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China's Employing Economic Instruments in Dealing with  
the South China Sea Disputes to the Philippines and Vietnam

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## Abstract

This study explores how China has employed economic instruments in handling South China Sea disputes with the Philippines and Vietnam. Borrowing Keohane and Nye's notations of sensitivity and vulnerability in asymmetrical interdependence, this study analyzes how China's charm offensive strategy developed since 1997 has created tactical spaces for China to utilize economic attractions and economic coercions in making her weaker economic partners to concede in territorial disputes. In terms of sensitivity to economic attractions, nevertheless, findings in both cases fail to support the argument that economic incentives would persuade the weaker parties to refrain their claims. I argue that one of the missing elements in Keohane and Nye's analytical framework is "trust". Without sufficient political "trust" between China and her economic partners, economic attractions to induce concessions could hardly work. In terms of vulnerability to economic coercions, findings in both cases suggest that compared to the substantive measures stressing the short-term loss, the symbolic measures projecting to high degree of risks and uncertainties might be more effective to deter the weaker parties.

**Keywords:** South China Sea, charm offensive, asymmetrical interdependence, economic coercion, economic attraction, China, The Philippines, Vietnam.

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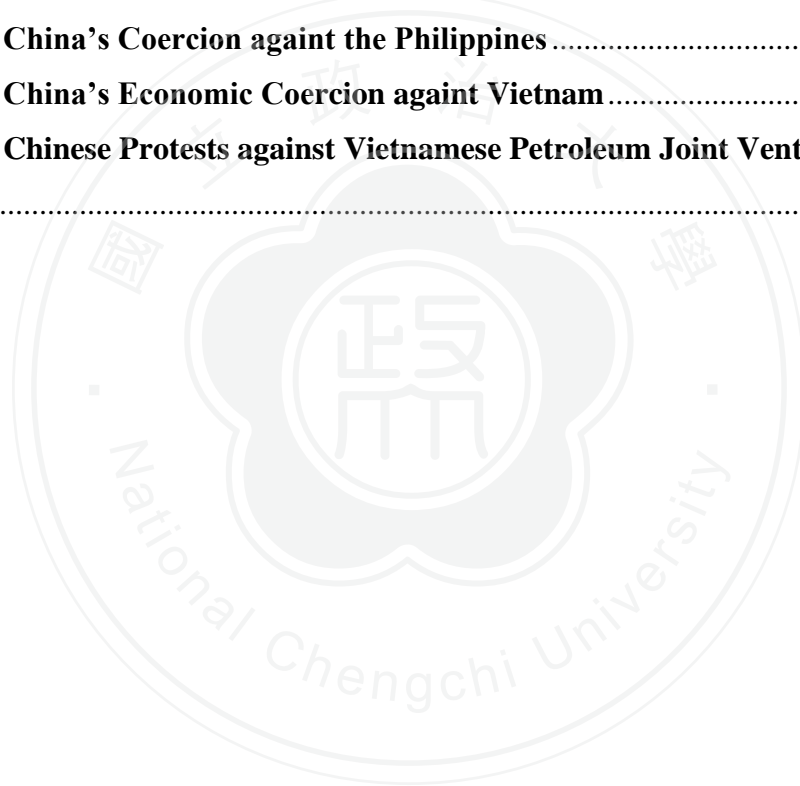
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## **List of Abbreviations**

ASEAN: Association of Southeast Asian Nations

CAEXPO: China-ASEAN Expo

CAFTA: China–ASEAN Free Trade Area

CNOOC: China National Offshore Oil Company

CPC: Communist Party of China

EIA: Energy Information Administration

FDI: Foreign Direct Investment

IEA: International Energy Agency

MOU: Memorandum of Understanding

ODA: Official Development Assistance

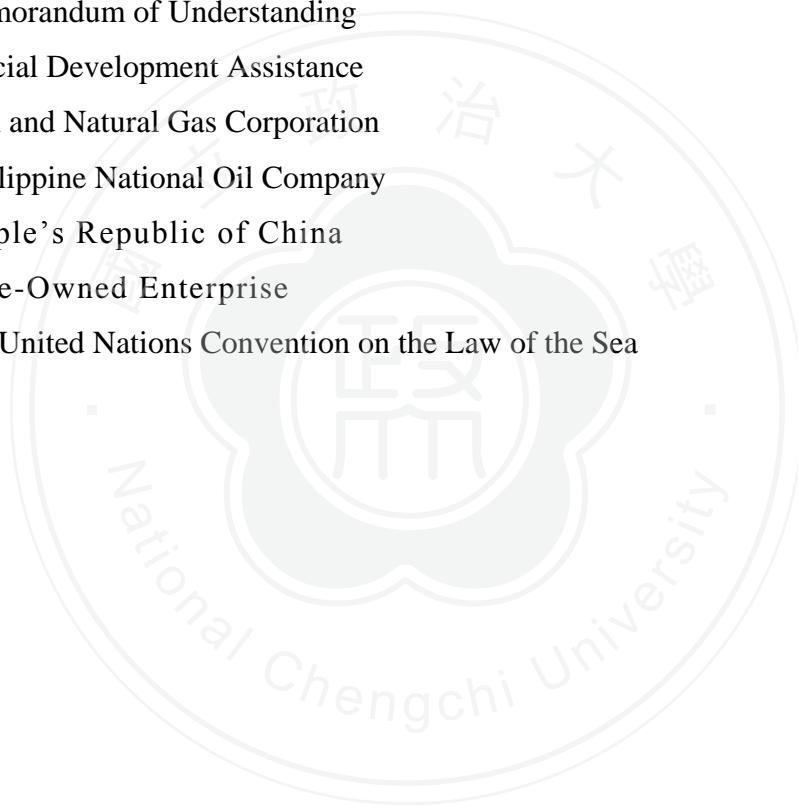
ONGC: Oil and Natural Gas Corporation

PNOOC: Philippine National Oil Company

PRC: People’s Republic of China

SOE: State-Owned Enterprise

UNCLOS: United Nations Convention on the Law of the Sea



## **Chapter 1. Introduction**

### **1.1 Objectives of the Study**

The South China Sea is a crucial shipping lane between the Pacific Ocean and the Indian Ocean, connecting Asia and Oceania. As a trade-critical sea lane between the Paracel Islands and the Spratly Islands, and as the only major route linking East Asia with Africa and Europe, strong strategic interests in the South China Sea have been advanced and sought by major powers in East and Southeast Asia (Cáceres, 2014). Vast numbers of shipping lines and sea routes for international trade pass through the South China Sea. The shipping capacity of this international trade sea lane is second only to the Mediterranean Sea. It carries one quarter of the global transportation of crude oil and petroleum products. A third of the total global trade of liquid natural gas is transported over the South China Sea (U.S. Energy Information Administration [EIA], 2013). More than 90% of the petroleum exported from East Asian countries relies on the South China Sea. Ninety percent of the total flow comes from the Strait of Malacca, and the rest comes from intra-Southeast Asia regional trade (EIA, 2013).

The South China Sea not only plays the role of a major shipping channel but also has rich strategic resources. Its petroleum endowment reaches 40 billion tons of which 70% lie in deep waters. Currently, there are more than 200 oil and gas engineering structures and approximately 180 gas fields equivalent to 12% of global reserves. For this reason, the South China Sea is also called the second Persian Gulf. Apart from this, the South China Sea has seabed resources such as metal minerals and combustible ice, which provides new energy. At the same time, this sea contains more than 1,500 varieties of fish and marine life, which have a high economic value.

Among the numerous maritime and territorial disputes between China and its regional neighbours, the dispute over Paracel and Spratly Islands is increasingly attracting the attention of the Association of Southeast Asian Nations (ASEAN) countries. The dispute concerns the control and absolute ownership of some 200 midocean islets in the South China Sea. The dispute is fueled by the reasonable expectation that whoever eventually owns the islands will be entitled to all of the natural resources, such as fisheries, oil, and gas, and the economic windfall



that may be developed from the islands' offshore waters (Cáceres, 2014).

Brunei, the People's Republic of China, the Republic of China, Malaysia, the Philippines, and Vietnam have claims over the islands and their ocean areas within the South China Sea. Among these claimants, the People's Republic of China, the Philippines, and Vietnam are the most vigorous parties using marine economic resources in the South China Sea for national security purposes.

Former Philippine President Ferdinand Marcos' Presidential Decree No. 1596, Declaring Certain Area Part of the Philippine Territory and Providing for Their Government and Administration (11 June 1978), proclaimed that the partial Spratly Islands as the Kalayaan Island Group were vital to the security and economic survival of the Philippines (South China Sea Studies, 2013). According to the International Energy Agency (IEA), the Philippines' primary energy demand in 2007 stood at 40 Mtoe, and was projected to grow at an average rate of 2.8% per year from 2007 to 2030 (IEA, 2009). Oil accounted for 35% of the Philippines' total primary energy consumption in 2010. The Philippines' oil consumption in 2010 was 282,000 bpd, but its production in 2008 was only 23,000 bpd. Most of the Philippines' oil production came from the Malampaya and Palawan fields in the South China Sea (IEA, 2009). On 11 April 2012, the Philippine Department of Energy issued the "Philippine Energy Plan 2009–2030" on its website (The Philippine department of energy, 2012). Manila's policy was to ensure energy security and expand energy access. To achieve these purposes, the number of oil and gas exploration contracts approved by the Philippine government increased from 34 to 117 (Philippine Department of Energy, 2012), signalling its urgency for developing offshore resources.

Vietnam has proposed that the "marine economy is the core of marine strategy" as the concept for its development strategy since the end of the cold war. In 2007, Vietnam issued the "Strategy on Vietnamese Seas Toward 2020," which claimed that Vietnam will establish itself as a marine power in 2020 (Communist Party of Vietnam Online Newspaper, 2010). In addition, Vietnam approved the "Master Economic Development Plan for Vietnamese Islands in 2020" to clarify the concept of closely linking national defence with economic development. The reason for Vietnam's ambitious operations in the South China Sea is the huge oil and natural gas resources. In particular, Vietnam has gained financially from the oil resource since 1986. Oil accounts for half of Vietnam's resource exports, bringing US\$15 to \$20 billion in foreign reserves (Wang, 2013). According to Prime Minister Nguyen Tan

Dung, Vietnam regards the ocean and islands not only as full of critical economic interests but also as a new living space. In particular, the South China Sea is of high strategic value. Therefore, Vietnam must ensure the sovereignty of the Paracel and Spratly Islands (Yang, 2014). In addition, the Vietnamese government closely links economic development of the islands with national defence construction (Vietnam Ministry of Justice, 2009).

