



# BASC NEWS

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## INDUSTRIAL POLICY IN THE POST-CRISIS ERA

By: Vinod K. Aggarwal and Simon J. Evenett

### IN THIS ISSUE

- 3 Director's Note
- 4 BASC Projects
- 5 BASC Spotlight
- 7 APEC Update
- 9 China: Unleashing the Economic Potential of the West.
- 12 Sub-Saharan Africa's Oil Trade with China
- 15 Southeast Asian Rail Projects and China



*Photo Credit: WTO*

In the aftermath of the Global Financial Crisis of 2007-08, observers of international markets disagreed about the likely response of the World Trade Organization.<sup>1</sup> Pointing to a contraction of global trade flows by 9 percent in 2009, some commentators suggested that the WTO's rules were incapable of stemming a tide of increasing protectionism.<sup>2</sup> Still, others cautioned that overzealous regulation of national industrial policies by the WTO would limit distressed governments' ability to cope. Who was right?

As editors of a recent Business and Politics Special Issue (16(4)), we used the financial crisis as a "stress test" for the strength of the WTO's capacity to police protectionism. The controversy over the degree to which WTO membership limits the industrial policy options of governments gained a new lease of life with the onset of the global economic crisis in 2007. That crisis saw substantial resort to government intervention of many types, including steps often associated with industrial policy. In fact, advocates of industrial policy, long on the backfoot in many industrial economies, have had plenty of wind in their sails as hard times led many policymakers to conclude that national

economies needed to be rebalanced away from the financial sector and towards manufacturing.

**The crisis is a fruitful moment to study the WTO's effectiveness because economic downturns create the demand for policy changes at the national level, some of which may violate WTO rules. Thus if WTO rules do constrain governmental choices concerning industrial policies, then surely evidence of those constraints should be found in the period since the onset of the global economic crisis. Alternatively, if governments felt industrial policy was so important and chose to break binding multilateral trade rules, then evidence from the cases brought to the WTO for dispute settlement would shed useful light on the real constraints facing states.**

The Special Issue finds that against much existing scholarship, the evidence from a wide range of sectoral and national contexts suggests that the WTO's ability to constrain member governments' use of industrial policy is highly exaggerated. The incomplete and contested nature of WTO accords combined with pressures on national policymakers has created a fertile ground for the growth of national industrial policies

post 2008.

The Issue contains articles by a group of high-profile scholars investigating policies in five sectors. Joanna Lewis (Georgetown University) analyzes the global wind power industry and finds that national governments with large wind power sectors have gradually moved towards protectionist policies to maintain a competitive edge. Specifically, despite the dispute settlement process of the WTO that has worked against China and Canada in wind, many actions have gone unchallenged, producing a gray area in wind power policy.<sup>3</sup> In the petroleum sector, Kun-Chin Lin (Cambridge University) compares the industrial policies of the United Kingdom and China, specifically examining their post-tax and pre-tax subsidies, respectively, and concludes that existing multilateral trade rules, which he notes are “highly fragmented and largely incoherent,” do not constrain certain protectionist policy actions of national governments.<sup>4</sup> Kevin Young (University of Massachusetts, Amherst) examines the financial sector and, using an innovative network-analysis technique, shows that market entry restrictions, asymmetric treatment of domestic and foreign firms, and government bailouts have all been used to quell the extent of the crisis, which goes far beyond the goal of restoring financial stability, signaling inadequate strength of multilateral rules.<sup>5</sup>

Exploring the aerospace industry, Steven McGuire (Aberystwyth University) unpacks the production of wide-bodied aircraft, concluding that the industrial policy actions of various national governments differ based on the position that country holds in the industry’s Global Value Chain. He argues that national governments with incumbent firms in the upper-tier—highly concentrated with high barriers to entry—are likely to utilize industrial policies to maintain that position, such as the U.S., the E.U., Canada, and Brazil; that national governments have used industrial policy to break their firms into the upper-tier, as evidenced by Russia and China; and that national governments with firms in the lower-tiers are more likely to

liberalize their aerospace sector and succeed as in the case of Mexico.<sup>6</sup> Lastly, Seung-Youn Oh (Bryn Mawr College) examines the industrial policies of China, France, and the United States in the automobile industry and argues that despite multilateral rules governing national governments’ actions, policymakers have ways to circumvent and favor domestic over foreign firms. A case in point was the U.S. bailouts of GM and Chrysler, which, on the one hand, helped save those manufacturers, while on the other, legitimized industrial policy actions for others.<sup>7</sup>

As the studies in this Special Issue show, a reorientation of research on the effectiveness of WTO rules is called for—one that takes seriously emergent forms of industrial policy not covered adequately by existing institutions. The focus of the Issue is on the implications of binding multilateral trade

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accords for policy choice—rather than an assessment of whether state intervention makes sense. Indeed, reconciling the legitimate objectives of government policy with the tenets of non-discrimination is something trade negotiators and analysts have been thinking through for decades, a point that industrial policy advocates might wish to dwell on. Readers of the Special Issue may find that there is much more common ground between supporters and opponents of industrial policy than meets the eye. ■

For endnotes to article, please go to page 17.

**Vinod K. Aggarwal** is Professor of Political Science, Affiliated Professor in the Haas School of Business, and Director of the Berkeley APEC Study Center at the University of California at Berkeley. He is also the Editor-in-Chief of the journal *Business and Politics* and is a Global Scholar at Chung-Ang University.

**Simon J. Evenett** is Academic Director, MBA Programs and Professor of International Trade and Economic Development, University of St. Gallen. He also serves as Co-Director, International Trade and Regional Economics Programme, CEPR.

## DIRECTOR'S NOTE

Dear Colleague,

Thank you for your continued interest in the Berkeley APEC Study Center (BASC). This newsletter brings to you our most recent research on China's Western Development Strategy, China's trade and investment with Sub-Saharan Africa, and ASEAN railway projects.

The newsletter opens with an analysis of industrial policy in the Post-Crisis Era. Simon Evenett and I analyzed responses to the financial crisis as a "stress test" for the WTO's capacity to constrain industrial policy. BASC and St. Gallen University organized conferences on industrial policy in Berkeley and Brussels and the papers from the conferences came out as a Business and Politics Special Issue (16(4)). The Issue reviews industrial policy in various sectors—manufacturing sectors such as automobile and aerospace; energy sectors such as wind and petroleum; and services sectors such as financial services. We find that the WTO's capacity to constrain industrial policy is limited and call for a reorientation of research on WTO rules.

Kevin Ratana Patumwat reviews intra-ASEAN rail projects that connect China to Southeast Asia in two routes—West to Myanmar and Center to Thailand. Patumwat reviews the history, current state, and future prospects of ASEAN railway projects. He analyzes China's regional strategy and geopolitical ambitions through this railway project. Once successful, China's influence will be expanded in the region. He also reviews responses by Southeast Asian nations—Laos, Myanmar, Thailand, and Vietnam—to the railway projects.

Katheryn Sehyen Lee analyzes China's Western Development Strategy of the last decade. Lee reviews the progress of the Strategy in terms of increased foreign investment in the region. However, she finds that regional inequality is rising at a much faster rate than foreign investment, and a sustained expansion of the program may be needed. Nevertheless, the Western Development Strategy could facilitate China's shift from export-oriented growth to domestic-consumption growth and achieve balanced growth.

Vanessa Man-Yin Cheuk analyzes the trajectory of China's investment in Sub-Saharan Africa in the last decade, especially after the recent financial crisis. Cheuk reviews China's infrastructure for oil projects in Angola, Nigeria, and Sudan and finds that China increased its assets in the region after the financial crisis through mergers and acquisitions. The increasing geopolitical risk in Nigeria and Sudan has put Chinese investments at a greater risk and brought the Chinese government out of its usual "non-interference" foreign policy position.

