t-i} \\ & + \sum_{i=0}^q b_{2i} \Delta \ln Y_{t-i} + \sum_{i=0}^r b_{3i} \Delta i_{t-i} + \sum_{i=0}^s b_{4i} \Delta \ln REER_{t-i} \\ & + \sum_{i=0}^t b_{5i} \Delta \ln Y^*_{t-i} + \sum_{i=0}^u b_{6i} \Delta i^*_{t-i} + e_t \end{aligned} \quad (2)$$

where e_t is residual. It is estimated by OLS estimator in order to reject the null hypothesis $H_0: \gamma_1 = \gamma_2 = \gamma_3 = \gamma_4 = \gamma_5 = \gamma_6 = 0$ (i.e. no level relationship), against alternative hypothesis, H_1 : at least one of them $\neq 0$ (i.e. a level relationship). The statistical inference of the computed *F*-statistic has been previously discussed, i.e. Section 2. Again, an error-correction model of equation (2) is presented as

$$\begin{aligned}
\Delta CAFA_t = & \eta ECT_{t-1} + \sum_{i=1}^p b'_{1i} \Delta CAFA_{t-i} + \sum_{i=0}^q b'_{2i} \Delta \ln Y_{t-i} \\
& + \sum_{i=0}^r b'_{3i} \Delta i_{t-i} + \sum_{i=0}^s b'_{4i} \Delta \ln REER_{t-i} \\
& + \sum_{i=0}^t b'_{5i} \Delta \ln Y^*_{t-i} + \sum_{i=0}^u b'_{6i} \Delta i^*_{t-i} + e'
\end{aligned} \quad (3)$$

where ECT_{t-1} represents error-correction term, that is $CAFA_{t-1} - c - \gamma_0 CAFA_{t-1} - \gamma_1 \ln Y_{t-1} - \gamma_2 i_{t-1} - \gamma_3 \ln REER_{t-1} - \gamma_4 \ln Y^*_{t-1} - \gamma_5 i^*_{t-1}$. The η is the estimated speed of adjustment that the underlying variables are co-moving over time towards long-run equilibrium path – it is expected to be negative and less than one.

Following a *rule of thumb* of quarterly data in use, a lag length of four is used, and $ARDL(p=4, q=2, r=0, s=0, t=2, u=4)$ is selected based on Akaike information criterion (AIC). The computed F -statistic is 6.956 which is above the 0.01 critical band, 4.68, that the null hypothesis of no level relationship can be rejected. It suggests that all of the underlying variables are cointegrated, that is the underlying variables are moving together in the long run (i.e. toward equilibrium) as predicted by theory – general equilibrium perspective. Table 4 presents the estimated cointegrating relation $CAFA(.)$. The empirical results inform that China's twin surpluses behaviour can be explained by domestic income ($\ln Y$), exchange rate ($\ln REER$), and world income ($\ln Y^*$) in the long run. These macroeconomic variables are statistically significant at 1% level with their estimated coefficients of -0.170, -0.354 and 1.734 respectively, and their signs are as expected in $CAFA$ relation (1). However, real interest rates of home (i) and world (i^*) are statistically insignificant at 10% level, and these results suggest that both interest rates do not affect China's twin surpluses in the long run – it implies that monetary policy via interest rate channel implemented by the home country, China, and by the U.S. has no implication on China's CA as well as FA imbalances.

Also, an interesting finding is that the U.S. real GDP is the only reason for the upsurge of China's twin surpluses, i.e. the higher the U.S. real GDP, the larger China's twin surpluses. China's real GDP and exchange rate both play a crucial role in ratifying the country's BoP imbalances by reducing their surpluses via higher output, and Renminbi appreciation, for examples.

Table 4 ARDL Long-Run Relation (Dependent Variable, $CAFA_t$)

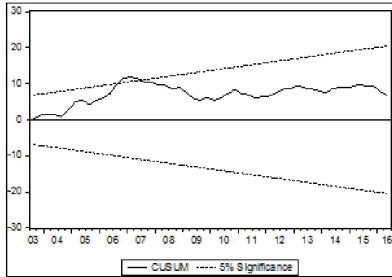
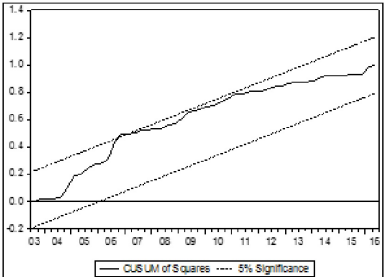
$\ln Y_t$	-0.170*** (0.002)
i_t	0.148 (0.142)
$\ln REER_t$	-0.354*** (0.000)
$\ln Y_t^*$	1.734*** (0.000)
i_t^*	0.707 (0.193)
Constant	-24.574*** (0.000)

Notes: Asterisks *** indicate significance level at 1% level. Figures in parentheses (.) indicate p -value.