From the Chinese perspective, oil is the predominant concern for the future of the country's economy. An official Chinese report from 2003 noted that by 2020, China will need to import 500 million tons of oil and 100 billion cubic metres of natural gas, which will account for 70% and 50% of China's total domestic consumption, respectively (Xu, 2005). In addition, China's known oil deposits in 2003 had decreased by 20% in comparison to ten years prior. Meanwhile, China's oil production from 1997 to 2003 had remained nearly constant at 160 to 170 million tons annually (Li, 2008; Zhongguo guotu ziyuan bao, 2005). On 29 November 2003, at a Central Economic Work Conference, former President Hu Jintao explicitly emphasized China's oil security and urged a viewing of the energy concern from a new strategic perspective, including adopting a new oil development strategy and taking effective measures to ensure China's energy security (Li, 2008; Shi, 2004).

Thus, the South China Sea is entirely involved in China's marine development strategy, in which China plans to become a marine power by 2020. In a political report to the 18<sup>th</sup> National Congress of the Communist Party of China (CPC), Hu Jintao claimed that

We should enhance our capacity for exploiting marine resources, develop the marine economy, protect the marine ecological environment, resolutely safeguard China's maritime rights and interests, and build China into a maritime power. (Xinhua News, 2012)

As for developing into a maritime power, Liu Cigui (2012), director of the State Oceanic Administration of China, offered this explanation: "Building China into a maritime power is an essential path on the way to the sustainable development of the Chinese nation and global powers. A 'maritime power' is a country that has great comprehensive strength in terms of the development, use, protection, management, and control of the seas." Therefore, fully operating the maritime resources of the South China Sea is of great urgency for China, especially in the face of the Philippines and Vietnam's vigorous activities.

Because China's foreign policies have exhibited diverse and contradictory stances, the country is perceived as a deeply conflicted rising power with a series of different identities (Cáceres, 2014; Shambaugh, 2011). Where Chinese resource security and Vietnamese sovereignty claims have intersected, connections regarding interests and motivations can be made. The Chinese government has a vast interest in maintaining a balanced supply of oil and gas to the mainland, and has for some time sought to develop its offshore exploration, drilling, and extraction of crude oil and natural gas in the South China Sea; however, to attain its long-term goals, the Chinese will have to find binding and lasting solutions to geopolitical and strategic problems that have been further complicated by overlapping territorial claims, which analysts and observers believe could lead to tensions or conflicts between China and other claiming countries, in particular Vietnam (Salameh, 1995).

China's claims overlap with those of other disputant states, including the Philippines and Vietnam. Major marine conflicts have occurred between China and the Philippines over the Spratly Islands, and with Vietnam over the Spratly and Paracel Islands.

The overlapping strategic interests have inevitably exacerbated sovereign disputes. If China, the Philippines, and Vietnam do not manage the tension well, the situation can harm the economic and security interests of all three countries, as well as cause regional instability. Closer attentions to the actions, attitudes, and reactions of China, the Philippines, and Vietnam relating to promoting their economic-strategic interests in the South China Sea should be encouraged. The objective of this study is thus to examine how China employs its economic power to affect the Philippines and Vietnam to attain its preferred political goals in handling South China Sea disputes.

## **1.2 Political Effects of Economic Interdependence**

In terms of economy and commerce, China and Southeast Asian countries are rapidly developing their economic relations, even though the global economy is undergoing a general downturn. Southeast Asian countries regard China's economic power as the main driving force to promote their economic development (Yan & Zheng, 2012, p. 15). China was the Philippines' third largest export partner and their largest import partner in 2013. China placed the third export partner of the Philippines, accounting for 12.7% or US\$15.098 billion in total trade in 2013. Receipts from exports to China were valued at US\$7.025 billion and its payment for imports totalled US\$8.072 billion, reflecting a trade deficit of US\$1.047

billion (Philippine statistics authority, 2014). Vietnam benefits from being adjacent geographically with China. The establishment of the China–ASEAN Free Trade Area (CAFTA) resulted in a closer trade relationship between China and Vietnam (Yan & Zheng, 2012, p. 15). China is Vietnam’s fourth largest export partner and its largest import partner. Regarding Vietnam’s total trade volume, China is its top trading partner (European Commission, 2015). China, the Philippines, and Vietnam demonstrate the asymmetric economic structure, in which China is strong and the Philippines and Vietnam are weak. Since 2001, China has implemented a “going out” strategy; the former head of the National People’s Congress, Wu Bangguo, encouraged competitive enterprises to invest abroad and to become global (People’s Daily, 2001). As outlined by former President Jiang Zemin at the 16<sup>th</sup> National Party Congress, the government hopes this going-out strategy will result in strong multinational enterprises and brand names (People’s Daily, 2002). Under this strategic thinking, the Philippines and Vietnam are essential to China for their low labour costs and rich natural resources. Hence, these three countries’ economic structures are asymmetrically interdependent.

According to neorealists, trade and economic interdependencies lead to war or conflict (Awad, 2013, p. 8). According to Kenneth Waltz (1979, p. 138), close interdependence means closeness of contact and raises the prospect of occasional conflict.

If interdependence develops beyond a state’s control, then the likelihood of war or conflict increases; when interdependence grows too swiftly, a state’s future is at a large risk of becoming dependent on others (Awad, 2013). This is especially costly for states. From a neorealist perspective, China has the advantage of using economic instruments for political aims, under the structure of asymmetric economic interdependence.

Economic power can be used to affect the policies of other states, at a lower cost than that of military power. Economic power can be classified as hard or soft power, and can be crafted through coercion or attraction. Both negative and positive instruments are part of economic statecraft. The term “economic diplomacy” is sometimes used to mean economic statecraft. Baldwin (1985) proposed the concept of economic statecraft, comprising the following three basic components:

1. Type of policy instrument used in the influence attempt, i.e., economic.
2. Domain of the influence attempt, i.e., other international actor(s).
3. Scope of the influence attempt, i.e., some dimension(s) of the target(s’)

behaviour (including beliefs, attitudes, opinions, expectations, emotions, and/or propensities to act).

A similar concept to economic statecraft is the term “economic leverage,” which as defined by Klaus Knorr means that economic factors can be used as a means to achieving state policy (Knorr & Trager, 1977). To operate economic instruments is a way for a strong state to affect a weak state, from people’s livelihoods at the bottom to political decision making at the top.

Economic sanctions are a common way for a strong state to demonstrate its economic power. There are at least three definitions of economic sanctions. The first is the use of economic measures to enforce international law. The second refers to the types of values that are intended to be reduced or augmented in the target state. The third use is for a strong state to demonstrate its economic power (Baldwin, 1985, p. 36). Economic coercion forms a part of economic sanctions, corresponding to the concept of economic techniques in statecraft. The concept of coercion can be defined as

One actor (A) is able to manipulate the cost/benefit ratios of the alternatives perceived by another actor (B) so that the latter would be foolish to choose any alternative other than X, where X represents either a single alternative or a category or alternatives. (Baldwin, 1985)

Ni (2010) classifies interdependence as follows: States link each other highly which makes sensitivity and vulnerability interdependencies easily generate between interdependent states. Following the trend of globalization, it is insufficient to depend on only one state for global issues such as energy, food, and finances. Besides, low-end political issues (economic development and social welfare) attract more attention than high-end political issues (defence, security, and military power). High-end political issues transit to low-end ones gradually. Because increasing numbers of states employ open policies, free trade gradually plays a main role. Also, international cooperation is a new trend, complex interdependencies are becoming critical. The effect of using traditional military force in handling international disputes gradually decreases; international negotiation gradually replaces confrontation. Interdependence is not only employed on an economic dimension, but also for politics, diplomacy, and military security, further expanding the relationship between developed and developing states.

To determine the relationship between economic interdependence and conflicts, this

study examines various viewpoints as follows.

(a) Economic interdependence does not cause peace in international relations. Scholars representative of this perspective include Kenneth Waltz and Albert Hirschman. Waltz regarded interdependence as vulnerability interdependence. When interdependence is linked with payment, it is a measure of dependence. That is, interdependence relies on both the quality and quantity of money and goods. If either side cancels or destroys the relationship, it will result in severe payments (Waltz, 1979, pp. 143–146). Waltz postulated that interdependence between states generates conflict, and that once the speed of interdependence exceeds the developing speed, then the interdependence increases the possibility of war. Hirschman (1980, pp. 176-178) indicated that the state valuing trade benefits more is in a weaker bargaining position. Hence, trade does not cause peace; instead, trade can be used as a weapon by a state, by threatening to cut off trade with others to attain more power in an asymmetrically dependent relationship.

(b) Economic interdependence affects states. Cooper (1968) regarded economic interdependence as an economic structure (the interdependence of an economic event occurring in one state affects other states), an economic goal (the interdependence of each state's economic policies are jointly limited), and an economic instrument (the interdependence of a state's economic purpose can be implied by the other states). It typically refers to the dollar value of economic transactions among regions or countries, that is, to the economic development within those nations. Cooper observed how interdependence affects state policies. His perspective represents the idea of sensitivity interdependence. The masterpiece on this topic is *Power and Interdependence*, written by Keohane and Nye (2001) and regarded as the most systematic and representative work on interdependence. Keohane and Nye (2001, p. 10) regarded that asymmetrical economic interdependence as a source of power that can be used to control resources, or potentially affect outcomes. However, the impact of interdependence relies on the restriction of cost. When bilateral sides need to pay unequal costs, a complex interdependent relationship exists. Keohane and Nye's research transformed interdependence from economic interdependence linked to economic development towards economic concerns linked to politics and security. Furthermore, they emphasized that interdependence means payment and persuasion those which may exist in mutual benefit or occurs in competition or conflict

(Keohane & Nye, 2001, pp. 7–9).

In terms of the cost of dependence, *sensitivity* [emphasis added] means liability to costly effects imposed from outside before policies are altered to try to change the situation. *Vulnerability* [emphasis added] can be defined as an actor's liability to suffer costs imposed by external events, even after policies have been altered. (Keohane & Nye, 2001, pp. 10-11)

(c) Economic interdependence decreases conflicts. Gartzke, Li, and Boehmer (2001, pp. 395–396) contended that economic linkages are signals of resolve and credibility. If confrontations arise, states may threaten to disrupt economic ties and increase the opportunity costs for status quo states. Morrow (1999) claimed that trade will be reduced *ex ante* where the risk of conflict is greatest. States will not be deterred from conflict even if the threat of conflict deters trade. Gasiorowski (1986) contended that trade reduces conflict. Thus, trade can be regarded as an instrument that states use to signal to others a willingness to pursue costly acts such as harming trade.

(d) The relationship between economic interdependence and conflicts is complex. For instance, according to Gasiorowski, if we consider interdependence through the lens of cost, then interdependence increases the possibility of international conflicts; however, if we consider interdependence through the lens of benefits, then interdependence decreases the possibility of international conflicts. Crescenzi (2005, p. 4) defines economic interdependence as the potential exit costs states incur by breaking economic ties. Baldwin indicated that economic interdependence results when the mutual benefits of interstate economic linkages exceed the alternatives. Economic interdependence manifests itself as the reciprocal of opportunity costs. These costs refer to the severing of existing economic ties (Baldwin, 1980). Barbieri (1996) suggested that the relationship between interdependence and conflict is curvilinear, where low to moderate degrees of interdependence reduce the likelihood of dyadic disputes, and extensive economic linkages increase the probability of militarized disputes. Extreme interdependence, whether symmetrical or asymmetrical, has the greatest potential for increasing the likelihood of conflict (Barbieri, 1996, p. 29).