Cheuk also reports on the APEC Summit in Beijing, China in November 2014. The leaders focused on regional economic integration in pushing for the realization of the long-discussed Free Trade Area of the Asia-Pacific (FTAAP). Moreover, China and the U.S. agreed on a historic Climate agreement to cut carbon emissions. Finally, in October 2014, BASC's newest edited volume, *Responding to China's Rise: US and EU Strategies*, was published by Springer. This book examines theoretical perspectives of China's rise and responses from the United States and the European Union. Sahil Gupta reviews the findings of this work.

I hope this newsletter will help enhance your understanding of politics, economics, and business in the Asia-Pacific. The Berkeley APEC Study Center is grateful for support from the Institute of East Asian Studies, Center for Chinese Studies, Center for Japanese Studies, Center for Korean Studies, EU Center for Excellence and the Institute of International Studies at UC Berkeley and the University of St. Gallen for our cooperative projects. We are also deeply grateful for the sustained support of the Ron and Stacey Gutfleish Foundation.

Vinod K. Aggarwal  
Director, Berkeley APEC Study Center



## BASC PROJECTS

Trade negotiations have taken center stage in many countries this year. Mega-Free Trade Agreements (FTAs) such as the Trans-Pacific Partnership (TPP), Regional Comprehensive Economic Partnership (RCEP), and Trans-Atlantic Trade and Investment (TTIP) brought together negotiators across the Pacific and the Atlantic to agree on ambitious inter-regional free trade agreements. These international negotiations have revealed national priorities that induced domestic debates over these preferences.

On October 24-25, 2014, the Berkeley APEC Study Center organized a conference on Mega-FTAs and the Global Political Economy in Berkeley. Scholars from Asia, Europe, and the U.S. gathered to examine the origins, evolution, and impact of mega-FTAs in both economic and political dimensions. The conference focused on the Asia-Pacific mega-FTAs such as TPP and RCEP, and scholars are now revising their papers for publication.

This conference was generously funded by TECO, the Center for Chinese Studies, the Center for Japanese Studies, the Center for Korean Studies, the EU Center of Excellence, the Institute of International Studies, and the Clausen Center for Business at UC Berkeley. We will have another conference in April 2015 on the Trans-Atlantic Trade and Investment Partnership and its implications for the Asia-Pacific.

Our website has more information on our current projects, scholarly research articles, books, and commentary. Please visit us at [basc.berkeley.edu](http://basc.berkeley.edu). We also have four talented undergraduate research assistants who bring unique perspectives on a variety of topics on our blog. You can find more of their analyses in this newsletter and on our website.

Bora C. Park  
Project Director, Berkeley APEC Study Center

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Research Assistant

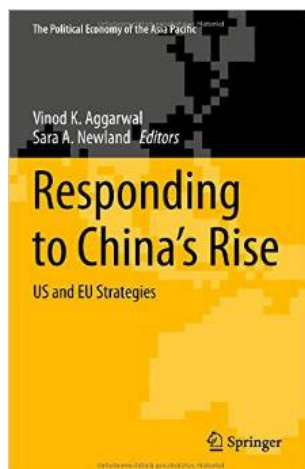
**Vanessa Man Yin Cheuk**  
Research Assistant

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Tel: (510) 643-1071  
[basc@berkeley.edu](mailto:basc@berkeley.edu)  
<http://basc.berkeley.edu>

552 Barrows Hall #1970  
University of California  
Berkeley, CA 94720-1970



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# BOOK REVIEW

## RESPONDING TO CHINA'S RISE: US AND EU STRATEGIES

Edited by Vinod K. Aggarwal and Sara A. Newland



Shanghai Skyline, Pudong District. Photo Credit: Huffington Post / Getty Images

By: Sahil Gupta, BASC Research Assistant

Since the end of World War Two, China's rapid development into an economic super power has marked one of the most profound transformations of our time. However, as China's economic output and sphere of influence has grown, so have concerns and questions from the West about the new implications of China's rise. In the book *Responding to China's Rise: US and EU Strategies*, scholars focus on the perceptions of China's rise within the United States and Europe. In doing so, the authors detail the significant variations in perceptions of China's rise between the United States and Europe, how Chinese history can be used to forecast China's future actions, and how China itself will react to its recently found super power status.

The book moves discussion beyond the simple concern that China's rise could return us to a bipolar world. While at first glance China's rise may position it to be an economic, ideological and military threat to Western powers, the book emphasizes that thus far China has had a "peaceful rise" and has also looked to cooperate economically with Western countries.

In the first chapter of the book, Vinod Aggarwal and Sara Newland analyze China's rise from its isolationist economic state after World War II to how it underwent export-oriented industrialization to become the exporting giant it is today. Concurrently, China's evolving political relationship with the West

is also described. Starting first as an ideological adversary to the Western capitalist world, China's tensions with the USSR and eventual friendship with Europe are detailed, as well as China's diplomatic breakthroughs and economic ties with the United States. The book discusses the differences in implications for the United States and Europe in regards to China's rise. Specifically, whereas Europe is primarily concerned how China's influence could affect its domestic economy, the United States is also concerned with China's military might and security in East Asia.

For both Europe and the United States, China is a large source of influence in policy, but the interests for these policies may not necessarily align.

In the following chapter, David Kang explores China's rise to a position of leadership in East Asia and its relations with other countries in the region. Kang analyzes China's rise from theoretical the leadership dynamics are subject to change. One hypothetical possibility is the balance of power politics as in Europe. Another possibility is that China could rise and become a regional hegemon, similar to what the Soviet Union was in the Eastern Bloc that rivaled the West directly. Kang concludes that neither is likely due to the globalized nature of the world and of the Chinese economy, but rather the real question is whether China can find a status for itself in a Western dominated world.

*The book moves discussion beyond the simple concern that China's rise could return us to a bipolar world.*

Following David Kang's account, Yuan-kang Wang portrays China's rise in the historical framework of "Chinese exceptionalism"—the belief that Chinese culture is rooted in Confucianism, fostering a peaceful culture that cherishes harmony and abhors wars. Unlike Western history, which is littered with wars and conflicts, Chinese exceptionalism holds that power politics within China have been benevolent and humane and will continue to follow this path. Chinese exceptionalism alleviates fear that a rising China will expand its might. However, Wang notes that every culture believes their culture is exceptional, and China is no different. He first notes that China has indeed been expansionist by citing examples of the Ming Dynasty, campaigns against the Mongols, and the annexation of Vietnam. Wang then discusses that even Zheng He's voyages, which are touted to be peaceful excursions, were militaristic in nature. Next, Wang refutes the belief that the Great Wall is reflective of the defensive culture of China, as the Great Wall arose more as a product of insufficient offensive capabilities, not a cultural preference for defense.

In the following chapter, Jisheng Sun looks at how the concept of "China's Rise" has become a focus point of theoretical debates in the US perception of China's growth and a response to it. Sun first looks at how language choice essentially shapes a country's perceptions and understanding, which eventually influences responses by foreign policy makers. Sun then compares terms such as "China's Peaceful Rise," a term commonly used within China, and the "Chinese Threat," a term used more commonly in Western discourse. Sun then uses language to breakdown China's positioning in international relations, as it reflects China's inconsistent identity in diplomatic relations. In looking at these different discourses, there is also an idea of a self-fulfilling prophecy to consider, particularly that if the "Chinese Threat" becomes a primary discourse in the West, then indeed China could become a threat. Therefore it is important that the West not exaggerate the risks of China rising.

The next chapter, "Rising China: Political Leadership, Foreign Policy, and 'Chineseness'" by Yinong Shi, discusses the concept of "Chineseness," the set of characteristics that have come to define the Chinese identity, and shows its relevance in the context of contemporary Chinese political leadership and foreign policy. The chapter describes how "Chineseness" could explain maintenance, reform, and development of domestic and foreign policy of China. Learning how to define a Chinese identity in the context of China's history could help understand China's rise and its relations with other countries. Shi presents how Chinese values will shape Chinese foreign policy in balancing its rise and international responsibilities.

In "US-China Economic Integration and its Implications for US Policy in the Taiwan Strait," Scott Kastner explores how the deepening economic integration with China affects US policy toward China and Taiwan. A specifically contentious issue between the two countries is that of Taiwan, and

how economic ties influence the United State's policy decision regarding Taiwan. He reviews the trajectory of political relationship between the US and Taiwan with the rise of China and analyzes how state-level economic dependence affects US politicians' support for security policies toward Taiwan.

