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Southeast Asia: The Need for Economic Statecraft

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My name is Walter Lohman. I am the Director of the Asian Studies Center at the Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

Thank you, Mr. Chairman, for requesting my testimony before the subcommittee. It is an honor for me to be a part of its proceedings.

What I wanted to do today was put America's economic engagement with Southeast Asia in strategic context. So let me start by stating what I think should be the strategic goal of U.S. foreign policy in East Asia and the Pacific broadly. It is, as it has been for more than 100 years, to deny any single state dominance over East Asia and its littoral seas. This is because from a geographical position so ensured, such a power would have a free hand to dictate order at sea and establish a basis from which to threaten the American homeland.

This is a grand vision. Even if we narrow its execution to Southeast Asia there are quite a few variables involved. Not least of these is the energy of U.S. policy engagement. America has not always been up to the task. There are Southeast Asian states' own objectives—securing their borders, disputed territory and resources, and economic development. They also have domestic politics to contend with. The Association of Southeast Asian Nations' (ASEAN's) long-held strategic rationale to maximize autonomy for its members has the potential to complicate any effort to subjugate the region. There is the engagement of other outside powers to consider and the suite of international and domestic interests they bring to the table. For these reasons, the challenges to preventing hegemony in Asia must be considered on a sliding scale. The closer a state approaches the dominance end of the spectrum, the greater its capacity to dictate terms of peace to its neighbors and values in contradiction to those that have traditionally driven America's engagement with the world: Rule of law, free trade, and liberal governance. And even if distant, the greater threat it poses to the United States at home.

Currently, it is China that is the embodiment of this challenge. The answer, however, is not as simple as some geopoliticians would have it. This is not nineteenth-century Europe. Economic globalization has changed the way sovereign nations interact. Nor is it the Cold War. China cannot be "contained." Unlike the Soviet Union, it is too integrated into the global economy and far from isolated from the free world. Indeed, it is a net contributor to global prosperity and a potential positive force in solutions to collective problems. Domestically, of course, China is much different than the Soviet Union. Its people suffer from political and religious oppression, but the state has largely given up on controlling the economic lives of its citizens. It is not a "market economy," per se, but it has freed its market to an extent that would have been unimaginable in the Soviet Union—to the good of hundreds of millions of people.

To be sure, there are many areas where the U.S. must push back on China's efforts to coerce its neighbors and change international rules and norms to its advantage. So much of the day-to-day policy discussion focuses on these areas. China's permissive approach toward North Korea, its aggressive activity in the East and South China Seas, its designs on Taiwan, and other behaviors are matters the U.S. must confront directly. This requires a robust and ready forward-deployed military. It requires very active diplomacy. But in an environment characterized by economic interconnectivity, the U.S. response to the "China challenge" must also have a positive context. Without it, the U.S. will come to be seen as an interloper unconcerned with the general well-being of the region. It will essentially marginalize itself. So the way the U.S. prevents China from advancing toward a dominant position in the region is not just reacting and pushing back, but by staying energetically engaged across the range of interests—including on the economic side of things.

Whatever you may read in the headlines, the states of Southeast Asia are most interested in economics, not conflict. Singapore is the region's only significant high-income economy. And it is deeply dependent for its continued prosperity on the free flow of trade and investment. For this reason, it is consistently one of the two freest economies in the world. It is why it is constantly encouraging its ASEAN neighbors and others, including the U.S., toward openness. On the other side of the spectrum—Cambodia and Laos have severe development issues. While offering many promising economic opportunities, Malaysia, Thailand, and the Philippines are stuck in the middle-income trap. Others—Indonesia and Vietnam—may be headed in that direction.