(e) Economic interdependence and conflicts have no direct connection. The representative scholar of this perspective is Mearsheimer, who rightly debunked the myth of

economic interdependence as a brake on conflicts (Snelder, 2014). He used the cross-strait relationship as an example to show no direct connection between economic interdependence and conflict. In 1997, strong political conflict nearly caused a million incidents between the People's Republic of China and the Republic of China, but bilateral trade and economic activities remained unaffected by the harsh political distrust. It shows that although interdependence exist between these two actors, economic power is not a decisive factor for certain political events. That is, security always takes precedence over prosperity.

This study applies the perspective of Keohane and Nye. From a neorealist point of view, China has the advantage of using economic instruments to achieve political aims. To discuss how China employs economic instruments as statecraft diplomacy in handling South China Sea disputes, this study classifies China's economic instruments as attraction and coercion. Regarding coercive measures, China has not taken any economic sanctions against the Philippines or Vietnam. Therefore, this study examines coercive cases other than economic sanctions.

### **1.3 China's Charm Offensive**

Kristof (1993) wrote an article on the rise of China. He described China as the fastest growing economy in the world, which may displace the United States in the first half of the 21<sup>st</sup> century to become the largest economy in the world. In addition, China's steady rise in economic power projected its political influence, which may reshape international politics. China's economic superiority affects the status of the United States in the Southeast Asian market to some extent. In particular, China has bypassed the United States to become the major trading partner of the Philippines and Vietnam. Thus, China's economic power plays a more influential role in Manila and Hanoi. Through employing economic instruments, Beijing may eventually attain its political purposes to make Manila and Hanoi compromise in South China Sea disputes.

Because economic interests and South China Sea disputes have become the main diplomatic concerns in Southeast Asia, countries in the region have strived to increase trade volumes, investments, and loans. It offers China the opportunity to display its economic power, though inviting Southeast Asian countries, including the Philippines and Vietnam, to strengthen economic and trade relations. It is notable that regional stability is also useful for China's economic sustainable development. China became a dialogue partner of ASEAN in



2006, proposed the establishment of a free trade area with ASEAN in 2001, and signed the CAFTA in 2002. Under the framework of the CAFTA, China planned to complete a free-trade agreement with ASEAN-6: Indonesia, Thailand, Singapore, Malaysia, the Philippines, and Brunei. In addition, China will plan a free-trade area with Cambodia, Laos, Myanmar, and Vietnam by 2015. In 2005, China provided preferential tariff treatment to Cambodia, Laos, and Myanmar. In 2007, China and ASEAN signed agreements on trade in services. These acts demonstrate China's attempts to create a friendly investment environment and to draw ASEAN countries to its side.

In addition to China's economic attractions, it has followed a policy of "good neighbour" diplomacy. Academics have called this behaviour a "charm offensive." Deng Xiaoping made building a favourable economic environment the top priority for Beijing. China's diplomatic policy also served this purpose. Following a strategy of "keeping a low profile and developing the economy," Deng Xiaoping proposed the principle of "putting aside disputes to develop communally" in handling South China Sea disputes.

China's attitude in handling South China Sea disputes was not only "keeping a low profile" but also "making a difference" (Chinese Communist News, 2010). To fulfil its national core interest, China needed to ensure and improve peripheral diplomacy and followed its principle of negotiating directly with disputing parties. Under the policy of an "amicable, secure, and prosperous neighbourhood" (CRI Online, 2007), China reinforced cooperation with ASEAN and established a strategic partnership. China created an atmosphere of demanding neighbouring countries to consider bilateral political interests when handling maritime disputes. In addition, China always sought win-win solutions based on full negotiations. Hence, China deepened and fostered economic ties with Southeast Asian countries, to emphasize that cooperation was superior to confrontation. It then pursued the policy of "putting aside disputes to develop communally" to finally resolve South China Sea disputes (People's Tribute, 2014).

China's strategic involvement in Southeast Asia is of specific concern (Yang, 2014). By providing economic incentives, including foreign direct investment (FDI) and developmental aid in local infrastructure projects, China has successfully refined its relations with its Southeast Asian counterparts. As Ikenberry (2008, pp. 23-24) observed, China may try to use its growing influence to reshape the rules and institutions of the international system to effectively serve its interests.

Since the late 1980s, China has pursued a charm offensive strategy. It was exhibited in 1997, the year of the Asian financial crisis; Beijing refused to devalue the Renminbi, which would have exacerbated devaluations in Thailand and Indonesia, and portrayed its decision as standing up for other Asian nations. Because of this, 1997 marks the date to mark China's soft-power emergence in Southeast Asia (Kurlantzick, 2006). In the report on China's 15<sup>th</sup> National Congress of the CPC, China's General Secretary of the CPC Central Committee, Jiang Zemin, noted that Chinese investors shall be encouraged to invest abroad in areas that draw on China's comparative advantages, to effectively use both Chinese and foreign markets and resources (Jiang, 1997). Taking the chance, Beijing expanded its economic influence as a major political force in the region and an engine for economic recovery (Yuan, 2006). Since December 11, 2001, China has been a member of the World Trade Organization. Beijing not only accelerated its process of internationalization and opening of markets, but also provided Asian countries with additional opportunities for trade and investment. However, Beijing's economic power affected China's major trade partners in attracting foreign investment and exporting competition. Hence, the countries at China's periphery worried about facing the challenges of its emerging economy (Yen *et al.*, 2003). In 2002, China and ASEAN signed the "People's Republic of China and the ASEAN Framework Agreement on Comprehensive Economic Cooperation," promising to open each member country's market gradually. As Glaser (2014) noted, this was followed by Deng Xiaoping's diplomacy and is known as the first charm offensive.

Since ASEAN countries highly participated in globalization and were deeply dependent on exports, they were affected during the financial crisis of 2008. It also created a chance for ASEAN countries to increase their economic autonomy. Meanwhile, China escalated its economic position. With its geopolitical advantage, the closer trade relationship between China and ASEAN countries fostered China's international competition.

After the financial crisis of 2008, with many countries eager for foreign investment to improve their infrastructure, China expanded its direct investment. At the same time, China faced some risk because of anti-foreign investment movements and globalization boycotts.

From 1997 to 2006, China's basically adopted Deng Xiaoping's diplomatic strategy of not allowing South China Sea disputes to become a hindrance to China's economic development. That is, in 1984, Deng Xiaoping outlined his diplomacy for handling South

China Sea disputes: (a) sovereignty belongs to China; (b) disputes can be set aside; and (c) joint development can be pursued. The main purpose of the policy was to focus on China's economic development. Hence, China actively established economic relations with Southeast Asian countries during its period of "keeping a low profile." With China's economy growing rapidly, Beijing transformed its attitude from "keeping low profile" towards "making a difference"; China's national interests were now at the core, and thus, the South China Sea issue infringed on China's sovereignty. Therefore, following the good-neighbour policy, China intensified its economic relationship with ASEAN countries, aiming to make them realize that cooperation was preferable to confrontation, and then returning to "shelving disputes and joint development" (Zhang, 2005).

Storey (2011, p. 267) observed that during the "golden age" of closer Philippine relations with China, President Arroyo was determined to take advantage of China's burgeoning economy. Beijing responded positively as part of its charm offensive strategy, promising to provide large infrastructure projects in the Philippines. China took economic-friendly actions to make amends with the Philippines and create deeper interdependence. In providing what the Philippines wanted, China also alleviated its unemployment problem by sending Chinese workers to carry out infrastructure projects.

One group of Chinese scholars, Zhang (1999), Guo (2004), Wang and Deng (2006), Shao and Fu (2005) etc. concerned about the international image of the "threat of rising China," agreed with the good-neighbour policy. Some Chinese scholars tending towards nationalism initiated a revival of *wuwang guochi* (never forget the national humiliation), and regarded the friendly diplomacy as a humiliation to the state. They point out that China abides by the principle of "putting aside disputes to develop communally"; however, countries such as the Philippines and Vietnam do not do the same. Hence, they advocate deviating from the original principle, giving up the passive attitude, and taking tough measures, including economic punishments, to handle South China Sea disputes. These scholars claim that other states are extensively exploiting oil and natural gas in the disputed waters, and hence China must accelerate its development (An, 2011); Li Liang (2011) suggests that China's further development can resolve these disputes. If China had already effectively achieved the management and development of marine resources within the

traditional nine-dash line area,<sup>1</sup> then South China Sea disputes or conflicts would not easily occur. Based on these considerations, China is intentionally expanding its energy exploration area, and is encouraging energy corporations to develop oil and natural gas resources.

S. Zhao (1999) contended that although China felt it needed a peaceful and stable peripheral environment for its own domestic interests, it initiated a diplomatic offensive to develop friendly economic and security relations with ASEAN countries in accordance with its periphery and good-neighbour policies. As Yang (2014) observed, maintaining and stabilising relational asymmetries in Southeast Asia was thought to be conducive to the fulfilment of China's domestic need for development and to secure its centrality in the region. Storey (2010), H. Zhao (2013), and Glaser (2014) proposed that China is continually losing its momentum to employ the charm offensive in Southeast Asia. China has departed from practicing its good-neighbour policy and has become assertive over energy exploration, seemingly in contrast to Deng Xiaoping's guidelines. For example, the Scarborough Shoal standoff is a reflection of the underlying tension and competition between China and the Philippines (H. Zhao, 2013). It reflects Beijing's transformation in attitude and diplomacy, from employing economic attractions to employing economic coercion. The following section describes how China employs such economic instruments.

## **1.4 Research Framework and Research Design**

### **1.4.1 Research Framework and Hypotheses**

*Power arises from asymmetric interdependence.*

Klaus Knorr

Following the concept developed by Keohane and Nye, economic interdependence has an effect between states. According to Nye (2011),

Power is the ability to affect others to obtain preferred outcomes, and that can be done through coercion and payment or attraction and persuasion.

This study adopts the concept of asymmetric economic interdependence and explores how

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<sup>1</sup> Nine-dash line means China delineated the boundaries of the South China Sea by nine national boundaries which are shown on the map. Originally, nine-dash line came from nan hai zhu dao wei zhi tu (南海諸島位置圖) [The Map of South China Sea Islands Location], announcing by the Republic of China in 1947. On this map, R.O.C. uses eleven-dash line to delineate the boundaries of the domain of the Southern territory. Eleven-dash line is also called U shape. Since People's Republic of China has founded, PRC removed two dash lines within Beibu Bay in 1953. This made eleven-dash line become nine-dash line. See Chinese (Taiwan) Society of International Law. Retrieved from <http://csil.org.tw/home/2014/06/16/%E4%B9%9D%E6%AE%B5%E7%B7%9A/>

the rising power of China employs economic attraction and economic coercion.