The following chapter by Jonathan Holslag, titled "Explaining Economic Frictions Between China and the European Union," explores the trade relationships between China and European countries. After providing a brief history of trade relationships, the chapter describes why current friction exists between China and the EU economically. Specifically, economic relations between China and Europe have become tense as both sides gear up to defend their markets. In response to China's protectionist policies, Europe is also exploring options such as new investment guidelines, a tougher trade strategy, and a policy for maintaining a supply of raw materials. How China opens its market to European businesses will set precedent for the economic protectionist policies Europe takes in the upcoming future.

In the final chapter of the book, "China's Rise: Towards a Division of Labor in Transatlantic Relations," Øystein Tunsjø argues that while China's rise may present more challenges than opportunities for the US-Europe transatlantic relationship, the US and Europe can still develop complementary strategies and a division of labor in dealing with a rising China, US-China bipolarity, and a more East Asia-centered world. The chapter examines the triangular relationship between China, US, and Europe, and then looks at risk balancing and hedging strategies that have been implemented to deal with China's rise. While European powers continue to manage the risk of China's rise through hedging strategies, the US is rebalancing its strategies to face China's increased power and perceived threats to US interests. ■

*Responding to China's Rise: US and EU Strategies* was published in October 2014. It is available for purchase at Amazon.com and Barnesandnoble.com. See page 3 for more details

For endnotes to article, please go to page 18.



## APEC UPDATE: BEIJING 2014



*The 2014 APEC Summit was hosted by China.*

*Photo Credit: CCTV America*

Between November 5-11 2014, leaders and representatives of APEC member economies met in Beijing, China for the 26th APEC Summit, which was also the 25th anniversary of APEC. As the host, China selected the theme of “Shaping the Future through Asia-Pacific Partnership,” and pursued an agenda for an “Integrated, Innovative and Interconnected Asia Pacific.”<sup>1</sup> In this APEC Update, the first part addresses APEC-specific achievements. The second part addresses the non APEC-specific achievements as a result of the bilateral meetings between China and other countries, specifically the US, Japan, and Korea, on the sidelines of APEC. And the third part addresses the implications of the Summit, specifically on China’s growing regional leadership.

For this year, there are three priority areas of APEC collaboration: deepening regional economic integration, promoting economic reform and innovative development, and building infrastructure investment and comprehensive security.<sup>2</sup> To pave the way for further cooperation among APEC member economies in these three areas, APEC has reached a number of agreements.

First, in the area of deepening regional economic integration, China has secured the endorsement from other APEC member economies of a roadmap for the realization of the Free Trade Area of the Asia-Pacific (FTAAP) to embody the Bogor Goals of achieving free and open trade and investment by 2025.<sup>3</sup> A collective strategic study is launched to look into options of building on existing trade agreements, including the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP), for the realization of the FTAAP.<sup>4</sup> According to the Pacific Economic Cooperation Council (PECC), FTAAP

would bring promising economic benefits by stimulating the global economy by as much as US\$2.4 trillion.<sup>5</sup>

Second, in the area of promoting economic reform and innovative development, APEC has announced its commitment, most notably, towards small and medium sized enterprises (SMEs), women, and fighting corruption. Reiterating its commitment to strengthen SMEs in the international market, APEC has called on member economies to build up collaborative networks for SMEs to identify global business opportunities and invest in innovative SMEs still in their early stages of development.<sup>6</sup> To empower women in the Asia-Pacific who are a vital economic force, APEC has illustrated its commitment to eliminate barriers hindering women’s access to the market, ensure equal opportunities, and support women entrepreneurship.<sup>7</sup>

Also, APEC has announced to collaborate and launch a transnational law enforcement network to fight corruption in the Asia-Pacific.<sup>8</sup> This initiative is pushed by China, and is seen as a broader effort by President Xi Jinping to fight corruption at home. Just in July 2014, Xi launched the Operation Fox Hunt to track down corrupt officials who have fled abroad.<sup>9</sup> However, the pursuit of these officials has often been met with difficulties due to a lack of extradition treaties between China and other countries, particularly the US, Canada and Australia, which are considered to be safe havens.<sup>10</sup> With the endorsement of a cross-border law enforcement network, China and other countries would be able to pursue corrupt officials, seize their assets, and combat transnational corruption.

Third, in the area of building infrastructure investment and comprehensive connectivity, APEC has en-

dorsed a new APEC Connectivity Blueprint for 2015-2025 to enhance physical, institutional, and people-to-people connectivity in the Asia-Pacific region. This is APEC's first long-term plan to be committed to increasing infrastructure development, coordinating laws and regulations to reduce regulatory obstacles, and increase the flow of people such as labor and students across borders.<sup>11</sup>

Moreover, China has established a US\$40 billion Silk Road Fund to invest in infrastructure and boost connectivity in the region. As President Xi illustrates, the fund is established to finance transportation infrastructure in Central Asia and South Asia, and hence to "break the connectivity bottleneck" in the region.<sup>12</sup> Likewise, Xi promoted China's sponsorship of the US\$50 billion Asian Infrastructure Investment Bank, seen as a rival to the US-oriented World Bank and the Japan-oriented Asian Development Bank, to further finance regional infrastructure.<sup>13</sup>

On the sidelines of the Summit, member economies have also held bilateral meetings and reached significant agreements. In particular, the respective bilateral meetings between China and three of its most important regional partners—the US, Japan and Korea—are the most notable. During the one-day bilateral meeting between President Obama and President Xi, several agreements over global warming, visa issuance, defense mechanism, and the WTO Information Technology Agreement were reached.

First, China and the US have concluded a climate deal. Both countries have agreed to cut carbon emissions. The US has agreed to reduce carbon emissions to 26-28% below 2005 levels by 2025, and China has agreed to stop the rise of its carbon emissions by 2030 and increase the share of clean energy to 20% of its overall energy supply.<sup>14</sup> This agreement is considered to be 'historic' because it is the first time that the two biggest carbon emitters are committed to reduce carbon emissions.<sup>15</sup> Especially for China, its commitment is a departure from its previous stance at the 2009 Copenhagen UN climate conference that developing countries should be given leeway to adhering to the strict carbon reduction regulations.<sup>16</sup> Now, with the endorsement of both countries, a conclusion of a new global climate agreement in the upcoming 2015 Paris UN climate conference is expected. Developed countries may likely be pressured to follow suit while developing countries may be less worried that reducing carbon emissions would put them at a comparative disadvantage economically.<sup>17</sup>

Besides the climate agreement, China and the US have also reached a deal to reform visa rules for both Chinese and American citizens. Under the agreement, business and visi-

tor visas can be made valid for up to ten years while student and cultural exchange visas can be made valid for up to five years, as opposed to the previous one-year limit for all types.<sup>18</sup> Along with the climate agreement, this visa deal is considered to be major as it brings economic benefits, potentially "contribut[ing] US\$21 billion to the economy and support[ing] more than 100,000 jobs" in the US.<sup>19</sup>

In addition, both countries have come to terms with regards to national defense. This is a response to the unfriendly encounters between the two countries' military forces, which have strained the US-China bilateral relations. For instance, in August 2014, Chinese jets in the South China Sea were accused of flying unnecessarily close to US surveillance jets.<sup>20</sup> To forestall such encounters, both countries have agreed to a code of conduct regarding air and maritime encounters, and to notify each other in advance of any major military exercises and activities and ballistic missile launches.<sup>21</sup>

The last agreement between the US and China has to do with extending the WTO Information Technology Agreement (ITA). The ITA was signed in 1996, but recent talks to expand the agreement have been stalled due to China's opposition.<sup>22</sup> Under the new US-China deal, 200 tariff lines on information and technology products, including semiconductors, MRI machines, and GPS devices would be eliminated.<sup>23</sup> According to the US