Most of these countries are badly in need of infrastructure investment. The Asian Development Bank (ADB) recently calculated that Southeast Asia needs to invest roughly $2.8 trillion in infrastructure over the next 14 years.[1] The deficiencies are many, including in electricity generation, where at least five, including Indonesia, Vietnam and the Philippines

[1] Asian Development Bank, "Meeting Asia's Infrastructure Needs," 2017, https://www.adb.org/sites/default/files/publication/227496/special-report-infrastructure.pdf (accessed May 15, 2017).

lag the developing country average. Production capacity is growing fast in some countries, especially Vietnam, but at least in one major case, the Philippines, it is not keeping up with growth in population. Transportation infrastructure is another major need,

On the face of it, the U.S. is in a strong position to help Southeast Asia develop. It is the third-largest investor in the region—behind the EU, which is first, and Japan. It invests almost twice as much in ASEAN as China does. However, a few things must be kept in mind about these rankings. First, more than half of American investment in the region goes to Singapore. Second, American investments are, on the whole, not going into the sort of infrastructure investments that the region needs the most. For a variety of reasons, this is not the American private sector's strong suit. And three, very unlike China, the U.S. government has little control over private-sector investments, and so it must be creative in efforts to leverage them into strategic goals.

When it comes to trade, the U.S. is the region's fourth-largest trading partner. China is the first, followed by Japan and the EU. For the U.S., China, and the EU, more than a quarter of trade in the region is also with Singapore. Japan has a similar concentration, but its leading trading partner in the region is Thailand—and vice versa.[2] Thailand's leading foreign investor is also Japan.

China does not dominate the Southeast Asian regional economy. There are several very significant players and shares of investment and trade vary from country to country. What the Chinese seemingly understand better than the United States, however, is the connection between their economic and strategic goals. This is what some of its most eye-catching development initiatives, like the trillion dollar one-belt-one-road (OBOR) and the Asian Infrastructure Development Bank (AIIB) are all about. It is largely what their trade initiatives like the ASEAN-China Free Trade Area (ACFTA) and involvement in ASEAN's Regional Comprehensive Economic Partnership (RCEP) are about. China's all-encompassing 2+7 Cooperation Framework for its approach to Southeast Asia announced in 2013 to little attention in the U.S. is a veritable blueprint for "binding Southwest China and Southeast Asia into one economic space."[3] It explicitly links political security cooperation and economic cooperation—as these are the overarching "2" principles governing the "7" initiatives which include the AIIB, upgrading the ACFTA, and reaching $1 trillion in two-way trade by 2020.[4]

What the Chinese are effectively doing is broadening the value proposition for Southeast Asian neighbors who otherwise might be inclined to challenge China's creeping hegemony. They are making it attractive for countries to get along—perhaps to their long-term detriment—in exchange for the promise of a productive economic relationship.

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[2]Association of Southeast Asian Nations, "ASEAN Community in Figures: ACIF 2016," The ASEAN Secretariat Jakarta, 2016, http://asean.org/?static_post=asean-community-figures-acif-2016 (accessed May 15, 2017).
[3]Bilahari Kausikan, "Dealing with an Ambiguous World Lecture III: ASEAN & US-China Competition in Southeast Asia," March 30, 2016, https://lkyspp.nus.edu.sg/ips/wp-content/uploads/sites/2/2016/02/IPS-Nathan-Lectures_Lecture-III_ASEAN-US-China-Competition-in-Southeast-Asia_300316.pdf (accessed May 15, 2017).
[4]David Arase, "Explaining China's 2+7 Initiative Towards ASEAN," *Trends in Southeast Asia* No. 4, ISEAS Publishing, 2015.

This explains why, for instance, the Philippines would throw away the extraordinary success it enjoyed last year before the Permanent Court of Arbitration (PCA) concerning its dispute with Chinese activity in the South China Sea. Instead of doubling down on this success and rallying international support, Philippines President Rodrigo Duterte has decided to set aside the dispute to forge better relations with China. There are serious limitations to how far he can go with this impulse. There are other centers of power in the Philippines that will constrain him. There is Filipino public opinion, which although it currently supports him, remains very pro-American. There are very strong people-to people ties with the U.S. And there are strong bureaucratic ties, particularly between our two militaries. It is also important to note that this is not the first time in recent years that the Philippines has reached out to China for a more constructive relationship. But aside from personal motivations which may be involved, this new direction is the result of a simple and reasonable calculation.