A more powerful state will seek to promote the power resources and means to influence a relatively weaker state, through employing positive or negative economic instruments, that is, economic attraction or economic coercion.

In terms of economic attraction, China's careful and comprehensive engagement with its neighbours can be delineated from its various bilateral and multilateral agreements and initiatives (Yang, 2014). For instance, CAFTA plays a major role in easing regional anxieties about intensified competition for export markets (i.e., high-value manufactured goods) and FDI. ASEAN countries desired CAFTA to enlarge the size of the market and enhance cooperation on trade. Furthermore, the closer integration of ASEAN with China may entice more foreign investment into the region (Cordenillo, 2005; Yang, 2014). On the basis of China's economic performance and future prospects, we can say that China has successfully refined its relations with Southeast Asian states by providing economic incentives (Yang, 2014). Accordingly, a strong economic power may shape an atmosphere in order to make weak states yield to follow the strong's political intention and keep their mutual flourished trade performances and foreign investment injection. That is, economic fruits and future opportunities form part of the calculated gains.

Regarding economic coercion, this study observed that China had transformed its policy in handling South China Sea disputes, from shelving the disputes to making a difference. For example, Beijing coerced Philippine fruit imports in 2012 and deployed its HYSY-981 oil rig into the disputed waters in 2014. The main purpose was to transmit a message. Beijing attempted to create more facts, such as mobilization of fishing boats and exploration of natural resources, via conflicts that are too small for the United States to be concerned with. Yet, China wants its Southeast Asian neighbours to know that a containing strategy is not useful to Beijing; it does this by employing the risky strategy of economic coercion, such as interfering with the fishing and energy exploitation activities of other countries. These two economic activities are crucial to both the Philippines' and Vietnam's economies. Employing economic coercion may cause the two states to consider their losses and payments, ultimately leading them to yield to China's political purposes.

The trigger point for China's changed attitude in South China Sea policy was in 2009. After the United Nations Commission on the Limits of the Continental Shelf set a deadline for submitting claims for extending the continental shelves beyond the 200 nautical miles

specified by the United Nations Convention on the Law of the Sea (UNCLOS), tensions re-escalated. Before 2009, the South China Sea situation was considered to be “in dispute”; this was a result of China’s charm offensive, which ran from 1997 to 2009. In 2009, the territorial disputes re-escalated.

This study aims to explore how China used the asymmetric economic interdependent structure with the Philippines and Vietnam as a way to handle South China Sea disputes. The study attempts to answer following questions. First, China has committed to economic ties with Southeast Asian countries over several years, as part of Beijing’s peripheral foreign policy. Do these friendly initiatives transform into political influence to make Manila and Hanoi, which are the most active in challenging China’s territorial claims, compromise in the South China Sea disputes? Second, China employs economic coercion regarding the natural resources from Manila and Hanoi when tensions escalated. Do these coercive measures transform into political influence to make Manila and Hanoi compromise in territorial disputes? Thus:

**Hypothesis 1:** If tensions do not escalate, the use of economic attractions by China, the stronger, is more likely to make the Philippines and Vietnam, the weaker, compromise.

**Hypothesis 2:** When tensions escalate, the use of economic coercion by China, the stronger, is more likely to make the Philippines and Vietnam, the weaker country compromise.

Figure 1. **Research Framework: Economic Attraction.**

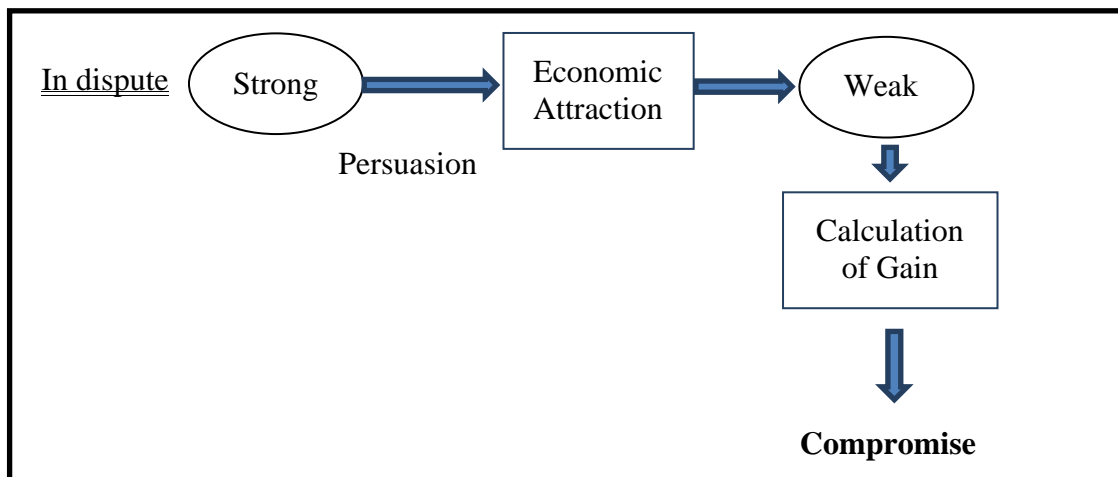
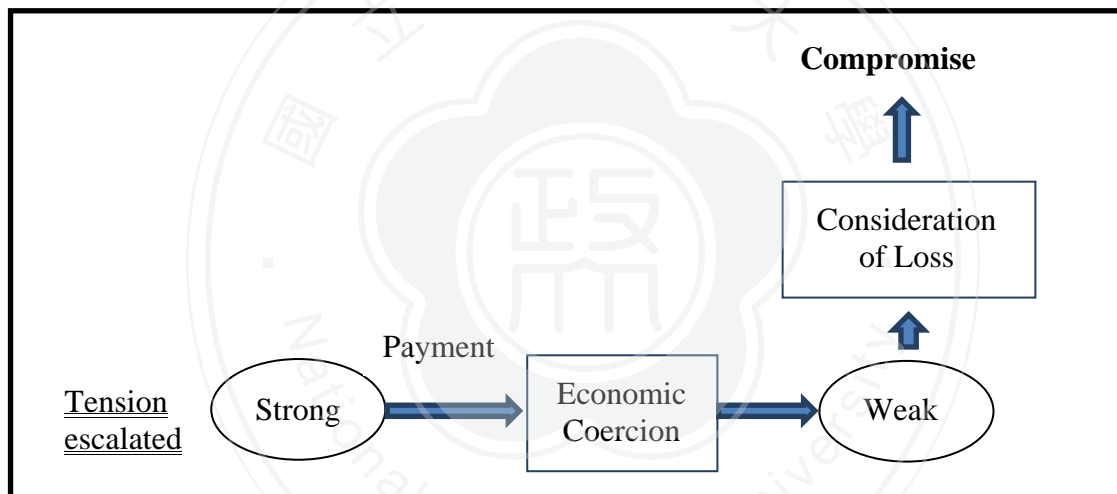


Figure 2. **Research Framework: Economic Coercion.**



### 1.4.2 Research Design

Under China’s “going out” strategy, the emphasis was on foreign markets and resources. To serve this strategic purpose, China was eager to initiate economic diplomacy with Southeast Asian countries, including the Philippines and Vietnam. The importance of Southeast Asian countries stems from their rich natural resources, which meet China’s heavy demand caused by its developing industry. With the good-neighbour policy, China not only deepened the degree of interdependence among states but also made economic factors play a considerable role in international relations, relative to traditional geopolitics and military security, especially for the sustained development of economic globalization (Cai, 2014). That is, because China is located in the Asia Pacific, regional stability and prosperity meet

China's economic development interests. China endeavours to ensure and maintain peace and stability in the region as a basis for future economic development (Hsu, 2007). Economic influence plays a key role to promote closer ties, trade interactions and improved relations with Southeast Asian countries. This is China's charm offensive. Regarding improved relations, the purpose is the restoration of historic wounds; for example, Chinese and Vietnamese navies clashed at Johnson Reef in the Spratly Islands in 1988, China and Vietnam had naval confrontations at the Paracel Islands in 1994, and China occupied the Philippine-claimed Mischief Reef in 1995 (Global Security, 2014). Therefore, China's economic power is the main driving force for maintaining its relationship with Southeast Asian countries, followed by a regional security system to meet its regional interests (Hung & Yu, 2009).

In terms of attraction, China's charm offensive since 1997 has not constructed relations of sensitivity interdependence for the Philippines or Vietnam. The dilemma between economic attractions versus territorial conflict is difficult for the Philippines and Vietnam, in contesting the South China Sea with China. Manila and Hanoi need the funds to drive their economy. The aid and infrastructure from China builds an effective environment for absorbing other foreign investment. Due to China's money injection, the Southeast Asian countries jump to the status of emerging market. Participating in China's development plans means increasing profits. That is, China provided affluent economic attractions that did not make the Philippines and Vietnam concede in their sovereignty conflicts.

Since 2006, the key maritime security concern in the South China Sea has been the competition to claim, assert, and enforce maritime rights in these waters. This study uses the time frame of 1997 to 2006 to test whether economic gains have the power to persuade. In January 2007, the fourth plenum of the Vietnamese Communist Party's Central Committee adopted a resolution mandating the development of the national Maritime Strategy Towards the Year 2020. The strategy envisions that maritime industries such as fishing and petroleum, the main forces for Vietnam's economic development, would account for 55% of gross domestic product in 2020, up from 48% in 2005 (Swaine & Fravel, 2011). The strategy reflects Vietnam's vital interest in obtaining economic gains from the sea. In November 2007, the Philippine legislature began a debate on an archipelagic baseline law, which included 53 features from the Spratly Islands as part of the Philippine archipelago (Swaine & Fravel, 2011). These official acts clearly demonstrate that both countries did not compromise to



China despite their sensitivity interdependence relationships.

The situation escalated in 2009, after the UN Commission on the Limits of the Continental Shelf set a deadline for submitting claims to extend the continental shelves beyond UNCLOS's 200 nautical miles. China, the Philippines, and Vietnam spared no effort in claiming their sovereignty. China interfered in Philippine and Vietnamese fishing activities and oil exploitation in the South China Sea, as a form of coercion. In this interwoven context, this study aims to determine whether China's economic attraction and economic coercion made the Philippines and Vietnam compromise in South China Sea disputes.

China does not stand a good chance of using both economic attraction and economic coercion for the purpose of making the Philippines and Vietnam compromise in South China Sea disputes. According to the concept of sensitivity interdependence, China expects to avoid escalating tension before conflicts occur, through providing the Philippines and Vietnam economic attractions, such as establishing ties in trade and investment.

The pattern of China's use of economic instruments in handling South China Sea disputes can be divided into two parts. In the period from 1997 to 2009, China reinforced trade and commerce interactions with peripheral countries and pursued its charm offensive. Tensions escalated in 2009 after the UN Commission on the Limits of the Continental Shelf set a deadline for submitting claims to extend continental shelves. At this point, China increased the frequency of economic coercion acts towards the Philippines and Vietnam. Thus, this study sets 2009 as a basis for comparison.