Trade Representative Michael Froman, the deal "would eliminate tariffs on sales of roughly \$1 trillion and could generate as many as 60,000 US jobs."<sup>24</sup> Again, this agreement marks China's departure from its previous rhetoric. The US-China agreement will be introduced at the WTO this December.<sup>25</sup> Once ratified, a reduction in the prices of information technology products covered in the global agreement can be expected.<sup>26</sup>

Apart from the bilateral meeting with the US, China's groundbreaking meeting with Japan is also worthy of attention. Tensions between the two countries have always been high due to competing historical interpretations over Japan's wartime aggression in WWII. In recent years, bilateral relations have been worsened as Abe paid official visits to the Yasukuni Shrine which honors 14 A-class war criminals and as Japan nationalized three of the disputed Senkaku-Diaoyu islands in the East China Sea in 2012.<sup>27</sup> In fact, since Xi Jinping and Shinzo Abe came into office in 2012, both leaders have not yet met until this meeting.<sup>28</sup> Therefore, the bilateral meeting at the Summit this year was considered to be a "first step" towards improving the bilateral ties.<sup>29</sup> Both countries agreed to "gradually resume political, diplomatic, and security dialogue through various multilateral and bilateral channels" and "to make efforts to build political trust."<sup>30</sup> On the maritime dispute in the



*President Obama meets President Xi. Photo Credit: Radio Free Asia*



East China Sea, both countries have acknowledged that there exist different positions between them and have agreed to “prevent the situation from aggravating through dialogue and consultation and establish crisis management mechanisms to avoid contingencies.”<sup>31</sup> Though it has yet to be observed how the agreements at the Summit turn out, this bilateral meeting at APEC is significant nevertheless.

Last but not least, the bilateral meeting between China and South Korea is notable as well. After two years of trade talk, the China-Korea Free Trade Agreement has been concluded over a meeting between Xi and President Park Geun-hye.<sup>32</sup> Under the agreement, tariffs on more than 90% of goods traded between China and Korea over the next 20 years would be removed, accounting for more than 85% of the trade volume between both countries.<sup>33</sup>

To conclude, 2014 was a big year for APEC. The number of breakthroughs reached was unusual for an APEC Summit and only highlights the growing leadership of China. At the

same time, it casts “an uncomfortable light on the lack of leadership and vision provided by other APEC hosts, and by the institution as a whole.”<sup>35</sup> In particular, China’s growing leadership has undermined US regional power in the Asia-Pacific. By securing endorsement from other member economies for the realization of the FTAAP, China has taken the focus off TPP, which was expected to be concluded on the sideline of the summit. Also, by establishing the US\$40 billion Silk Road Fund, China has addressed the critical need of financing regional infrastructure, which has often been sidelined at previous summits.<sup>36</sup> It is clear that China has established itself as an indispensable regional power and responsible international actor through this APEC Summit, and has likely undermined the US goal of “Pivot to Asia.” ■

For endnotes to article, please go to page 18.

## CHINA: UNLEASHING THE ECONOMIC POTENTIAL OF THE WEST



Map displaying the division of China into three regions: Eastern, Central, and Western. The Western provinces include Shaanxi, Chongqing, Guizhou, Guangxi, Yunnan, Sichuan, Gansu, Ningxia, Inner Mongolia, Qinghai, Tibet, and Xinjiang.

Photo Credit: UNICEF / National Bureau of Statistics

By: Katheryn Sehyan Lee, BASC Research Assistant

■ In recent years, the western region of China is leading the country with growth while traditional industrial provinces in the eastern coastal region are experiencing the slowest growth. A notable shift in the economic growth from east to west is largely credited to the Chinese government’s Western Development Strategy (WDS) that began to address economic un-

derdevelopment in the west in 2000. In fact, since the launch of the WDS, the western region has experienced accelerated rate of growth, surpassing that of the east. For instance, in the first quarter of 2014, the west experienced an average of 21% investment growth compared to the east with 0.11% growth.<sup>1</sup> Thus, although economic disparity between the advanced east

and the underdeveloped west still exists, relative success of the west in expanding the domestic market and attracting investment from overseas like South Korea makes China's Western Development Strategy a winning economic policy.

In the 1980s and 1990s, the Chinese Communist Party (CCP) gave policy priority to the development of eastern coastal regions by concentrating investment of resources, especially foreign direct investment (FDI) and establishing special economic and technological development zones in the region with a reduced corporate income tax rate of 15% and two-year tax holidays.<sup>2</sup> As a result, compared to the western region that only accounted for 3% of China's total FDI inflows, the eastern coastal region attracted more than 88% from 1983 to 2001.<sup>3</sup> The eastern region's share of total GDP also rose from 52.5% in 1978 to 64.3% in 2000 in contrast to the western region where it declined from 17.8% to 14.6%.<sup>4</sup>

In response to increasing regional inequality, the CCP initiated the Western Development Strategy in 2000 to create a more favorable investment environment in the western region<sup>5</sup> that accounts for more than 70% of the China's mainland area. Specifically, Chengdu-Chongqing, Guanzhong-Tianshui and Guangxi-Beibu Gulf were designated as economic zones to help bolster western development. China's 11th and 12th Five-Year Plans for national economy also began to adhere to the strategy. For example, the 12th Five-Year Plan (2011-2015) dedicates a whole section to the development of the west, specifically stressing the need to provide "special policy supports" for infrastructure construction, environmental protection, and science and education in the region.<sup>6</sup> The National Development and Reform Commission (NDRC) of China also set up the Department of Western Region Development, designating the west as priority areas of economic development with the goal of "redesigning the regional structure and alleviating im-

balances in regional development."<sup>7</sup>

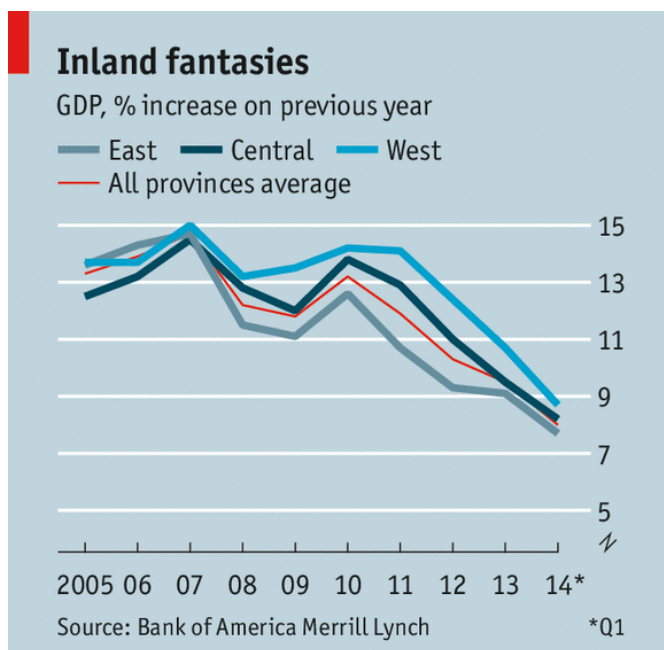
Likewise, with economic policies that focus on the development of the western region, the central government spent more than 3.5 trillion yuan (512.4 billion USD) since 2000.<sup>9</sup> Concentrated and ambitious effort on the western development helped to boost the region's GDP from 1.66 trillion yuan (270.8 billion USD) to 5.82 trillion yuan (949.4 billion USD) in 2008, with an annual average growth rate of 11.7%.<sup>10</sup> As a result, GDP growth in the western region has continued to exceed that of the eastern region since 2005. (Figure 1)

The remarkable growth of the west reflects the major progress that has been made in the first decade of the WDS. For example, the initial phase of transportation and infrastructure constructions such as Qinghai-Tibet railway, the West-East natural gas pipeline from Lunnan in Xinjiang to Shanghai, and the West-East power transmission from western provinces like Guizhou and Yunnan to eastern provinces like Guangdong and Beijing have been completed. Special policy support has also been granted to attract foreign investment. In 2012, the Chinese government extended the valid period for the reduced tax rate of 15% to December 31, 2020 to companies located in the western regions that fall within the Catalogue of Encouraged Industries,<sup>11</sup> also classified as "priority industries" in the 12th Five-Year Plan.<sup>12</sup> These additions complement traditional sectors of the western region that are predominantly based on natural resource such as "petrochemicals, energy, mining, and minerals processing."<sup>13</sup>