Table 5 presents the estimated ECM equation (3) which is about the short-run estimates of how the *change* in (or *growth* of) China's twin surpluses behaviour responds to the change in the underlying macroeconomic variables. In the short run, the expansion of China's twin surpluses can be explained by growth in domestic income ($\ln Y$), exchange rate ($\ln REER$), and the U.S real interest rate (i^*), respectively. The past three years of twin surpluses have negative coefficients suggesting that China's twin surpluses behaviour is "self-correcting", i.e. reducing the surpluses. The estimated coefficient of error-correction term ECT_{t-1} is -0.736 which is statistically significant at 1% level, and with an expected sign and size that 73.6% of disequilibrium (in the short run) is corrected in a quarter toward its equilibrium (in the long run). This finding further reaffirms the existence of a level relationship (cointegration) between twin surpluses and the underlying

Table 5 Estimates of Error-Correction Model (ECM)

$\Delta CAFA_{t-1}$	-0.224*(0.089)
$\Delta CAFA_{t-2}$	-0.368*** (0.001)
$\Delta CAFA_{t-3}$	-0.357*** (0.000)
$\Delta \ln Y_t$	0.131 (0.238)
$\Delta \ln Y_{t-1}$	0.256** (0.034)
Δi_t	0.109 (0.144)
$\Delta \ln REER_t$	-0.261*** (0.008)
$\Delta \ln Y_t^*$	-0.663 (0.346)
$\Delta \ln Y_{t-1}^*$	0.850 (0.211)
Δi_t^*	-0.231 (0.822)
Δi_{t-1}^*	3.545** (0.036)
Δi_{t-2}^*	-1.457 (0.377)
Δi_{t-3}^*	-1.441 (0.169)
ECT_{t-1}	-0.736*** (0.000)
LM test	0.066 [2] (0.936)
Adj. R-squared	0.608
F-stat. (<i>p</i> -value)	7.294*** (0.000)
Durbin-Watson test	2.052

Notes: Asterisks ***, ** and * indicate significance levels at 1%, 5% and 10% levels, respectively. Figures in parentheses (.) indicate *p*-value. The lag structure is selected by AIC from a maximum lag of 4. ECT is error-correction term which is derived from the respective long-run relations. For example, A *CAFA* relation $CAFA_{t-1} = (-0.170 \ln Y + 0.148 i - 0.354 \ln REER + 1.734 \ln Y^* + 0.707 i^* - 24.574)$. The LM tests (*F*-statistics) is under the null hypothesis of no serial correlation exists.

macroeconomic variables as derived from the general equilibrium perspective of open economy macroeconomics. Additionally, the LM test suggests no serial correlation, while the CUSUM and CUSUM squares tests suggest a structural break which is dated in 2007Q1 (at the 5% significant level) because of the 2007-2008 global financial crisis.

4. Transmission Channels of China's Current and Financial Accounts

What are the possible transmission channels of CA and FA in China? More generally, this question assumes that money left over in China's CA would not at least cause (transmit to) FA account surplus *directly* without any "transmission" channels (i.e. through other variables). A conceptual framework advocated by Fausten (1989-1990) on the current and capital accounts (of BoP) interdependence helps to understand the fundamental relationships between CA and FA.²⁰ He conceptualizes and explains the possible inter-linkages between real sector (i.e. CA) and financial sector (i.e. FA). According to him, *"If domestic saving falls short of an increase in demand of real assets, the resulting excess demand has an upward influence on their price and on the CA deficit. The excess demand must be funded either by running down financial assets or by issuing liabilities, i.e., by securing new credit extensions from the financial sector."* (Fausten, 1989-1990: 280-281) Intuitively, it reflects a one-way causality from CA to FA of BoP, that is the presence of (predicted) FA surplus is because of CA surplus. Or, it is to say that CA surplus comes first, and followed by FA surplus. Causality is about *what came first the Chicken or the Egg?*

Of literature search, the existing studies have only tested their causality between CA and FA of BoP. They ignore the transmission channel(s) either by using a bivariate VAR framework, or by