To explore the relationship between economic attraction and political persuasion, this study collects data on trade, commerce, and FDI, which depicts China's economic ties with the Philippines and Vietnam. In particular, China and Vietnam share a common border; hence, border trade cannot be ignored. To test Hypothesis 1, China's economic attractions were matched with the protestations of the Philippines and Vietnam to observe that whether the states compromised in territorial issues. To explore the relationship between economic coercion and political payments, this study collects data on China's interference in the fishing activities and oil exploitation by the Philippines and Vietnam. To test Hypothesis 2, China's use of economic coercion was examined to determine whether it made the Philippines and Vietnam avoid payments in South China Sea disputes.

### 1.4.3 Thesis Organisation

The first chapter expounds key points of asymmetric economic interdependence. Using the concepts of sensitivity interdependence and vulnerability interdependence, this study proposed two hypotheses. In contrast to military and geopolitical perspectives, this study regards economic instruments as an indicator of China's will and ability to achieve the policy goal of a peaceful periphery. In addition, this study explores the relationship between economic instruments and conflict through the perspective of asymmetric economic interdependence.

The second chapter details the Philippine and Vietnamese cases. By listing the economic attractions provided by China and the protests by the Philippines and Vietnam, this study finds that the relationship between economic attractions and conflict is insignificant. The degree of sensitivity interdependence for both the Philippines and Vietnam is insufficiently high to generate the power of persuasion in South China Sea disputes.

The third chapter surveys key coercion cases by China, in its harassment of fishing activities and hydrocarbon exploitation conducted by the Philippines and Vietnam. Because the degree of vulnerability interdependence in the Philippines is higher than that of Vietnam, economic coercion made Manila avoid payment in the short term. However, the coercion failed in the long run when the Philippines finally submitted the case to international arbitration.

In the fourth chapter, findings of this study suggests that the original framework by Keohane and Nye misses the trust factor as a link to analyze asymmetric economic interdependence. The finding help to explain why sensitivity interdependence did not work in the framework. In addition, this study finds that China's use of economic coercion was skilful. In the Philippine case, symbolic coercion appeared and gradually became a new trend. In the Vietnamese case, China's two-pronged strategy used the art of "hard in soft and soft in hard" (硬中有軟，軟中有硬).

The fifth chapter summarizes our findings and suggests future research directions. With China's economic landscape expanding globally, its use of economic instruments are crucial to the observation of China's power.

## Chapter 2. Sensitivity to Economic Attraction

The Philippines and Vietnam are two ASEAN countries that have built their respective economic relations with China, and further participate in regional economic cooperation with China. This layer of economic ties appears to increase the sensitivity of their degrees of interdependence. This chapter discusses how China has established economic attractions with the Philippines and Vietnam, and focuses on the responses Manila and Hanoi have made in South China Sea disputes. This study examines these responses to test Hypothesis 1: Can economic attractions become persuasive during conflict? Degrees of sensitivity interdependence among China, the Philippines, and Vietnam are examined.

### 2.1 The Philippine Case

The People's Republic of China and the Republic of the Philippines established diplomatic relations on June 9, 1975. In the past 40 years, Sino-Philippine relations have changed drastically and were affected by the South China Sea disputes. In the early 1970s, the Philippines sought the possibility to begin diplomatic relations with China, which were established by the Marcos administration in 1975. However, Beijing and Manila did not truly share a friendship; their ties suffered over quarrels in the South China Sea. This worsened during the period of Rome's administration. In the late 1990s, ties between the two countries were tense and unproductive, dominated by China's assertive behaviour in the South China Sea (Storey, 2011). Deeply fearing the threat of China, bilateral relations deteriorated and even let the Philippine economic development became the straggler among the ten members of ASEAN. In 2004, then President Arroyo visited China and established a strategic partnership with Beijing. Bilateral relations improved, peaking with the establishment of a strategic and cooperative relationship for peace and development between the two countries; this period was referred to a "golden age of partnership" (Embassy of the People's Republic of China [PRC] in the Republic of the Philippines, 2005). By 2010, Manila and Beijing were on the most friendly terms since their diplomatic tie was normalized, and the expansion of bilateral economic ties gained momentum. However, Aquino III's ascension to the leadership has turned this around. Aquino's political attitude is highly prone to the United States. In addition, Manila protested against Beijing's "nine-dash line"<sup>2</sup> claim to the South China Sea. The Sino-Philippine relationship is now at a low point because of quarrels over the South

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<sup>2</sup> Ibid.

China Sea.

### **2.1.1 China–Philippine Economic Relations**

China and the Philippines have signed a trade agreement, an agreement on protecting bilateral investment, as well as an agreement on avoiding double taxation. Gradually, the bilateral partnership reached a new level in terms of regional cooperation, trade, investment, agriculture, and tourism (Ministry of Commerce of PRC, 2010). Since 2000, their bilateral trade volume has grown at an average annual rate of 41.77%, with the Philippines gradually selling more to China than it buys from the country (Morada, 2009). In April 2005, they signed a Memorandum of Understanding (MOU) on the Promotion of Trade and Investment Cooperation (Republic of the Philippines, 2014). When Chinese President Hu Jintao visited the Philippines on 26 April 2005, a trade volume of US\$30 billion was targeted by 2010. In June 2006, the two countries signed a framework agreement on expanding and deepening bilateral economic and trade cooperation. China was the Philippines' third highest trading partner in 2006, moving up from ninth place in 2002 (Valderama, 2014). China was the Philippines' fourth largest export market and fifth largest supplier of imports in 2006. Regarding the impact of the international financial crisis in 2008 and 2009, bilateral trade amounts decreased to US\$286 million and US\$205 million, respectively. During the so-called golden age in Sino–Philippine relations, China was the Philippines' third largest trading partner, accounting for US\$9.715 billion or 9.2% of Philippine total trade (US\$105 billion) in 2008. The 2.7% decline in total Philippine–China trade from 2007 to 2008 was caused by the slowdown in exports in 2008; however, China remained the third largest export market for the Philippines for the following two years. Yet, China ranked as the Philippines' fifth largest supplier of imports in 2008. In 2010, bilateral trade restored its growth and increased to US\$278 million. However, since the third quarter of 2011, relations between the two countries have deteriorated over the South China Sea. In 2013, bilateral trade amounted US\$380.7 million, a decrease in the year-on-year ratio of 7.2% (Ministry of Commerce of PRC, 2014).

According to statistics by the General Administration of Customs of the People's Republic of China, the main categories of Chinese exports to the Philippines include: (a) motors, electrical equipment, audio equipment, and parts; (b) mechanical appliances and parts; (c) steel; (d) fossil fuels, mineral oil, bitumen, and mineral waxes; (e) clothing; (f) plastics and plastic articles; (g) steel products; (h) toys, games, sports equipment, and spare

parts; (i) vehicles and their parts, other than railway or tramway; and (j) footwear, gaiters, and similar articles and parts thereof.

The main categories of items that China imports from the Philippines include: (a) motors, electrical equipment, audio equipment and parts; (b) mechanical appliances and parts; (c) ores, slag, and ash; (d) copper and copper articles; (e) edible fruits and nuts, citrus fruit or melons bridge peel; (f) plastics and plastic articles; (g) optical, photographic, medical, or surgical instruments; (h) fossil fuels, mineral oil, bitumen, and mineral waxes; (i) animal or vegetable fats, and oils; and (j) glass and glass products (Ministry of Commerce of PRC, 2010).

Besides trade relations, economic ties include infrastructure construction and official aid. For example, China and the Philippines agreed on a US\$500 million loan from the Export-Import Bank of China to fund the Northrail rehabilitation project (Morada, 2009). In addition, China provided US\$100 million in credit loans to construct the Philippine-Sino Center for Agricultural Technology, the first grant project by China in the Philippines, constructed in March 2003. In August 2003, China provided US\$400 million in preferential export buyer's credit to assist in infrastructure. An additional US\$500 million was provided in April 2005 (Chen, 2009). In January 2007, Premier Wen Jiabao signed a US\$3.8 billion agricultural project to develop approximately a million hectares of land in the Philippines to grow rice, corn, and sorghum that could be exported to China (Morada, 2009, p.112). According to statistics from the Ministry of Commerce of the People's Republic of China, the Chinese government signed 80 new contracts with the Philippine government in 2013, and the new contract amounts were US\$10.93 hundreds, with turnover amounts of US\$12.47 hundreds. Newly signed large engineering projects included China Energy Construction Group and Tohoku Electric Power First Engineering constructing the Philippine power plant, Huawei Technologies constructing telecommunications in Philippines, and China Nerin Engineering constructing the Philippine Associated Smelting and Refining Corporation expansion (Morada, 2009).

Another essential element to the bilateral economic relationship is the FDI provided from China, governed by bilateral investment protection agreements. In July 1992, the two countries signed the Agreement between the Republic of the Philippines and the People's Republic of China concerning Encouragement and Reciprocal Protection of Investments (Philippine Treaties Online, 2002). Because of domestic political instability and a poor

economy, together with the disputes over the South China Sea, the Philippines did not seize the opportunity for economic liberation as China has done. As a result, the Philippines has been less developed compared to other ASEAN countries.