Improved infrastructure and business environment in the western region have also promoted foreign direct investment, a top priority in the WDS. By 2009, nearly 200,000 enterprises from eastern China moved to the western region with combined investment exceeding 2.2 trillion yuan (323.5 billion USD).<sup>14</sup> For example, many multinational IT companies have relocated to the special economic zones in the west like the West Triangle Economic Zone consisted of Chengdu, Chongqing, and Xi'an to take advantage of the region's low wages, low corporate tax rates, and human resources.<sup>15</sup> As a result, in 2009 alone, Chongqing signed with Hewlett-Packard and Taiwan's Quanta Company to build a processing base for 20 million laptops and 40 million laptops, respectively.<sup>16</sup> More recently in 2014, Intel announced plans to invest up to \$1.6 billion over the next 15 years in its microchip plant in Chengdu.<sup>17</sup>

However, although implementation of the WDS has dramatically accelerated growth in the western region, there is still much doubt about the real effect of the strategy in improving regional economic inequality and the overall Chinese economy. For instance, the substantial portion of GDP still shows that the west may not be contributing much to the Chinese economy. The western region accounted for 17.8% of national GDP in 2008, an increase of only 0.3% from the 1999 level, while the eastern region's share rose from 56.6% to 58.3%.<sup>18</sup> In addition, the GDP per capita of all the western provinces except Inner Mongolia during this period have continued to fall short of the country's average, accounting only 43.5% of the east.<sup>19</sup>

**Figure 1: GDP Growth Rate by Region**



Source: Bank of America Merrill Lynch/The Economist<sup>8</sup>



*Xi'an Bell Tower lit up at night. Source: The Daily Star*

In short, the western region does not seem to be catching up with the east just yet.

Likewise, if the WDS is evaluated solely based on the numbers relative to that of the east, its success may be seriously questioned. However, in light of such criticism, growing foreign investment, particularly from South Korea, re-highlights the progress and future prospects of the WDS. In 2013 at the Korea-China Business Forum, South Korean President Park Geun-hye pointed to China's "Great Western Development Project" as a way to expand both nations' domestic markets.<sup>20</sup>

In fact, Korean companies in China are moving from east to west, signaling newly growing investment opportunities in the region. For instance, in the auto sector, increasing competition among multinational automakers in the eastern region has made companies turn to western China and its emerging automotive market. According to the China Association of Automobile Manufacturers (CAAM), automobile sales in the western region in the first nine months of 2009 surged 51%, offering incentives for companies to set up factories to supply the local market.<sup>21</sup> As a result, Hyundai Motor Company, the largest automobile manufacturer in South Korea with three manufacturing plants located in Beijing, is now considering building a fourth car plant in Chongqing.<sup>22</sup>

Korean companies in other sectors like Samsung Electronics, the world's second-largest smartphone maker, have also been aggressive in expanding to the western regions to capitalize on the growing demand. In 2013, Samsung announced its plans to build a semiconductor plant and invest a total of \$7 billion to create manufacturing and research facilities in Xi'an, the second largest overseas investment after Austin, Texas.<sup>23</sup> SK Hynix of SK Group, the world's second-largest memory chipmaker, also recently decided to build a semiconductor plant in Chongqing in response to increasing memory chip demand

in China.<sup>24</sup> Korean companies are also joining the traditional sectors in the west such as resource processing and chemicals. POSCO, the world's fourth-largest steelmaker, signed a memorandum of understanding (MOU) with Chongqing Iron & Steel in the city of Chongqing in July 2014 for the plant construction.<sup>25</sup> SK Global Chemical of SK Group will also build a joint plant with China's state-run oil firm, Sinopec, to produce butanediol in Chongqing.<sup>26</sup>

Korean companies' interest in breaking into China's western market exemplifies positive progress and future prospects of the WDS in making the region an attractive market for businesses. Since the implementation of the WDS, infrastructure and transportation capacities of the west has improved, facilitating inter-regional trade. Furthermore, an increasing number of businesses has encouraged potential migrants to stay in the west and spend locally. Thus, the west has become a sizable market and the new area of growth for China.<sup>27</sup>

In conclusion, according to Vice Premier Li



*Source: The Korea Times*



Keqiang, turning to the west is a “strategic move,” which would help China to expand “domestic demand and accelerate transformation of the economic growth pattern.”<sup>28</sup> As the growing number of business activities and foreign investment in the west shows, the WDS has been successful in improving business environment and bolstering foreign companies’ confidence in the growth potential of the western market. Therefore, although eastern coastal areas still remain key markets,

developing western China through the WDS has significant implications for China’s future economic direction by expanding China’s internal market for more sustainable option of growth and consolidating the geographical balancing of development. ■

For endnotes to article, please go to page 19.

## CHINA’S OIL TRADE AND INVESTMENT IN SUB-SAHARAN AFRICA



*Then Chinese Vice-President Xi Jinping at the 2010 Forum on China-Africa Cooperation (FOCAC) in Pretoria.  
Photo Credit: The Guardian*

By: Vanessa Man Yin Cheuk, BASC Research Assistant

Oil has been a major interest in the relations between China and sub-Saharan Africa (SSA). Since 2000, Chinese state-owned oil companies—mainly China National Petroleum Corporation (CNPC), China Petroleum and Chemical Corporation (Sinopec), and China National Offshore Oil Corporation (CNOOC)—have increasingly ventured into SSA for oil under the support from the Chinese government. Oil trade and investments have been booming ever since. However, as China expands its activities in SSA, China modifies its approach accordingly to difficulties encountered to secure its oil supply. The first part of the paper will address the evolution of China’s engagement in SSA for oil, in particular, the shift from the oil-for infrastructure approach to the increasing activities of mergers and acquisitions. The second part addresses the difficulties encountered in China’s search for oil, particularly the attacks from criminal gangs and Islamic extremists in Nigeria, and the civil war in South Sudan, and in response, China’s decision to diversify away from SSA oil imports to those from more politically stable regions. Finally, the third part addresses

the prospects of China-SSA oil ties. I argue that the prospect of China-SSA oil ties remains to be observed in the near term due to the civil war in South Sudan, but may fade in the long term as a result of China’s increasing production of shale gas.

China-Africa relations go back to the 1950s when China contributed foreign aid to Africa in search for political allegiance. As Deng Xiaoping came to power and implemented the ‘reform and open up’ policy, China shifted its focus on domestic economic growth. As industrial production boomed, China’s energy needs increased dramatically. In 1993, it became a net importer of oil.<sup>1</sup> In order to satisfy its oil demands, China officially endorsed the “Going Out” strategy as national policy in 2000.<sup>2</sup> State-owned oil companies were then encouraged to invest abroad in oil-rich countries. With vast oil reserves and a longstanding relationship with China, Africa was seen as a suitable partner. In 2013, 59% of China’s oil consumption was met by imports,<sup>3</sup> and Africa was the second-largest oil supplier to China.<sup>4</sup> It provides around 23% of China’s oil imports in 2013, behind the Middle East (Figure 1).<sup>5</sup> Within SSA, Angola and

South Sudan are the main oil suppliers to China while it also relies on imports from Congo-Brazzaville, Equatorial Guinea, and Nigeria.<sup>6</sup> In particular, Angola is China's second-largest source of oil imports behind Saudi Arabia.<sup>7</sup>

In its search for oil throughout SSA, China has adopted an oil-for-infrastructure approach since the 2000s. A Chinese state policy bank—either China Export Import Bank (Exim) or the China Development Bank—pays pre-selected and approved Chinese construction companies to build infrastructures. In return, the African country repays its loan with export revenue of oil for a long term.<sup>9</sup>

As China extends this approach to Angola, Sudan, Nigeria—which alone account for two-thirds of the total value of China's infrastructure investments in Africa<sup>10</sup>—and other oil-rich partners, China and SSA have benefited from the bilateral oil trade. For China, SSA's oil exports have satisfied its energy needs. As the second largest oil consumer in the world after the US, China needs foreign oil supplies to support its robust economic growth averaged out at 10% from 2000 to 2011.<sup>11</sup> Holding 8% of global known oil deposits and having experienced one of the fastest regional growth rates in oil reserves, Africa is important to China as an oil supplier.<sup>12</sup>

As for SSA, first, it has benefited from the Chinese-built infrastructures. As a region that suffers from low credit ratings, SSA has difficulty borrowing capital from the West to build the infrastructures it needs desperately. According to the World Bank, the lack of infrastructure in Africa increases manufacturing costs of production by about 200%, and lowers private sector productivity by about 40%.<sup>13</sup> So, the infrastructure investments that China provides are essential. Over the past decade from 2001 to 2011, China increased its infrastructure investments in Africa from US\$500 million to US\$14 billion.<sup>14</sup> As a result, a boom in infrastructures, such as bridges, schools, hospitals, railroads, roads and dams, which are critical for economic development can be seen.