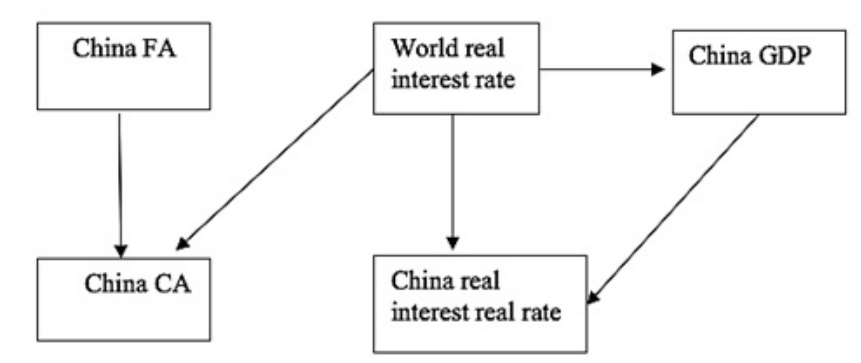
considering a set of *ad hoc* variables such as GDP, exchange rate as well as the components of FA's components (i.e. FDI, equity investments, debt, and bank liabilities) that are not systematically derived from a theory.²¹

This section fills this gap by looking at the possible causal relationships between CA and FA of China's BoP with a set of transmission variables as outlined in the *CAFA(.)* relation, namely domestic income ($\ln Y$), domestic interest rate (i), exchange rate ($\ln REER$), world income ($\ln Y^*$) and world real interest rate (i^*). To recall, an empirical equation that explains the twin surpluses behaviour had been derived from a general equilibrium perspective (see, Section 3), which also explains a causal relationship from CA to FA. It is highlighted that an *effect* cannot occur before its *cause* (see, Granger, 1969). Of equation (1) *CAFA(.)* relation, an open economy with flexible exchange rate is assumed; given CA surplus, money supply may overweigh money demand, so interest rate falls, and capital flows out, resulting in deficit in FA. On the other hand, an opposite direction of causality holds, i.e. from FA to CA via exchange rate channel – when a large amount of capital flows in, it may cause a rise in exchange rate, which makes exports more expensive and imports cheaper, hence CA runs into a deficit.

This section employs the so-called (Granger) non-causality testing method which has been extended by Toda and Yamamoto (1995) (T-Y) in order to find out the possible transmission channel(s) via causality(ies) between CA and FA by including domestic income, domestic interest rate, exchange rate, world income, and world real interest rate in a multivariate framework. Again, the data are those used in the previous section (Section 3). T-Y method is applicable regardless of whether the underlying time series are $I(0)$, $I(1)$ or $I(2)$, non-cointegrated or cointegrated of an arbitrary order. In brief, it involves

two steps. The first step is to compute the OLS estimates of an augmented vector autoregressive model $\text{VAR}(k+d_{\max})$ with an optimal lag length k^{th} and a maximum order of integration d_{\max} of the time series. And, it is followed by a standard Wald test of the estimated coefficients of k from the estimated $\text{VAR}(k+d_{\max})$. Their tests statistics are reported in Appendix B.

For convenience, Figure 2 illustrates the T-Y non-causality findings. Surprisingly, no transmission channel has been suggested by the data between CA and FA of BoP in China. A one-way causality is found from FA to CA. This finding implies that China's CA surplus is reflected (caused) by her FA surplus, in which it is consistent with Liu *et al.* (2007). Or, it is to say that FA *came first* and then CA. According to Yu (2007), "... *market distortion or imperfection has led to excess capital inflows to China, while it has to 'park' its excess domestic savings abroad as foreign exchange reserves*" (p. 17), which justifies this finding that causality is from FA to CA. Furthermore, CA and FA balances are *not interdependent* as intuited by Fausten (1989-1990) that a two-way causality is assumed to hold. Perhaps, world (the U.S.) interest rate is an important variable (cause) to be monitored closely by China, and has important policy implication, because it is another reason at the side of China's FA that China's CA runs into surplus. The world interest rate also affects China's interest rate either directly or indirectly via China's real GDP. And, the country's economy (GDP) is directly caused by world interest rate which is being considered as *exogenous* variable as informed by the findings – the U.S. interest rate is determined by the Federal Reserve (Fed) on her target range for its benchmark interest rate.