The situation improved slightly in 2000. Former President Estrada visited China and signed a joint declaration, the Framework of Bilateral Cooperation in the 21<sup>st</sup> Century. Trade in both countries has risen greatly since then. In 2002, China and ASEAN negotiated the Declaration on the Conduct of Parties in the South China Sea, which is a nonbinding agreement to encourage cooperative confidence-building measures to deal with the Spratly Islands and overlapping exclusive zones. China and the Philippines were in an atmosphere of understanding and full of cooperative opportunity. In the same year, 2002, China became one of the Philippines' top ten trade partners; according to the China Customs Statistics Yearbook, the trade value accounted for 4% of the Philippines' total trade. In 2004, then President Arroyo paid a state visit to China. Arroyo and then Premier Wen Jiabao reached an agreement to set aside both countries' territorial claims in the South China Sea, and pursue the joint exploration of maritime resources. For example, China National Offshore Oil Company (CNOOC) and Philippine National Oil Company (PNOC) signed an agreement to jointly carry out seismic studies in the South China Sea. With the cooperative experience growing, bilateral relations remained warm. In particular, Arroyo promoted closer economic interaction with China to benefit from China's growing economic power. The two governments also signed the Memorandum of Understanding on Fisheries Cooperation. In 2005, they signed Memorandum of Understanding on the Promotion of Trade and Investment Cooperation. In 2006, they signed the Memorandum of Understanding for Establishing Economic Partnership between China and the Philippines. In January 2007, Premier Wen Jiabao signed a US\$3.8 billion agricultural project to develop approximately a million hectares of land in the Philippines to grow rice, corn, and sorghum that could be exported to China (Bakshian, 2007). The two governments also signed the Framework Agreement on Expanding and Deepening Bilateral Economic and Trade Cooperation. In 2011, they signed a five-year economic and trade cooperation development plan (Ho, 2011). Overall investment from China in the Philippines remains small. According to the Ministry of Commerce of China, China's FDI in the Philippines was US\$294 million in 2011, accounting for 4.5% of China's total FDI in ASEAN. In 2012, Guangxi Hydropower Engineering Bureau invested US\$1 million in the Philippines, establishing itself as the first company to engage in the

business of water conservancy and hydropower construction (Ministry of Commerce of PRC, 2014). According to statistics from the Ministry of Commerce of the People's Republic of China, Chinese FDI into the Philippines was US\$4,383 ten thousand in 2013 (Ministry of Foreign Affairs of PRC, 2014). Chinese FDI stock in the Philippines was US\$6.92 million in 2013. The main areas China invests in are mining, manufacturing, and electricity. On September 25, 2013, the Philippine Investment Promotion Plan Steering Committee and the China-ASEAN Business Council signed an MOU during the 10<sup>th</sup> China-ASEAN Expo (CAEXPO) in Nanning, to improve investment promotion cooperation (Bases Conversion and Development Authority [BCDA], 2013). In the first half of 2014, the Philippine government approved up to US\$214 million in investment amounts from China (which was higher than the amount for the same period in 2013). Many Philippine government officials and entrepreneurs express their hope that Sino–Philippine economic and trade ties will not be interrupted by political factors in the 11<sup>th</sup> CAEXPO. It expresses a hope that, despite the South China Sea disputes between China and the Philippines, their economic situations will continue to improve.

### **2.1.2 Sensitivity to Economic Attraction**

China often renders some economic attraction when bilateral leaders formally meet. Several months before the Philippine President Aquino III visited China on 5 April 2011, the Philippine official to the United Nations submitted a diplomatic note and protest against the “nine-dash line.” In addition, Aquino III stated publicly that the United States and Japan were Manila's best and most responsible allies (Liu & Wu, 2012, p.143). Manila's activities expressed its strong stance of protesting Chinese assertiveness. It transmitted a clear message to China: the Sino–Philippine relationship was far from persuading Manila to listen to Beijing. Two options were available to Beijing to achieve its peripheral diplomatic purpose. One option was to produce more economic attractions for Manila. The other option was to not capitulate to Manila's wants. This is the process of turning economic attraction into economic coercion. From the visit by Aquino III from 30 August to 3 September 2011, Beijing chose the first option as its response. China and the Philippines signed a series of agreements for prospering bilateral economic, cultural, and media cooperation.

To understand whether economic attraction generates a compromising effect in the conflict, we use 2011 as the index year to examine the relationship between economic ties and compromise in disputes. An incident involving Manila and Beijing occurred in the Reed

Bank in March 2011, and Chinese Marine Surveillance ships forced a Philippine seismic survey vessel to leave the area. According to Ministry of Foreign Affairs of the People's Republic of China, some of the indicators that represent bilateral economic ties in 2011 include:

- Bilateral trade of US\$12.6 billion;
- Major Philippine exports to China: Electrical products and copper cathodes;
- Major Philippine imports from China: Electronics, parts and accessories for office machines, liquefied petroleum gas, urea, and ceramic products;
- Major sectors of Chinese investment in the Philippines: Power, mines, and manufacturing;
- Official Development Assistance (ODA) commitments from China as a percentage of total ODA commitments: 13%.

Did bilateral economic linkages become the leverage for persuading the Philippines to compromise in South China Sea disputes? In the case of the year 2011, these economic indicators seemed to be a compensation for the Reed Bank incident. However, the pacifying effect did not last long. In April 2012, a standoff occurred between the Philippines and China surrounding the Scarborough Shoal. In order to struggle for territorial benefits, the Philippines did not compromise to China.

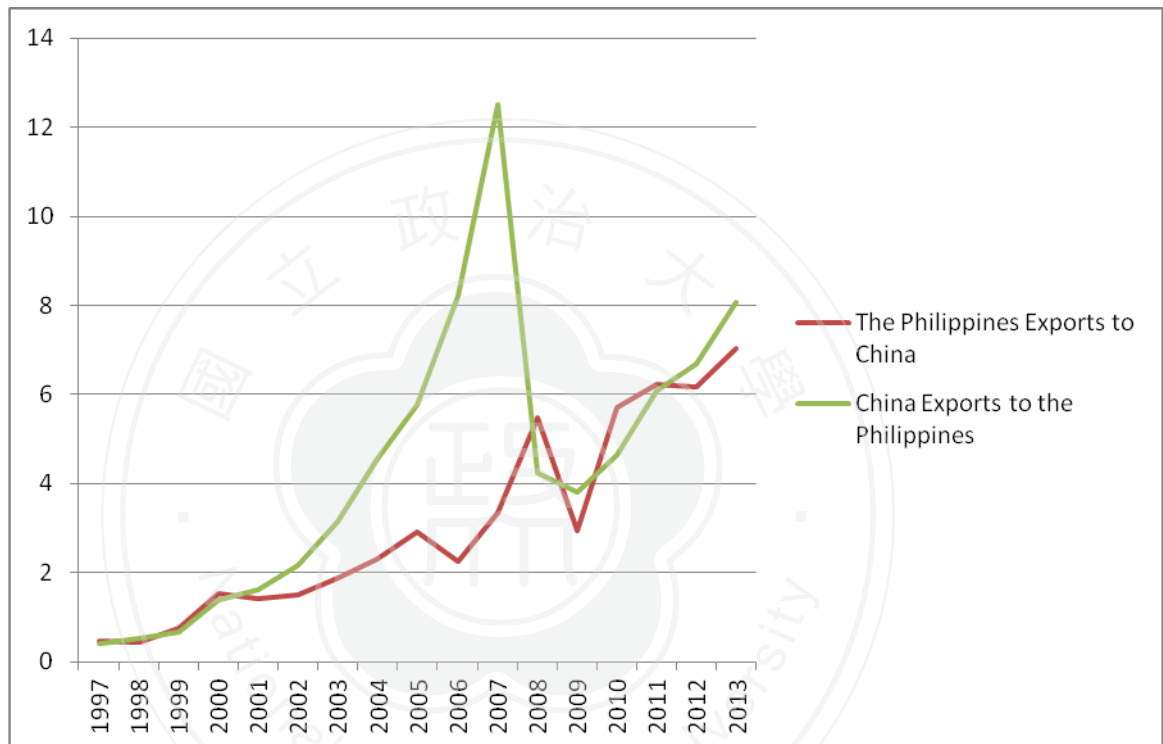
To test whether 2011 was an exceptional case or part of a regular pattern, this study reviewed the period from 1997 to 2013 to examine the relationship between economic attraction and persuasion. As Table shows, the Philippines protested against China in the South China Sea 12 times in 2011, 16 times in 2012, and 10 times in 2013.

Observing the trade performance in Figure 3, trade values varied dramatically in the two periods. Philippine exports to China increased tremendously in 2008 from US\$3.357 billion to US\$5.47 billion, and then sank to US\$2.93 billion in 2009. China exports to the Philippines increased tremendously from US\$5.779 billion in 2005 to US\$8.215 billion in 2006, reaching US\$12.502 billion in 2007, but dropping to US\$4.25 billion in 2008. Data from the China Customs Statistics Yearbook showed that in the period of 2003 to 2011, bilateral trade increased sharply from US\$9.4 billion to US\$32.3 billion, representing an increase of 244%. Hence, after the United States and Japan, China became the third largest trading partner of the Philippines. The year 2011 was significant. During Aquino's visit to China in August 2011, he made a statement that China-Philippine relations would not be affected by the dispute over the South China Sea, and he reaffirmed the need "to deal with



the disputes through peaceful dialogue, and to continue to maintain regional peace, security and stability, creating a favourable environment for economic growth” (Ministry of Foreign Affairs of PRC, 2011). However, in 2012, the Scarborough Shoal dispute occurred. Examining the variation in trade, the shutdown degree was not as obvious as it was before. It is notable that the opinion effect was huge; damage from the entire year’s trade turnover was less than that of the opinion effect.

Figure 3. **Bilateral trade relations between the Philippines and China, 1997–2013.**  
(US\$ billion)



Source: Direction of Trade Statistics Yearbook (Washington D.C.: International Monetary Fund, various issues 1997-2013)

This study notices that the effect of economic attraction followed the charm offensive. During the charm offensive, under Presidents Arroyo, Estrada, and Aquino III, economic attraction did generate positive effects to make Manila compromise in South China Sea disputes; however, the situation became tougher under President Aquino. This demonstrates that the Philippines’ sensitivity interdependence with China is insufficiently high. Therefore, Philippine protestations were sporadic from 1999 to 2007. However, since 2008, the Philippines increased its frequency of protests. In particular, the frequency peaked in 2011.

From 30 August to 3 September 2011, Aquino III visited China. Both countries agreed to aim for a bilateral trade volume of US\$60 billion in 2016. From this, it appears that China still embraces the hope for future prosperity to barter for Philippine compromise. Finally, the Philippines referred the Scarborough Shoal standoff to an international arbitral tribunal, showing that China's economic attraction did not force the Philippines into submission.