Second, as a consequence of the bilateral oil trade and China's infrastructure investments, SSA has enjoyed high economic growth. According to the IMF's April 2014 'Regional Economic Outlook for sub-Saharan Africa,' oil-exporting countries experienced an average real GDP growth of 5.9% from 2010 to 2013.<sup>15</sup> In both 2014 and 2015, the region is expected to experience a 6.5% growth rate.<sup>16</sup> Therefore, oil ties with China has spurred a leap in development in SSA.

In brief, with the use of the oil-for-infrastructure strategy, China and SSA have both benefited from the bilateral oil trade. However, as China expands its activities in the region, it realizes that this strategy is not sufficient to secure a stable

long-term supply of oil since negotiated projects are delayed and cancelled at times. A prominent example would be in Nigeria, which has received the most infrastructure investments from China in the region.<sup>17</sup> From 1999 to 2007, under the

leadership of President Olusegun Obasanjo, China's oil-for-infrastructure deals totaled US\$12 billion. China rehabilitated an oil refinery worth US\$2 billion, a railway of 1350km and a hydroelectric station worth US\$2.5 billion.<sup>18</sup> In return, Nigeria would repay the debt with export revenue generated from its oil blocks. However, when Obasanjo was succeeded by Umaru Musa Yar'Adua, most Chinese oil contracts and loans signed under his rule were frozen,<sup>19</sup> and Nigeria has yet to repay its loan. To minimize such risks resulting from delays and cancellations of projects and secure a stable supply of

oil in the long term, China has modified its strategy, especially after 2008, to directly acquire assets through mergers and acquisitions.

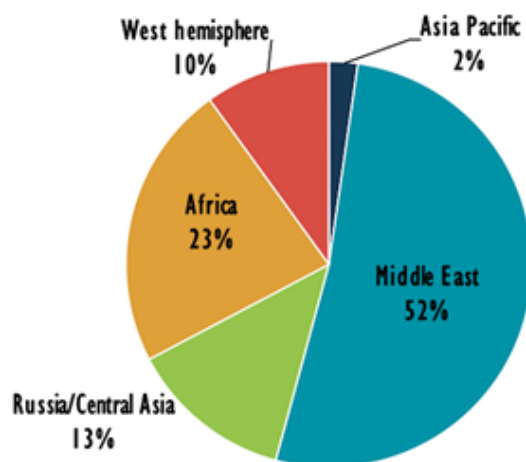
In 2008, the global financial crisis forced oil companies who were hit hard to look out for mergers to finance their operations or to sell their equity stakes. As China still enjoyed a GDP growth rate of about 9% during and after the financial crisis,<sup>20</sup> it provided an opportunity for China to ramp up its investments in SSA from 2008 to 2010. According to the International Energy Agency, most equity shares were located in only four countries among which SSA countries (Angola and Sudan) were two of them.<sup>21</sup> As a result, China's foreign oil production increased where the equity oil share of state-owned oil companies accounted for about 50% of its total overseas production.<sup>22</sup> Therefore, although China still negotiates oil-for-infrastructure deals, China has taken advantage of the global financial crisis to directly acquire assets through mergers and acquisitions in SSA to further secure its long-term oil supply.

However, in recent years especially from 2011 onwards, the geopolitical instabilities in SSA have undermined China's oil interests on the ground. The most notable threats are the political instability in South Sudan, and the attacks on oil workers from criminal gangs and Islamic extremists in Nigeria.

In South Sudan, the political instability poses the most significant threat to China's oil interests in SSA as Chinese national oil companies are the biggest investors in the industry. The disputes between Sudan and South Sudan, and the civil war in South Sudan have adversely undermined China's oil interests in the country.

On July 9 2011, South Sudan declared independence from Sudan. As 75% of oil production is located in South Sudan and the pipelines of oil exports to the Red Sea run through

**Figure 1. Source of Chinese crude oil imports in 2013 by region**



Source: IEA 2014<sup>8</sup>

Sudan, the two countries attempted to reach a profit-sharing agreement where Sudan tried to charge South Sudan a transit fee of US\$32-38 a barrel.<sup>23</sup> In January 2012, the talks to reach an agreement broke down and South Sudan halted oil production. Although a deal was brokered in March 2013 and South Sudan resumed oil production briefly, the country plunged into a power struggle between the government forces led by President Salva Kiir and the rebel forces loyal to Vice-President Riek Machar in December 2013. Thousands were killed and more than half a million fled their homes. Consequently, oil production fell dramatically (Figure 2). By the end of 2013, the level of oil production by CNPC and Sinopec was only half of that in 2011.<sup>24</sup> The ongoing civil war has damaged Chinese national oil companies' investments in the country as oil fields were either shut down or destroyed.

In Nigeria, kidnapping of oil workers by criminal gangs and murder by Islamic extremists are rampant in the oil-rich regions. On multiple occasions between 2012 and 2014, Boko Haram militants—radical Islamists infamous for kidnapping more than 200 schoolgirls in April 2014<sup>26</sup>—killed workers from Chinese construction companies in the Borno state where most government-funded projects are undertaken by Chinese companies.<sup>27</sup> In response, China has made multiple calls to the Nigerian government to protect its state personnel. However, China could do little and the situation on the ground remains grim.

As a result of these geopolitical instabilities in SSA, China has modified its strategy to shift its investments to more politically stable countries and diversify its sources of oil imports. Most notably, it has extended two long-term oil-for-infrastructure deals with Russia worth US\$50 billion and shifted its activities of mergers and acquisitions to OECD member countries (particularly the US and Canada) whose assets include shale oil and gas—a substitute for crude oil.<sup>28</sup> In addition, China has increasingly cooperated with international oil companies and other countries' national oil companies to develop its vast shale gas reserves at home.<sup>29</sup> According to China's Ministry of Land Resources, China has shale gas reserves larger than that of the US, reaching more than 10 trillion cubic meters.<sup>30</sup> Therefore, in light of geopolitical instabilities in SSA since 2011, China has diversified its oil investments and imports to more politically stable regions, most notably the US, Canada, and Russia.

To conclude, China-SSA oil ties have become vibrant since the 2000s under the “Going Out” strategy. To search for oil,

China has widely negotiated oil-for-infrastructure deals with SSA countries. However, although these deals have satisfied China's energy demands, it realizes that it is not able to secure a long-term supply of oil. As a result, since the window of opportunity brought by the global financial crisis, China has increasingly acquired direct assets through mergers and acquisitions. During 2008 to 2010, China has invested heavily in Angola and Sudan. However, the years since 2011 have seen geopolitical instabilities arise in the region. There are rampant kidnappings and murders in Nigeria, and a civil war in South Sudan. In response, China has diversified its oil imports by extending oil-for-infrastructure deals to and acquiring direct assets from more politically stable regions, as well as developing shale gas production at home.