Figure 2 Diagram of Causality for China's CA and FA Surpluses

5. Conclusions and Policy Implications

This study complements the early work of Zhang and Tan (2015) by examining more systematically and empirically three fundamental concerns of China's twin surpluses. They are: the sustainability of China's twin surpluses, the macroeconomic factors explaining the twin surpluses behaviour in China, and the directions of causality or transmission channel(s) between current account and financial account of BoP. To refresh, twin surpluses reflect both positive balances (i.e. money left over) in a country's current account, and financial account of BoP simultaneously in the time period- t . The key findings are summarized as follows. Firstly, China's twin surpluses behaviour is reasonably sustainable over the period 1998-2016, and both surpluses will be ratified, i.e. both imbalances will approach zero in the long run. It offers a signal that contemporary China's government macroeconomic policies as well as other policies (i.e. monetary) are favourable in the long run. Secondly, China's twin surpluses, and its macroeconomic determinants, namely domestic income, domestic interest rate, exchange

rate, world income, and world interest rate, are cointegrated or moving together in the long run. The behaviour of China's twin surpluses can be understood and monitored by these variables, except for the domestic and world interest rates. Lastly, no transmission channel between current account and financial account has been identified from a simplified framework employed in this study. China's current account surplus is *directly* caused by financial account surplus, and world (the U.S.) interest rate. Also, it reveals that these two major components (accounts) of BoP are not interdependent – no “inter-feedback” between China's real sector (goods and services market) and financial sector (financial market) in China.

Policy implications from this study are that, in general, China is advisable to continue the existing policies both from fiscal and monetary perspectives of the country's economic reforms, for example, those policies in improving the structure of industries which have comparative advantage. This also suggests that the existing policies or more informally “negotiations” or “responses” ought to be continued (or to say to be favourable) regardless of the recent tension of trade war between China and the U.S., given a finding that China's twin surpluses behaviour is sustainable – both imbalances will be “zero-balanced” in the long run. Accordingly, the U.S. is expected to accelerate an ongoing structural change in China's current account balance making it a capital importer that buys more from the rest of the world than it sells to it.²² However, Li *et al.* (2018) have pointed out that “*China will be significantly hurt by the China–US trade war, but negative impacts are affordable*”. China is found to be feasible to spur her economy growth (i.e. growth in her real GDP) via fiscal reforms as they manage to ratify (i.e. reduce) China's twin surpluses over time. Also, a Renminbi revaluation is another possibility in a position of the country's twin surpluses. It does not assume China to have drastic liberalization

exercise on the exchange rates market, so that it can respond to the possible “shocks” more flexibly because: “*To use the exchange rate change as an instrument to achieve trade balance might lead to great exchange rate fluctuation.*” (Yu, 2007: 21). This study forwards that domestic (China) monetary shocks and world (the U.S.) real interest rates have no desirable implication on China’s twin surpluses position because of the fixed interest rate “guided” by PBOC, and a low interest rate (i.e. zero interest rate policy) by the rest of the world such as Japan and the U.S. Further liberalization and evolution on non-conventional monetary policy are urged for China in order to ratify (or adjust) the country’s current BoP imbalances – twin surpluses. More precisely, policymakers in China should formulate and implement such relevant policies in ratifying the country’s financial account surplus in priority, as an ideal financial market is where excessive investment from overseas can be utilized perfectly. By and large, this brief policy discussion is mainly based on the empirical findings from this study, in which they only depict a crude picture in order to understand better the twin surpluses behaviour in China, and are for a more general perspective of policy implications. It is due to the fact that more information or inputs (for example, comprehensive stimulation outputs from computable general equilibrium, CGE, models) are necessary for policymakers to design the related policies, in practice.

Also, further research on this topic of China’s twin surpluses behaviour is feasible since this study is not free from limitations. This study uses the available quarterly observations spanning between 1998 and 2016, but data *prior to* 1998 before China joining WTO are excluded. Pre-1998 official data (i.e. quarterly) are incomplete from the official sources which may give different stories on the twin surpluses results in China. In addition, for simplicity reason, this study employs the basic current account and financial account relations for

conceptualizing twin surpluses behaviour with a set of traditional factors. Perhaps, other potential factors are eventually ignored because of the lack of theoretical foundation. Among them are institutional quality – it is about law, individual rights, and high-quality government regulation and services, globalization including financial liberalization, and China's accession to the WTO on 11 December 2001. They are important to be considered for further study. Also, appropriate forecasting techniques can be applied in order to predict the behaviour of twin surpluses in China, in which it adds information for policy implication. Last but not least, comparative study is recommended between China and other countries which record a similar position of their BoP accounts, i.e. twin surpluses, for example, South Korea was in twin surpluses during the periods between 1999 and 2005 (Deng and Zhang, 2007).