Table 1. Philippine Protests against China

| <b>Year</b>   | <b>Event Description</b>  |   |
|---|---|---|
| 1999  | October: protesting China's concrete foundation on Mischief Reef.   |   |
| 2003  | November: protesting China erecting labels on the Spratly Islands.  |   |
| 2004  | November: protesting China's Nanhai-215 ship pulling an oil rig.  |   |
| 2005  | June: building a community of 365 people in seven islands of the Spratly Islands.   |   |
| 2008  | Terminating the Agreement on Jointly Conducting Marine Earthquake Exploring Work on the Agreed South China Sea Area.                      |   |
| 2009  | February: Congress passed the Baselines Act, which included parts of the Spratly Islands and the Scarborough Shoal.                       |   |
| 2011  | March: protesting two Chinese naval boats harassing a vessel exploring for oil in the Reed Bank.  |   |
|   | March: signing with an Anglo-French consortium to explore natural gas.  |   |
|   | March: pursuing oil exploration with Britain Forum Energy Co.   |   |
|   | April: protesting China's map of the "nine-dash line."  |   |
|   | April: issuing 15 Philippine oil and gas bidding contracts.   |   |
|   | May: protesting China's territorial intrusion into the Spratly Islands.   |   |
|   | May: protesting Chinese business moving an oil rig into deep waters.  |   |
| 2011  | May: protesting People's Liberation Army Navy placing an artificial structure on the banks of the South China Sea.                        |   |
|   | May: Aquino called for Brunei, Indonesia, Malaysia, and the Philippines to formulate a common status under ASEAN to negotiate with China. |   |
|   | May: inviting Hanoi to hold a football game on Thitu Island.  |   |
|   | June: renamed the South China Sea as the West Philippine Sea and Reed Bank as Recto Bank.   |   |
|   | July: criticising China's placement of a metal platform near Sabina Shoal.  |   |
|   | July: issuing a State of the Nation Address and stating it will take the dispute to the United Nations.                                   |   |
|   | September: signing an agreement with Japan to respond the China's assertiveness.  |   |
|   | December: Aquino protested China's harassment of British Forum Energy Co.   |   |
|   | 2012  | January: protesting Chinese vessels invading into Sabina Shoal waters.  |
|   |   | January: the Philippine Foreign Minister stating that the Philippines is preparing to validate its claim to the Spratlys to the United Nations. |
| February: welcomed foreign companies to exploit two oil field blocks in Palawan.                                      |   |   |
| March: declaring the construction of a runway on Thitu Island.  |   |   |
| March: declaring the building of Feisin and Mahuan Island for tourism and developing Thitu Island as a travel centre. |   |   |
| 2012  | April: reclaiming the ownership of Kalayaan and criticising China's nine-dash line.   |   |

|      |  |
|------|--|
|      | April: Navy attempted to arrest Chinese fishermen and a standoff between ships near the Scarborough Shoal.                     |
|      | April: considering the submission of the Scarborough Shoal case to an international tribunal.                                  |
|      | April: announcing the public bidding of oil field blocks.  |
|      | May: renaming Scarborough Shoal as “pana Tagg reef” (Panatag Shoal).   |
|      | July: offering three blocks for bidding, two of which are in waters claimed by China.  |
|      | September: completing a new map that called the South China Sea the West Philippine Sea.                                       |
|      | November: calling on four ASEAN claimants to develop a common position for dealing with China.                                 |
|      | November: protesting China’s new passport, which includes the South China Sea.   |
|      | November: protesting three Chinese vessels staying in Scarborough Shoal waters.  |
| 2013 | January: accusing Chinese vessels of preventing Filipino fishing boats from reach shelter.                                     |
|      | January: informing China of the submission of the Scarborough Shoal case to the International Tribunal for the Law of the Sea. |
|      | April: confirming a report of its protest against China’s claim of the nine-dash line.   |

## 2.2 The Vietnamese Case

The relationship between China and Vietnam became normalized in 1991. In May 2008, Beijing and Hanoi proposed the goal of developing relations to a “comprehensive, strategic, and cooperative partnership” (CRI Online, 2015). Some economic growth breakthroughs have occurred between China and Vietnam; for example, the trade volume grew from US\$32 million in 1991 to US\$40 billion in 2011, increasing over 1,000 times. Vietnam views China’s experience in economic development as a model. Furthermore, Vietnam is forced to compete with Cambodia, Laos, and Myanmar for Chinese funds and growth opportunities. Vietnam grasped the opportunity when China was eager to implement the CAFTA. Thus, Vietnam is more sensitively dependent on China, compared to the Philippines.

Because Vietnam and China both share communist values, it is commonly known that some communication channels exist between bilateral high-ranking officials.

With regard to the South China Sea, there have been moments of cooperation and confrontation. From 2000 to 2006, China and Vietnam jointly handled the exploration of rich oil resources in the South China Sea. For example, they signed agreements on the delimitation of the territorials sea, exclusive economic zones, and the continental shelves in Beibu (Bac Bo) Gulf. In addition, PetroVietnam signed a framework agreement with CNOOC to jointly tap oil and gas resources in the Beibu Gulf of the South China Sea.

### 2.2.1 China–Vietnam Economic Relations

Economic relations between China and Vietnam have grown tremendously since bilateral relations were normalized in 1991. In 1991, the trade amount between China and Vietnam was only US\$32 million. Trade relations were strengthened during the period of 1998 to 2008. In 2000, the total import–export value was approximately US\$3 million. In 2002, Jiang Zemin visited Vietnam and signed agreements to deepen bilateral trade cooperation and resolve some conflicts. The trade amount that China exported to Vietnam grew from US\$3.18 billion in 2003 to US\$48.59 billion in 2013, increasing by 14 times. The main export categories were electromechanical products, textiles, base metals, and chemical and mineral products, representing 80% of Chinese exports to Vietnam. Most Vietnamese exports to China were agricultural and resource products. A less comprehensive structure within Vietnam’s production chain caused an expanding trade deficit (Vietnam Trade Promotion Agency, 2014).

China has been one of Vietnam’s leading trade partners since 2004. Vietnam has become a popular market for Chinese engineering contractors. We chose 2008 as the index year for the bilateral economic relationship. In 2010, China became Vietnam’s largest trading partner with bilateral trade amounting to US\$30.094 billion, which was up from US\$32.23 million in 1991 (Ravindran, 2012). In May 2008, Beijing and Hanoi proposed the goal of developing the relations into a “comprehensive, strategic, and cooperative partnership,” indicating the direction of bilateral economic and trade relations. Bilateral trade amounted to US\$19.46 billion, increasing by 28.8%. China exported to Vietnam was valued at US\$15.12 billion, increasing by 27.2%. China imports from Vietnam amounted to US\$4.34 billion, increasing by 34.6% (Gu, 2012).

Another flourishing area is border trade. In 2005, China and Vietnam proposed a cross border economic cooperation zone at the China–Vietnam border. Guangxi province and some Vietnamese border cities signed a framework MOU between local governments in 2007. In this MOU, local authorities planned to establish three economic cooperation zones: Pingxiang (China) to Dong Dang (Vietnam), Dongxing (China) to Mong Cai (Vietnam), and Longbon (China) to Cha Kwo Ling (Vietnam). In addition, Yunnan province established the Honghe (China) to Laocai (Vietnam) cross-border economic cooperation zone. From the perspective of regional affairs, Vietnam has benefitted from China’s rapprochement with

ASEAN; from the perspective of the border, Beijing also supported the Longjiang Economic Zone and the Shenzhen–Haiphong Economic and Trade Zone. In September 2011, China established its first comprehensive free trade zone on a land border, the Guangxi Pingxiang free trade zone. It was regarded as the trademark of Sino–Vietnamese transborder cooperation. Trade amounted to RMB 7.65 billion. China is the biggest export market for rice, coal, and rubber. China is also the main source for machinery, textile raw materials, building materials, home appliances, and agricultural products (United Nations Development Programme, 2014).

The main categories of Vietnamese exports to China are: (a) Raw materials: coal, oil, rubber, and iron ore; (b) agricultural products: food, tea, vegetables, and cashews; (c) fresh and frozen shrimp, crab, and fish; and (d) consumer goods: handicrafts, fine arts, shoes, and high-quality household products (Ha & Do, 2008, p. 372).

China's FDI in Vietnam is vertical. Vertical FDI aims to search for a low-cost production base to create price differences caused by different productive factors between states. In vertical FDI, products are exported to the markets of the home country or developed countries. Hence, transnational corporations usually invest labor-intensive industries in other countries, and invest technology-intensive industries in the home country. It aims to reduce the costs of production and to compete for markets in developed countries. It causes highly external dependence. The impact of China's FDI on Vietnam was relatively minor before 2008. China's FDI projects were small-scale and employed only a limited number of Vietnamese workers; therefore, it had limited advantages to the Vietnamese employee market. For example, the total workforce directly employed by Chinese FDI projects could be 12,000 people, whereas the total workforce for all FDI projects in Vietnam would be 1.2 million people (Vietnam's Ministry of Planning and Investment, 2007).

The average value of China's FDI projects is US\$2.7 million per project, and the average value of all FDI projects in Vietnam is US\$8.7 million per project. China's FDI projects often involve little research, development, or technological capability; thus, little effect is made on the technological advancement of Vietnamese industries. Considering that China's FDI is mainly focused on mineral resource extraction industries to supply China's demand, as well as on the construction of hotels with entertainment services (i.e., casinos), China's FDI projects in Vietnam are not suitable for the long-term sustainability of Vietnam's economy because of the negative environmental impacts (Ha & Do, 2008, p. 395).

Table 2. China's Investment Focus on Industrial Production

| Year | Content  |
|------|--|
| 1999 | TCL Corporation invested RMB 100 million yuan to build television factories in Vietnam.  |
| 2004 | <ul style="list-style-type: none"> <li>✧ Chongqing Lifan Industry Group, together with six component plants in Chongqing, established the Lifan-Xing Yong Motorcycle Parts Manufacture Joint Venture.</li> <li>✧ Zongshen Industrial Group invested US\$2.2 million to establish Chongqing Zongshen Power Machinery Co.</li> </ul>   |
| 2011 | On 24 August, a new batch of Vietnamese foreign investment projects numbered 582, and the agreed investment was approximately US\$7.94 billion, up 34.2%. The actual capital was US\$7.3 billion, up by 0.7%. China's investments mainly concentrated on industrial park construction, auto and motorcycle spare parts manufacturing, feed processing, mineral development, and electricity. |

Source: Y. Li and J. Zhang (2012). *Zhong guo dui yue nan zhi jie tou zi fen xi: ji yu yao su bing fu hu bu de fa zhan zhong guo jia FDI li lun* [Analysis on China's FDI in Vietnam: based on complementary factor endowments applied in developing countries]. *Inquiry into Economic Issues*. 12, 22-28.

Promoting the construction of infrastructure was a ring of China's economic policy. The construction of roads and highways is the connection path for economic ties. Several large-scale electricity power plants were constructed or invested in by China. In addition, 6% of the Vietnamese electricity supply is provided by China. This makes some Vietnamese people worry about China's increasing investment in local critical infrastructure (Yang, 2014). The Vietnamese policy community and academics perceive a threat in China, which justifies the building of a firewall to hinder the effectiveness of China's economic attraction towards Vietnam. Furthermore, evidence of Vietnam's trade deficit and unemployment, and anxiety about infrastructure developments relate to national security and intensify this point of view (Yang, 2014). Considering the trade deficit, the volume of Sino-Vietnamese trade has been growing by 30% annually or more. Partly due to Guanxi province, China promotes a subregional strategy to make Vietnam its primary partner. Vietnam's trade deficit with China has significantly increased from US\$0.2 billion (2001) to more than US\$20 billion (2012). Reviewing their trade transactions, the exchange of Vietnamese raw materials such as coal, minerals, and rubber for China's higher-priced products such as machinery equipment, iron, and steel is one of the reasons that explain the huge trade deficit (Chen & Yang, 2013).

Although China has provided foreign aid projects to Vietnam, it has also brought

approximately 30,000 Chinese workers and families into the country, causing some local unemployment (Weston, Campbell, & Koleski, 2011). Regarding engineering contracts, China signed 1,685 contracts totalling US\$3.085 billion, with a completed turnover of US\$1.982 billion. According to official Vietnamese statistics, up until December 2008, Chinese corporations had already directly invested in 628 items in Vietnam, with a deal amount of US\$2.198 billion; however, the real amount was only US\$0.271 billion (Gu *et al.*, 2012, p. 76). It demonstrates that some items are under negotiation but not totally completed.