With regards to the prospect of China-SSA oil ties in the near term, the civil war in South Sudan—the second-largest oil supplier to China in SSA—has yet to be resolved. To protect its oil interests, China has become a major mediator. Contrary to its foreign policy of “non-interference” where China usually contributes only medical and engineering units in UN peacemaking missions, China has sent 700 soldiers to South Sudan to guard the oil fields and protect its personnel.<sup>31</sup> Zhong Jianhua, China's Special Representative on African Affairs, has reportedly met with the warring parties to secure a peaceful solution, and asked

the government to resume oil production and the rebel forces to stop attacking the oil fields.<sup>32</sup> At the time of writing, the third peace agreement is still being negotiated between the two warring parties, and has yet to be signed.<sup>33</sup> Therefore, the prospect of China-SSA oil ties in the near term remains to be observed depending on the political stability in South Sudan.

In the long term, China-SSA oil ties may fade. Considering the fact that China awarded 18 oil companies the right to explore its shale gas reserves in two auctions just between 2011 and 2012,<sup>34</sup> China is determined to develop its

shale gas reserves. Although the necessary drilling technologies and infrastructures have yet to be developed, the increasing production of shale gas at home may gradually reduce China's dependency on oil imports. Therefore, China-SSA oil ties may fade when shale gas production in China booms. In other words, in the near future, China may continue to diversify its oil imports away from SSA, in particular South Sudan, if the civil war is not resolved. Whereas in the long term, China-SSA oil ties may fade eventually as the increasing production of shale gas in China reduces its reliance on oil imports. ■

For endnotes to article, please go to page 18.

**Figure 2. Sudan and South Sudan oil output and Chinese im-**  
**ports**

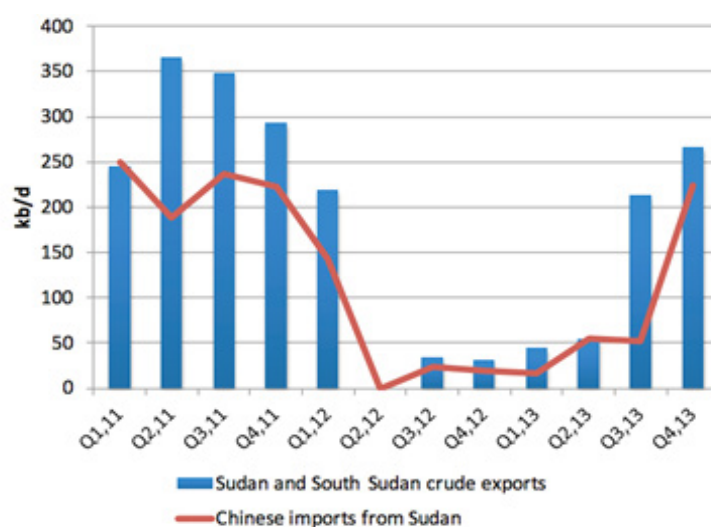


Figure from IEA 2014<sup>25</sup>



## RAILWAY DIPLOMACY: CHINA'S RAIL STRATEGY IN SOUTHEAST ASIA



*China's rapidly expanding railway network has played an increasingly important role in its economy. Photo Credit: Hindustan Times*

By: Kevin Ratana Patumwat, BASC Research Assistant

China surpassed Japan as Southeast Asia's largest trading partner in 2009 and has since asserted itself as a key political and economic power in the region.<sup>1</sup> This shift is evident in the three Southeast Asian countries that border China: Myanmar, Laos, and Vietnam. Beijing is Vietnam and Myanmar's largest import partner, and has been rapidly increasing its influence in Laos.

This article will discuss two of China's rail projects around its border with Myanmar, Laos, and Vietnam. An integrated China-Southeast Asia rail network offers China multiple advantages, including the opportunity to boost the economy of its underdeveloped Southwestern region as well as access to alternative seaports. Currently, it is pursuing two projects. The first project, the "Center Route," is intended to connect China with Thailand's seaports via Laos. The second project, the "Western Route," is planned to connect China with Myanmar's Indian Ocean coast. However, the neighbors' fears over projected costs and cooling relations with China have been an obstacle to Beijing's plans. Laos' commitment to the project is in doubt due to its financial burden on the Laotian economy. The influence of civil society groups in Myanmar as well as the Burmese government's attempt to reduce its dependence on China has similarly delayed progress. As for Vietnam, recent tensions between Beijing and Hanoi over territorial claims in the South China Sea have significantly dampened Chinese investment prospects in the country.<sup>2</sup> The current reluctance of the three Southeast Asian countries

to commit themselves to China's vision of the rail projects could potentially offer an opportunity to Japan, which is looking abroad to find customers for its world-renowned Shinkansen (high speed railway) technology. To illustrate the dynamics currently surrounding the rail projects proposed by China, this article will review the history behind the idea of bridging China and Southeast Asia by rail, examine Beijing's Southeast Asia strategy, and discuss the challenges that this strategy faces in Laos, Myanmar, and Vietnam. I will conclude with a brief analysis of rail transport's future prospects in mainland Southeast Asia.

The idea of a rail network connecting the Chinese Southwestern province of Yunnan to Southeast Asia is not new. Yunnan has long been recognized as a resource-rich and strategically valuable gateway to Southeast Asia. Both France and Britain attempted to connect Yunnan to their colonial holdings and their ports in Vietnam and Myanmar, respectively. In 1910, France successfully constructed a rail link between Kunming and northern Vietnam, part of its colony of Indochina.<sup>3</sup> The British tried to emulate the French and connect Myanmar, one of its Southeast Asian colonial holdings, to Yunnan, but the project was interrupted due to the outbreak of the Second World War and was never resumed. Both rail projects were aimed at facilitating Western access to Yunnan's extensive natural resources.<sup>4</sup>

In addition to the French project in northern Vietnam, nearly all mainland Southeast Asian countries also received their first rail networks during the colonial era. Britain created

an extensive network in what is now today Myanmar, Malaysia, and Singapore. France constructed several rail lines in the rest of Vietnam and Cambodia. However, the French did not extend their network into Laos as the sparsely populated colony was often overlooked in favor of Vietnam.<sup>5</sup> The colonial efforts were complemented by Thailand, known as Siam at the time, which established its own network connecting Bangkok to the country's major regions. The combined British, French, and Thai projects serve as the foundation of Southeast Asia's rail infrastructure to this day.

Since the establishment of these railway networks over a century ago, only Malaysia and Singapore have adequately modernized their networks. Thailand, Myanmar, and Vietnam's network use antiquated technologies and run slowly or not at all. Sources estimate that the maximum speed on Myanmar's rail network is 24 km/h.<sup>6</sup> Meanwhile, Cambodia's dilapidated network is undergoing a slow process of rehabilitation supported by the Asian Development Bank and the Australian government.<sup>7</sup> Laos still does not have a rail network. As such, the usage of railways to transport passengers and goods across borders has been minimal in Southeast Asia.

China's role as an avid advocate and funder for rail construction in Southeast Asia is driven by two primary considerations. First, linking Yunnan to Southeast Asia would significantly boost the province's economic potential. Despite its rich natural resources, Yunnan has consistently been one of China's poorest provinces. Its GDP per capita is among the lowest in the country, and its economy is dominated by state-owned enterprises, with relatively little private investment.<sup>8</sup> This is due, in part, to the perception that Yunnan is a "dead end" on the country's periphery.<sup>9</sup> Therefore, the attempt to transform Yunnan from a "dead end" to a regional gateway is a key element in Beijing's plan to stimulate the province's economy and part of the Western Development Strategy. Therefore, in 2011, China's State Council decided to designate Yunnan and its capital Kunming as an international hub of Southeast Asia.<sup>10</sup> Kunming is to act as a land "bridgehead," connecting China's inland regions to Southeast Asia,<sup>11</sup> and Beijing has endeavored to increase links between the two regions. In 2012, the Kunming-Bangkok Expressway, financed by the governments of China, Thailand, and Laos, started operating and significantly expanded ground shipping capacity. Furthermore, China has shown an interest in policing and exerting its influence in the Mekong River, another trade artery connecting Yunnan and Southeast Asia. The logistical capacity of river and road transportation, however, will be overshadowed by the capacity and speed that a rail network could provide. Thus, the establishment of a regional rail network that connects to Kunming has the potential to significantly enhance Yunnan's economic significance.