Notes

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1. “Why China’s current account balance approaches zero”. <<http://bruegel.org/2019/04/why-chinas-current-account-balance-approaches-zero/>>, retrieved on 17 June 2019.
2. See, National Bureau of Statistics of China. <http://www.stats.gov.cn/english/PressRelease/201602/t20160229_1324019.html>, retrieved on 21 August 2016.
3. Christopher J. Neely, “Chinese foreign exchange reserves and the U.S. economy”, 6 May 2016. <<https://research.stlouisfed.org/publications/economic-synopses/2016/05/06/>>, retrieved on 29 August 2016.
4. A name of “Financial Account” had been formerly labelled as “Capital Account” before IMF re-named it and re-defined its *transactors* in 1993. According to the new definition, “Financial Account” is the sum of (existing) “Capital Account” (KA) and net official monetary movements.
5. “China reports balanced current, capital accounts” (reported by Liyan Qi), *MarketWatch*, 11 May 2015. <<http://www.marketwatch.com/story/china-reports-balanced-current-capital-accounts-2015-05-11>>, retrieved on 30 August 2016.
6. Yiping Huang, “Fixing China’s Current Account Surplus”, *East Asia Forum*, 13 September 2009. <<http://www.eastasiaforum.org/2009/12/13/fixing-chinas-current-account-surplus/>>, retrieved on 8 August 2016.
7. In January of 1994, China had enforced the single managerial floating exchange rate system as part of reforms to embrace a socialist market economy.
8. See “China’s surpluses start to balance out” (reported by Aaron Back), *The Wall Street Journal*, 1 February 2013. <<http://www.wsj.com/articles/SB10001424127887323926104578277441519268074>>, retrieved on 1 September 2016.

9. Fixed exchange rate parity informs that exchange rate tends to appreciate when trade balance exceeds capital exports and depreciate when capital exports exceeds trade balance (Mundell, 1962: 71).
10. The sample period ends in 2016Q2 due to data availability. In fact, China's (net) FA balance runs into a deficit in 2016 and 2017. The data are measured in million US dollars and in nominal terms.
11. Of the reporting source, a positive value of FA represents a net decrease, while a negative value represents a net increase (see, State Administration of Foreign Exchange, China). For convenience reason, this study has reversed their sign, i.e. positive value is about net increase, and *vice versa*.
12. The computed test statistics of both unit root and stationarity tests are not reported here, but they are available upon request from the corresponding author.
13. According to Yu (2007), China's CA surplus is due to both global and domestic economic cycles, in which surplus occurs when the economy is weak, and deficit when the economy is overheating. Ding (2008) further labels "saving glut", a situation that savings exceed investment, as the main reason for China's CA surplus. Indeed, Yue (2015) notes that excess savings in China is due to culture for social security, health welfare, and so on.
14. The other 16 emerging countries have their long-run CA relation (i.e. the underlying variables are cointegrated) and their real exchange rate adjustment (i.e. increases) reducing CA imbalance in the long run.
15. There are a few of *ad hoc* variables that explain the CA balance – among them are trade openness, inflation volatility, secondary industry ratio, labour cost, demography, and so on. For simplicity and data availability, this study follows this relation as from Brooks and Fausten (1998).
16. Domestic income (Y) is expected to have negative association with CA as a rise in domestic income increases purchasing power for importing goods

and services. Exchange rate (e) is measured by the *number of units of domestic currency required to purchase one unit of a foreign currency* (Brooks and Fausten, 1998). An increase of e reflects domestic currency depreciation, so exports increase, and imports decrease. Exchange rate has positive implication on CA. CA is positively related to World income (Y^*) as higher world income reflects higher purchasing power of foreign countries – when demand from the world rises, it results in more exports, thus CA increases (i.e. surplus).

17. The existing empirical studies have incorporated other variables such as credit granted to private sector and financial openness.
18. Higher domestic interest rate (i) attracts funds inflow, and *vice versa*. Meanwhile, for foreign interest rates (i^*), a relatively higher level of interest rate abroad induces funds to flow out, weakening the FA position.
19. According to IMF's data (<http://datahelp.imf.org>), REER is defined as nominal effective exchange rate which is “*the value of a currency against a weighted average of several foreign currencies divided by a price deflator or index of costs. An increase in REER implies that exports become more expensive and imports become cheaper; therefore, an increase indicates a loss in trade competitiveness.*” Hence, an increase in REER implies Renminbi appreciation. However, the estimated equation (2) indicates that exchange rate variable has a positive impact on China's twin surpluses. Given the REER used is domestic currency (Renminbi) per one foreign currency (USD), a decrease reflects Renminbi appreciation making exports more expensive. The expected sign of REER from the empirical model should be reversely interpreted that is in negative sign to indicate appreciation.
20. Tang and Fausten (2012) have considered the sample countries used by Yan (2005) in order to examine the interdependence between CA and FA of BoP. Their study is inconclusive from different empirical specifications with OLS estimator.