First, there is very little that the Philippines can do to enforce the verdict of the court. All it can do is to maintain its claims, sustain and fortify the land features that it actually possesses, and develop resources residing in the maritime entitlements, like energy-rich Reed Bank, that were affirmed by the court. Beyond this, it is up to the U.S. and other concerned parties to demonstrate the rights to fly, sail, and operate as assured by customary international law. The Filipinos do not have the wherewithal to do that. The Chinese have also been accommodating at what has been the hottest area of contention between the two in recent years—Scarborough Shoal. They have allowed access to the area by Filipino fishermen, in keeping with the PCA ruling.

Second, the Chinese have demonstrated a willingness to help the Philippines develop. On Duterte’s visit to Beijing in October of last year, he was offered $24 billion in loans and investments, including major infrastructure projects. To call China the Philippine economy’s “only hope,” as Duterte has, is political showmanship. International involvement in the Philippines economy is reflective of the region’s diversity. Japan, the EU, the U.S. are much bigger investors in the Philippines than China. Japan is a larger trading partner than China, and by far the Philippines’ largest export market. Several countries, including Japan, the U.S., Australia, and Korea and the EU are bigger contributors of development assistance to the Philippines. But in the influence game, perceptions are critical. And despite the numbers, Chinese initiatives capture the headlines and create the narrative. There are similar dynamics at play in China’s relationships with other claimants in the South China Sea and with Indonesia.

There is an analogous situation in mainland Southeast Asia revolving around the development of the Mekong River. The Mekong is the longest river in Southeast Asia. It flows from Tibet through Burma, Laos, Thailand, Cambodia, and Vietnam and sustains the lives of sixty million people along the way. Chinese state-owned companies have financed and built 6 dams on its upper half of the river, with as many as 14 more planned. By gaining control of the river’s flow and its life-giving sediment, fish, and energy, China is imposing costs on downstream countries. Yet, the development continues both in China and downstream because there are more than just costs; there are benefits, too.

Take Laos, for example. Laos is small, poor, rural, and landlocked, with a corrupt, unimaginative leadership that sees few politically secure options for development. It has seized on its geographical position as the Southeast Asian country farthest upstream to aspire to become, in the words of Laotian officials, the “battery of Southeast Asia.” It plans a total of nine its own dams on the Mekong and many more on its tributaries. The first, the Xayaburi Dam being built by the Thais, is more than halfway finished and will come on line in just over 10 years. The Don Sahong Dam is being built by Chinese subcontractor Sinohydro. Construction on it started last year. Another state-owned Chinese company is due to begin building the third in the series.

China’s involvement in constructing the Laotian dams gives it significant sway with Vientiane, thereby muting its objections to China’s own dam building. But China is indirectly exercising its influence in the region in another way. It has established an alternative to the Mekong River Commission (MRC), the regional body meant to mitigate downstream costs. China’s new Lancang-Mekong Cooperation (LMC) mechanism allows it to finesse regional concerns over the downstream impact of its dams. Moreover, unlike the MRC—which is basically a regional regulatory body – the LMC has a development function that is very enticing to the other Mekong countries. In this way, it competes with another long-standing initiative called the Greater Mekong Subregion (GMS), a heavily Japanese-influenced initiative that channels substantial support across a range of development projects.

In another Mekong country, Cambodia, Beijing has found its most pliable Southeast Asian ally. This has been visible in discussions within ASEAN about the South China Sea, where Phnom Penh has clearly represented Chinese interests. It has taken Beijing’s side on other issues as well, deporting Uighur minority asylum seekers back to China and maintaining a hard line on ties with Taiwan. On one hand, Cambodia has joined Vietnam in complaining about Laotian dams, but on the other, it makes a show of thanking China when it releases water from its dams to deal with downstream drought. It is not a coincidence that since 2005, the Chinese have invested more than $8 billion in Cambodia,[5] some of which is going into building dams on tributaries of the Mekong.