Secondly, beyond giving China rapid access to mainland Southeast Asian markets, the construction of modern rail links between Yunnan and Southeast Asia has critical geopolitical significance. The rail lines could provide China with access to a wide range of major ports. With this objective in mind, Beijing

has been pushing two main routes. The first route, also called the "Center Route," will go through Laos and Thailand and provide China with access to Map Ta Phut, Thailand's largest industrial seaport, and Singapore, the second-largest container port in the world after Shanghai.<sup>12</sup> These two ports are part of the world's largest shipping lines. But apart from the increased trade capacity, direct access to Map Ta Phut and Singapore will allow Chinese exports to Europe, Africa, and much of Asia to bypass the South China Sea, a route that is both longer and under military tension. The second route, known as the "Western Route," will connect China and Myanmar. In 2013, China successfully built a gas pipeline leading from Kyaukpyu, a Burmese town on the Indian Ocean, to its southwestern provinces. It has also showed support for the Burmese government's plan to develop Kyaukpyu into an industrial seaport.<sup>13</sup> Access to Kyaukpyu would transform China's geopolitical position; the country will practically have access to a second coast. For Chinese manufacturers located in the country's deep southwest, a port in Kyaukpyu will be geographically closer than China's major ports in the east of the country. More importantly, the Western Route, along with Kyaukpyu, will allow China to bypass not only the South China Sea, but also the Straits of Malacca. The Straits of Malacca have been identified by Beijing as a key vulnerability, as much of its imports and exports go through it.<sup>14</sup> Port access is, therefore, a key motivation for China's decision to push for rail integration with Southeast Asia and a key factor in the design of its rail routes.



*Potential transportation corridors in the China-Southeast Asia border region (Kunming-Myanmar, Kunming-Laos-Thailand, Kunming-Vietnam)*

*Photo Credit: The Economist*



While China already has a rail link to Vietnam, the country is not yet connected by rail to Myanmar and Laos. Thus, it has begun to lay tracks towards its border as a first step in achieving region-wide rail integration. In October 2014, China authorized the construction of rail lines extending from Kunming, its designated strategic bridgehead, to towns on the Burmese and the Laotian borders.<sup>15</sup> China is currently building a 504km extension to its network that will connect Kunming to the Laotian border. The extension line is estimated to cost \$7.3 billion, with the Asian Development Bank partially funding it through a \$350 million loan, and is projected to be completed in 2019.

Beijing also approved a similar project in the direction of Myanmar, with a 330km extension to the Burmese border set to allow rail access from Kunming. The geography of the route to the Burmese border poses formidable challenges. The line will include the 30km-long Gaoligong Mountain Rail Tunnel, which will be the longest railway tunnel in Asia. Partly due to these engineering challenges, it is not expected to be completed until 2020.<sup>16</sup> The project's budget is estimated to be \$4.2 billion and is to be jointly funded by the central government, the Yunnan provincial government, and the China Railway Corporation.<sup>17</sup>

In contrast to China's enthusiasm for the rail projects, Southeast Asian governments have been markedly less eager in cooperating with Beijing. Myanmar, Laos, and Vietnam each have their own reservations. Their reluctance comes from a mix of wariness about China's regional ambitions and the fragility of their relatively undeveloped economies. In Myanmar, there is a growing concern over China's dominant role in the country's economy. China is the country's largest investor, and the growth of Chinese projects has led to an influx of Chinese migrants living in the country. Furthermore, political liberalization in Myanmar has allowed civil society groups to voice their opposition to the export of local natural resources to China.<sup>18</sup> As Myanmar's ties with China grew cooler over the past few years, it has steadily cultivated friendly economic and political relations with India, its western neighbor, and the United States. The country's ongoing liberalization has also restored its access to sources of foreign capital that has been previously out of its reach, and the government is now therefore able to compare Chinese investment projects with competing proposals from the West.<sup>19</sup>

A similar and arguably more consequential shift in attitude has also occurred in Vietnam, and contributes to the reason why there is little talk of a potential modernization of the "Eastern Route" connecting China and Vietnam. Despite the outsized role China plays in Vietnam's economy, Beijing and Hanoi have become increasingly distant over the past few years. Resentment against China reached a boiling point in May 2014 after China deployed an oil rig in an area of the South China Sea claimed by Vietnam. Anti-Chinese riots broke out and led to the death of Chinese expatriates as well as the destruction of several Chinese-owned factories throughout

the country.<sup>20</sup> The riots have made the investment projects in Vietnam riskier for Chinese investors, and Vietnam has correspondingly sought to develop ties with other regional partners such as Japan and South Korea. Tension over sovereignty in the South China Sea is unlikely to subside soon, with neither China nor Vietnam willing to back down from its territorial claims.<sup>21</sup> As a result, there has been little discussion of Chinese rail projects in Vietnam in recent years.

While Laotian authorities have been somewhat more eager than their counterparts in Myanmar and Vietnam to support China's rail project in the region, there still remain serious difficulties. While it is true that a modern rail link will allow Laos to transform itself from a landlocked country to a "land-linked" country, as Laotian officials like to say, it is far from an easy proposition for the country at the moment. Laos is the poorest country in Southeast Asia, and is heavily reliant on international aid. The country is also populated by only six million people, most of whom engage in subsistence agriculture. Nevertheless, in 2012, the Laotian parliament approved the construction of a rail line between its capital Vientiane and the Chinese border to connect to the Yunnan network. The mountainous terrain of Laos also adds further problems to the project: the line will require 76 tunnels and 154 bridges. It is estimated to cost \$7 billion, with the entire sum to be provided by a loan from China's Import-Export Bank.<sup>22</sup> The ambitious project has raised alarm both inside and outside Laos, as it would represent a severe financial burden for the already struggling Laotian government. The country's GDP in 2012 is \$9.4 billion, meaning that the project alone would represent 75% of the country's annual GDP. The IMF estimates that the project could push Laos's total external debt to over 120% of its GDP.<sup>23</sup> As of December 2014, the Laotian government has not set a definite timeframe, and it is unclear when the project will begin.

In short, the aforementioned political and economic obstacles pose a challenge to China's strategic vision in Southeast Asia. Both the political and economic obstacles are based on the large asymmetry of power between China and its Southeast Asian neighbors. The relatively underdeveloped economies of Laos, Myanmar, and Vietnam render any large-scale modernization or construction of the rail system dependent on a substantial foreign financial support. As Laos, Myanmar, and Vietnam want to engage in a balancing act in order to avoid being excessively dependent on China for political reasons, this could be beneficial for Japan, as it seeks to maintain its long-standing influence in the region. Moreover, Japan has been eager to export its high-speed rail technology to foreign markets as a way to boost its flagging economy.<sup>24</sup> Indeed, Japan is one of China's principal rival bidders in a high-speed rail construction project between Kuala Lumpur and Singapore, which is due to commence in 2015.<sup>25</sup>

Additionally, progress on Thailand's rail modernization project could also provide impetus to the Laotian project. In November 2014, the Thai legislature has approved a draft MOU with China regarding the construction of a rail line from



the Thai-Laotian border to Bangkok and to Thailand's largest deep sea industrial port, Map Ta Phut.<sup>26</sup> In the MOU, China was given responsibility for the construction of the railway project. Once construction of the rail lines actually begins, there will inevitably be greater pressure on Laos from both China and Thailand to move forward on its project, as Laos sits between Thailand and China.

If these rail projects succeed, they will be a significant foreign policy achievement for China. A physical connection to Southeast Asia will distinguish China from its regional competitors, particularly Korea and Japan, which both rely on sea and air routes to trade with Southeast Asia. Furthermore, a rail connection will also expand China's already formidable presence in the region vis-à-vis India's as well. If completed, these networks will further solidify China's status as *primus inter pares* in the region. ■

For endnotes to article, please go to page 20.

## Endnotes

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