21. Liu *et al.*'s (2007) study has considered GDP growth and three components of FA (i.e. FDI, portfolio investment, and other investments) in examining their causal linkages with CA in China for the period 1982-2004. They find that China's FA does Granger cause China's CA, but no reversed causality. Meng (2004) offers a two-way causality between China's CA and FA over the sample period of 1982-2002. A similar study is from Yan (2005) that considers five developed countries (i.e. France, Germany, Japan, the U.K. and the U.S.) and five developing countries (i.e. Argentina, Mexico, Indonesia, South Korea and Thailand) for the sample period of 1989Q1-2000Q4. Toda and Yamamoto non-causality tests show that FA does Granger cause CA in the developing countries, but reversed causality in the developed countries, in general. Studies of other countries are Kim and Kim (2011) for Korea, Ersoy (2011) for Turkey, and Garg and Prabheesh (2015) for India. Another branch of studies examines a set of macroeconomic variables in explaining the behaviour of China's twin surpluses. For example, Liu (2008) finds that China's twin surpluses (as proxied by foreign exchange reserves), FDI, trade surplus from OEM (original equipment manufacturer), and deposit-loan gap are cointegrated (i.e. co-moving) over the period 1994-2007. Indeed, FDI is the most influential variable to China's twin surpluses in the long run, while OEM and deposit-loan gap lead the way in the short run. All these variables do Granger cause twin surpluses, respectively.
22. "Trade war drives down China's current account forcing new reliance on foreign investment", *South China Morning Post*, 10 Jan, 2019. <<https://www.scmp.com/economy/china-economy/article/2181565/trade-war-drives-down-chinas-current-account-forcing-new>>

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Appendix A Unit Root and Stationarity Tests

		ADF	PP	KPSS	Structural break: Innovation outlier	Structural break: Additive outlier
$(CA+FA)/Y$	Constant	-1.558[4]	-2.545[3]	0.220[6]	-2.857[10] 2004Q1	-2.896[10] 2004Q1
	Constant & Trend	-1.481[4]	-2.510[3]	0.218[6]***	-4.682[10] 2004Q2	-5.090[0] 2010Q1
$\Delta(CA+FA)/Y$	Constant	-4.310[3]***	-19.323[60]***	0.138[23]	-5.091[3]*** 2009Q2	-10.143[2]*** 2008Q4
	Constant & Trend	-4.424[3]***	-23.329[43]***	0.123[23]*	-10.797[2]*** 2007Q4	-10.537[2]*** 2008Q4
$I(d)$	$I(1)$	$I(1)$	$I(1)$	$I(0)/I(1)$	$I(1)$	$I(0)/I(1)$
$\ln Y$	Constant	-0.963[0]	-0.988[1]	1.151[6]***	-3.193[1] 2005Q3	-2.850[10] 2001Q3
	Constant & Trend	-1.281[0]	-1.219[1]	0.127[6]*	-2.504[0] 2009Q4	-3.270[7] 2009Q1
$\Delta \ln Y$	Constant	-9.127[0]***	-9.126[1]***	0.179[1]	-9.799[0]*** 2010Q4	-10.866[0]*** 2004Q1
	Constant & Trend	-9.132[0]***	-9.132[0]***	0.143[1]*	-10.552[0]*** 2010Q4	-11.403[0]*** 2004Q1
$I(d)$	$I(1)$	$I(1)$	$I(1)$	$I(0)/I(1)$	$I(1)$	$I(1)$
i	Constant	-2.294[8]	-3.341[0]**	0.182[5]	-2.741[0] 2011Q4	-3.380[0] 2008Q2
	Constant & Trend	-2.094[8]	-3.326[0]**	0.151[5]**	-5.752[11]*** 2003Q4	-4.975[2]* 2005Q3
Δi	Constant	-4.986[7]***	-9.273[5]***	0.051[5]	-5.618[1]*** 2004Q1	-9.953[0]*** 2005Q1
	Constant & Trend	-5.098[7]***	-9.207[5]***	0.041[5]	-6.530[7]*** 2004Q1	-10.069[0]*** 2005Q1
$I(d)$	$I(1)$	$I(1)$	$I(0)$	$I(0)/I(1)$	$I(0)/I(1)$	$I(0)/I(1)$
$\ln REER$	Constant	0.050[2]	0.150[1]	0.801[6]***	-2.556[6] 2010Q4	-2.695[6] 2009Q3
	Constant & Trend	-1.571[5]	-1.904[1]	0.271[6]***	-4.730[1] 2004Q3	-4.694[1] 2004Q1
$\Delta \ln REER$	Constant	-5.522[2]***	-5.399[3]***	0.417[2]*	-6.089[1]*** 2003Q4	-6.352[1]*** 2008Q3
	Constant & Trend	-4.737[3]***	-5.307[5]***	0.057[2]	-6.187[1]*** 2002Q2	-6.665[1]*** 2008Q3
$I(d)$	$I(1)$	$I(1)$	$I(1)$	$I(0)/I(1)$	$I(1)$	$I(1)$
$\ln Y^*$	Constant	-1.910[1]	-2.101[4]	1.112[6]***	-2.957[1] 2009Q3	-1.843[1] 2011Q2
	Constant & Trend	-2.468[1]	-2.424[4]	0.200[6]**	-5.552[1]** 2008Q3	-3.238[2] 2008Q3
$\Delta \ln Y^*$	Constant	-5.525[0]***	-5.520[2]***	0.282[5]	-6.890[0]*** 2008Q4	-6.002[0]*** 2005Q1
	Constant & Trend	-5.705[0]***	-5.729[2]***	0.108[4]	-7.142[0]*** 2008Q4	-6.711[0] 2009Q1
$I(d)$	$I(1)$	$I(1)$	$I(1)$	$I(0)/I(1)$	$I(1)$	$I(0)/I(1)$
i^*	Constant	-2.375[1]	-2.051[4]	0.696[6]**	-3.334[1] 2007Q3	-5.813[0]** 2007Q1
	Constant & Trend	-2.502[1]	-1.985[4]	0.097[6]	-4.770[12] 2009Q1	-4.548[11] 2007Q4
Δi^*	Constant	-4.843[0]***	-4.911[3]***	0.135[4]	-5.188[0]*** 2004Q2	-5.470[0]*** 2001Q4
	Constant & Trend	-4.917[0]***	-4.987[3]***	0.056[4]	-5.497[0]*** 2006Q4	-4.548[11] 2007Q4
$I(d)$	$I(1)$	$I(1)$	$I(1)$	$I(0)/I(1)$	$I(1)$	$I(0)/I(1)$