So, what should the U.S. do about all this? The answer is obvious. Update its own value proposition. Security guarantees, military prowess, and diplomatic presence are not enough. The U.S. must be much more visibly involved in the economic life of the region. The Trans-Pacific Partnership (TPP) would have served this purpose, but U.S. participation in the TPP is now a dead letter. The Administration needs a plan B, and Congress, given its power over trade and budgets, needs to be a full partner in developing it. They should consider the following:

- **Develop new, high-standard bilateral free trade agreements (FTAs) in Southeast Asia.** The U.S. already has an agreement with Singapore. It needs to negotiate others and network them in ways that will maintain as free and open an economic environment as possible. FTAs can also help countries in or approaching the middle-income trap make the reforms they need to ultimately transition to high-income economies.

[5] Derek Scissors, “China Global Investment Tracker,” American Enterprise Institute, 2016, https://www.aei.org/china-global-investment-tracker/ (accessed May 15, 2017).

- **Look for opportunities to do things that are less than full-blown trade agreements.** Not every country in Southeast Asia is in a position to sign an FTA with the U.S. In such cases, the U.S. should be flexible. Several years ago, legislation was introduced in both houses to grant duty-free status to apparel made in the Philippines with American-supplied fabric. It was called the Save Our Industries (SAVE) Act.[6] Congress should take another look at this model and its application to other countries in the region.
- **Coordinate approaches with global partners.** The Japanese are a major long-welcomed presence in Southeast Asia. They are investing heavily, and their investments are complementary to America's own. The Japanese do build infrastructure, and they have ambitious plans for Southeast Asia. The U.S. and Japan should coordinate on deployment of resources and seek to match them to shared strategic objectives. The U.S. should also look toward leveraging its relationships, economic synergies and common values with European partners.
- **Continue Southeast Asia–specific ASEAN programming.** Previous Administrations have initiated a long list of programs to engage Southeast Asia where they live. The Bush Administration had the Enterprise for ASEAN Initiative; the ASEAN Cooperation Plan; the ASEAN–U.S. Enhanced Partnership; and ADVANCE (ASEAN Development Vision to Advance National Cooperation and Economic Integration). Obama had the E-3 initiative (U.S.–ASEAN Expanded Economic Engagement), ACTI (ASEAN Connectivity through Trade and Investment), and the Lower Mekong Initiative. These programs demonstrated a substantive interest in the economic concerns of the region. The Administration should evaluate this history of this engagement with an eye to creating its own mix of mechanisms.
- **Continue the U.S.–ASEAN Trade and Investment Framework Arrangement.** It is a way for officials from the U.S. and ASEAN to coordinate on the nuts and bolts of trade, customs facilitation, and the like, but also address standards and market access important to both sides.
- **Better leverage the private sector.** The U.S. cannot, and should not, direct U.S. investment toward Southeast Asia. It can, however, make a better show of what American companies are already doing, and offer them the entree with governments required to do more. It can do this by working through American trade associations in the region and by including company delegations in official travel by cabinet officials.
- **Get involved in the ASEAN process.** ASEAN has meetings at multiple levels throughout the year. President Trump has already agreed to attend the fall meeting of ASEAN leaders in the Philippines. But the ministers of trade, finance, agriculture, energy, and others also meet, as do their senior officials. The U.S. should be involved with as many of these as possible, especially those involving trade.

  Southeast Asia occupies a central stage in America's effort to service its traditional strategic goal of preventing hegemony in East Asia. To do this, it must have an active economic agenda that can frame its interests in a positive, constructive light.

[6] Walter Lohman, "How the U.S. Can Support Free Trade in the Philippines," Heritage Foundation *Issue Brief* No. 3566, April 12, 2012, http://www.heritage.org/asia/report/how-the-us-can-support-free-trade-the-philippines.

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