Notes: As for Table 2.

Appendix B T-Y (Toda and Yamamoto, 1995) Non-Causality Tests

	Dependent variable:						
	<i>CA/Y</i>	<i>FA/Y</i>	<i>lnY</i>	<i>i</i>	<i>lnREER</i>	<i>lnY*</i>	<i>i*</i>
$\Sigma CA/Y$		2.209 (0.820)	3.201 (0.669)	0.216 (0.999)	5.676 (0.339)	5.863 (0.320)	3.476 (0.627)
ΣlnY	5.89 (0.317)	0.377 (0.996)		7.107*** (0.004)	2.871 (0.720)	2.414 (0.789)	2.151 (0.828)
Σi	3.616 (0.606)	0.988 (0.964)	6.08 (0.299)		3.722 (0.590)	0.739 (0.981)	0.531 (0.991)
$\Sigma lnREER$	4.526 (0.476)	4.113 (0.533)	7.385 (0.194)	4.389 (0.495)		2.186 (0.823)	4.446 (0.487)
ΣlnY^*	6.244 (0.283)	3.818 (0.576)	7.651 (0.177)	6.85 (0.232)	3.723 (0.590)		4.883 (0.430)
Σi^*	13.669** (0.018)	5.508 (0.357)	14.368** (0.013)	12.465** (0.029)	5.01 (0.415)	3.189 (0.671)	
$\Sigma FA/Y$	10.436* (0.064)		6.083 (0.298)	1.344 (0.930)	7.411 (0.192)	4.979 (0.418)	3.622 (0.605)

Notes: Asterisk ***, ** and * indicate significance levels at 1%, 5% and 10%, respectively. The reported figures are Chi-square statistics, while the figures in parentheses (.) are *p*-value. A VAR(5+1) framework is employed because of no serial correlation residuals.

Book Review

Book Review

Peter Baláž, Stanislav Zábajník and Lukáš Harvánek (2020), *China's Expansion in International Business: The Geopolitical Impact on the World Economy*, London: Palgrave Macmillan, 335 pp. + xviii.

Owning the labour-abundant advantages, Asian countries became the destination of foreign capital since the early 1970s when various failures began to arise in the world. The flying geese paradigm forecast that China will follow the development path of Japan and the newly industrialised countries (NICs) and transform the production activities from low value added to high value added. Being contradictory to many of the existing development theories, China's fast economic growth attracts concern on exploring the real story of its development. The authors of this book (2020 edition, published on 20 September 2019) try to show the whole trajectory of development of the Chinese economy, and to identify the geopolitical effects on the world.

The new position of China in the world is introduced in chapter 1. The inflow of foreign capital from Japan, Hong Kong, Taiwan and Singapore brings not only new jobs but also technology and managerial skills. This is due to the external elements such as the increasing labor cost of those countries and areas. Meanwhile, since 1978, the Chinese government has changed its policy to embrace the market-oriented economy to fulfill the demand of the domestic market. With the average economic growth rate of 10 per cent in past few decades, China becomes

the world's second largest economy. Now, the Chinese economy is one of the important driving forces in the world economic development.

Chapter 2 shows the potential fundamentals of the development of the Chinese economy and explores the factors that contribute to the development of China such as labor force and education system. China's economic growth mainly relies on capital and labor in the short term, but more on technological progress in the long run. Meanwhile, China's economic sectorial structure has been upgraded from agriculture sector to industrial sector and services sector with the development of the Chinese economy. For education system, the central government realizes the critical role of education only after the Cultural Revolution. Education is one of the effective ways to attract foreign investors to build the affiliate in China to operate sophisticated production processes. Universities in China, as a main source of R&D and generation of new technology, have built a broad connection with the top universities in the United States and member countries of the European Union (EU). All the above helps China to achieve its economic position in the world.

Chapter 3 mainly explains the importance of China in global trade. To improve the Chinese economy, international trade is a vital factor for utilizing comparative advantages to expand the international market. The share of Chinese trade volume in the world trade increased from 1 per cent in 1978 to 11.75 per cent in 2018. In different periods, China's partnership with the Council for Mutual Economic Assistance (COMECON), Japan, Hong Kong, United States and the Western Europe changes. This can be explained by the dynamic changes of political doctrines and foreign relations. From the commodity perspective, China's export has changed from industrial inputs in 1980s to high value-added goods in 2010s. China's economic policy, foreign direct investment (FDI) and its long-term development strategy play an important role in advancing the country's foreign trade.

The power of FDI in China's expansion in the international economy is explained in chapter 4. Capital movement plays a critical role in promoting economic development by transferring technology and know-how. FDI plays the unique role in the development of the Chinese economy. Before 2010, the accumulation of inward FDI promoted economic growth and expanded foreign trade. After 2010, as the Chinese economy faced the pressure of slowdown, outward FDI helped Chinese enterprises to seek new market and cheap labor in order to keep the expansion of firms. The motivation of China's outward FDI has changed from resource-seeking to asset-seeking. With the proposing of the Belt and Road Initiative (BRI) by Chinese president Xi Jinping, the Chinese government highlights the importance of outward FDI in those countries and tries to find a new economic growth engine for China.

Chapter 5 describes the role of energy for China's development strategy. As the world's largest energy consumer, China has a huge demand for coal, crude oil, copper, steel and many other metals. As the world factory, energy consumption has a positive relationship with the economic growth in China. Energy consumption is not only to fulfill the demand for local Chinese consumption but also for the consumption of the rest of the world. Energy security is crucial for the long-run development of the economy. It can be predicted that China will follow the United States' strategy to reinforce the cooperation with the developing countries by importing raw materials and exporting goods. The dominant role of the Chinese economy in energy market will be enhanced.

This book helps the readers to understand the essence of China's expansion in international business from the perspectives of international trade, FDI and energy. It explores the development path of the Chinese economy and its impact on the world economy. Following the flying geese paradigm, China has successfully transformed its role from a

cheap labor and products supplier to a leading player in the world. By expanding export and attracting FDI, the labor in China is employed to produce goods and trained to be more skilled. With the accumulation of capital inflows, the Chinese companies learn the advanced managerial skill and high technology, which enhances its competitiveness in the world market. With the slowdown of the Chinese economy and increasing labor cost in China, outward FDI increases sharply to seek new market.

In international business, outward FDI is more controversial than international trade, as it outputs the capital and controls the economic even security sectors of the host country. For Chapter 4, some part of the contents is rather confused as the authors combine inward FDI with outward FDI. There should be a clear boundary between inward FDI and outward FDI, as they play different roles in the development of the Chinese economy. The authors only show the Chinese investment in the European Union and ignore the other import partners such as the United States and the Association of Southeast Asian Nations (ASEAN). For chapter 5, the authors do not explain clearly why they only compare the energy consumption between China and EU.

All in all, this is a good book that introduces China's expanding role in international business. It gives a big story from about 70 years ago until now. Meanwhile, the new economic conditions are also included such as the BRI and the new normal of China's economy. It is worth to read it.

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Contemporary Chinese Political Economy and Strategic Relations: An International Journal

Volume 5 Number 2 June/August 2019 (*Focus Issue*) ISSN 2410-9681

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