China's FDI in Vietnam is nearly all from medium or small businesses whose amounts are far less than that of Japan and the United States. It is characterised by low amounts, slow growing speeds, and short investment durations. For example, only US\$80,000 was invested into the jointly operated Hsin-Jiang Hotel in Beijing City of Vietnam (Gu *et al.*, 2012, p. 78). Chinese small-scale investment in Vietnam suffers from a series of problems, such as being difficult to gain scale advantages, a lack of market competition, lost business opportunities, and weakening the financing ability of the international market, which also limits China in broadening investments in Vietnam (Gu *et al.*, 2012, p. 79).

In the case of Vietnam, the shared border has developed into a strong bilateral trade relationship. Notwithstanding their history and current competing territorial claims, China gives concessional credit to Vietnam, focusing on such sectors as heavy industry, natural mineral exploitation, railways, textiles and garments, chemicals, and infrastructure. Furthermore, China opened land transportation with Vietnam, which improved the efficiency of transportation. Vietnam also used its location as an advantage between China and ASEAN. In 2012, China's Guangxi province had some interconnection and intercommunication with Vietnam. For example, China's State Council approved the China–Vietnam Beilun River Bridge Project. The two countries created protocols to formally amend and implement a motor transport agreement between their governments. The Departments of Transportation for both the Chinese and Vietnamese governments signed an agreement to establish an international car transport driver's license system between the two countries. These achievements represent a major progression for the two countries in developing land transport and promoting border transactions. Guangxi has opened 28 international road transport operations to Vietnam (Cui, 2013).

Following the effectiveness of these two protocols, land transportation between China and Vietnam makes goods and labour more accessible to the ASEAN market. Jointly, some

downtowns share location advantages in their border locations and earn more market shares. However, Vietnam's investment environment continues to lack infrastructure. Pingxiang, Guangxi increased its fixed asset investments in Vietnam in 2012. Pingxiang's budget planning was approximately RMB 6 billion, which represented an increase of 21% from 2011. Pingxiang's series investment included the China–ASEAN (Pingxiang) agricultural by-products professional market, the China–Vietnam commodity trading exhibition centre, and the China–ASEAN (Pingxiang) international bus terminal, and went into operation in 2012. Vietnamese border provinces have gained direct benefits from these border trading activities, such as faster economic progress, stronger financial abilities, and improved standards of living (Ha & Do, 2008, p. 397).

Regarding bilateral aid projects, China reportedly offered more than US\$312 million to Vietnam from 1992 to 2004; in fact, the true figures were probably far more. The effects of Chinese ODA on Vietnam's development are relatively small, and Chinese ODA has focused on investing in the heavy industry sector (e.g., iron and steel, timber products, fertilizers, and mining), the energy sector (e.g., hydroelectricity and thermoelectricity), and infrastructure development (e.g., houses, railways, and telecommunications) (Ha & Do, 2008, p. 396). China's FDI and ODA serve its going-out strategy, causing only limited positive effects on Vietnam's economic development. These items focused on China–Vietnam economic gains, and there was no overlap between Vietnam's poverty alleviation policies and Chinese ODA targets (Ha & Do, 2008).

Do Tien Sam, the former head of the Chinese Studies Review under the Vietnam Academy of Social Sciences, proclaimed that Chinese ODA flows were ultimately concerned with prioritising economic gains between Vietnam and China. Do's research determined that 2008 was a cutoff point in China's ODA to Vietnam. By 2008, China had used its ODA to support Vietnam in improving infrastructure construction, particularly in the border provinces. According to online records of the Vietnamese Ministry of Planning and Investment, China has not provided ODA to Vietnam since 2008, whereas Japan has continued to provide ODA. China changed its technique of economic leverage from providing ODA to launching cross border economic cooperation. For example, the Pingxiang comprehensive bonded zone on the Chinese side was launched in 2008, and formally established in September 2011. China and Vietnam also established a new cross-border economic zone between Mong Cai City (Thành phố Móng Cái) in Northern Vietnam and



Dongxing City, Guangxi (Rong, Huo, & Huang, 2010). Bilateral border cooperation has continued to make progress. Then Party Secretary of the Guangxi Zhuang Autonomous Region, Peng Qinghua, visited Vietnam in June 2013 and proposed to establish Pingxiang as a border free-trade demonstration area. The Chinese goal was to foster bilateral economic cooperation at the border between China and Vietnam. In October 2013, China's Premier Li Keqiang proposed establishing a cross-border free trade area when visiting Prime Minister Nguyen Tan Dung of Vietnam. On 7 January 2014, the government of Guangxi province approved Several Policies and Regulations on Promoting the Open Development of Guangxi Beibu Gulf Economic Zone Development, and enlisted two Chinese cities near Vietnam, Piangxiang and Dongxing, as experimental units.

According to Zhou, China's investment in Vietnam mainly focus on labour-intensive industries and export products for international markets such as Europe and the United States. Vietnam has a comparative advantage in labour power, mineral resources, and agriculture, whereas China has a comparative advantage in technics, capital, and the industrial sector. Such complementarity demonstrates that both Hanoi and Beijing have a potential trading demand within their industries, which has already linked China and its other neighbouring countries to work together and become part of the international value chain. Furthermore, China's FDI focuses on regional labour division, which reinforces Vietnam's international competition in the manufacturing industry, broadening its export market. It is beneficial for Vietnam's economic development (H. Zhao, 2013, p. 67).

### 2.2.2 Sensitivity to Economic Attraction

In comparison to the Philippines, Vietnam acquires more Chinese economic attraction. However, Vietnam's protesting activities are not fewer than those of the Philippines. As Table 5 shows, Vietnam protested against China in South China Sea disputes only three times in 2010, but up to 13 times in both 2011 and 2012, and back down to three times in 2013.

Table 3. Vietnamese Protests against China

| Year | Event Description  |
|------|--|
| 1997 | March: protesting Exploration No.3 located in Block no. 113.   |
|      | December: protesting China's ships in the Wanan block.   |
| 1998 | August: submitting a verbal note to the United Nations against the Law of the People's Republic of China on the Exclusive Economic Zone and Continental Shelf. |

|      |  |
|------|--|
|      | September: protesting China and the U.S. Christon Energy Co. exploring in the Wanan block.   |
| 2004 | April: National Travel Bureau organising an official tour to the Spratly Islands.  |
|      | November: protesting China's Nanhai-215 ship pulling an oil rig.   |
| 2006 | November: protesting China's setting a mark in the baseline of the territorial sea.  |
| 2007 | December: Vietnamese people hold demonstrations in front of the Chinese Embassy in Hanoi.  |
| 2009 | June: Vietnamese people gathered in front of the Chinese Embassy.  |
| 2010 | April: Vietnamese coast guard ships containing Chinese fishing boats.  |
|      | May: issuing a plan of defence and the development of islands in the South China Sea.  |
|      | August: protesting Chinese ships exploring and a ban of fishing (China exercises fishing moratorium in the South China Sea).                 |
| 2011 | January: Hanoi declaring that China was prepared to occupy the South China Sea.  |
|      | January: protesting the State Bureau of Surveying and Mapping of China's published maritime border.  |
|      | March: protesting jointly with the Philippines and Japan against China's actions.  |
|      | March: protesting China's Hainan province's issuance of the 12 <sup>th</sup> five-year plan, which included the Spratly and Paracel Islands. |
|      | April: the Diplomatic Academy of Vietnam organises the second national conference on the South China Sea.                                    |
|      | May: protesting three Chinese marine surveillance ships cutting cables off Vietnamese ship, Binh Minh 02.                                    |
|      | May: submitting a verbal note to the United Nations to reclaim the submission of continental shelf beyond 200 nautical miles.                |
|      | June: protesting Chinese fishing boats cutting cables of a PetroVietnam ship.  |
|      | June: Prime Minister Nguyen Tan Dung signs an order for military conscription.   |
|      | July and August: Vietnamese people demonstrated against Chinese imperialism.   |
|      | September: spokesman Nguyen Phuong Nga states that Beijing has no right to oppose Hanoi's economic rights.                                   |
|      | October: signing a MOU for navy cooperation with the Philippines.  |
|      | November: protesting China's Hainan Province operating tourism in the Spratly Islands.   |
| 2012 | February: asking China to stop threatening actions on the Paracel and Spratly Islands.   |
|      | March: sending six monks to re-establish abandoned temples on the Spratly Islands.   |
|      | June: passing the Law of the Sea for claiming jurisdiction over the Spratly Islands.   |
|      | July: extending the contract with Oil and Natural Gas Corporation (ONGC)   |

|      |  |
|------|--|
|      | in Block no. 128.  |
|      | July: assigning doctors to stay in medical stations on the Spratly Islands.                                      |
|      | September: demanding China to stop the illegal and invalid bidding on Block 65/12.                               |
|      | November: Prime Minister signs a decree on fishery organisation operations.                                      |
|      | November: criticising the inclusion of the South China Sea printed in new Chinese passports.                     |
|      | November: protesting China cutting cables of the Binh Minh 02 ship.  |
|      | December: PetroVietnam requested that the Vietnam authority demand that China respects its maritime sovereignty. |
|      | December: establishing a citizen patrol group to protect fishermen.  |
|      | December: accusing China's Sansha city of including disputed waters in Parcel Islands and Spratly Islands.       |
| 2013 | January: formal implementation of the Law of the Sea.  |
|      | April: PetroVietnam urges China to cancel the bidding of disputed blocks.  |
|      | July: President invited Russia to develop oil and gas fields in the South China Sea.                             |

Compared to the Philippines, Vietnam gained more economic attraction from China, providing more evidence to test Hypothesis 1. For example, in December 2008, China and Vietnam agreed to commence bilateral discussions on maritime disputes with the first priority given to developing a set of fundamental guiding principles as a framework for settling specific concerns. (These discussions began in early 2010 and five sessions were held in 2011.) In particular, the shared border is an important place for economic attraction. In October 2013, Beijing and Hanoi jointly announced the establishment of the Longjiang Economic Zone and the Shenzhen–Haiphong Economic and Trade Zone. It is notable that in spite of China's economic attraction, Vietnam does not accept Chinese assertiveness in the South China Sea; it appears that Vietnam's sensitivity interdependence with China is decreasing. Several events signal this phenomenon. When Vietnam was chairman of ASEAN from 2009 to 2012, the tension with China worsened (Yang, 2014, p. 137). On almost all critical occasions related to ASEAN meetings, Vietnam publicized South China Sea disputes and increased internationalization by cooperating with potential external allies to balance China's influence in the region (The Hanoist, 2010).

Between 2007 and 2011, with the tension intensifying, China and Vietnam arranged a high-ranking official meeting to control the situation. For example, in April 2007, the situation was tense but relaxed somewhat after a bilateral high-ranking officials meeting.

Another example occurred in September 2011, when Vietnamese official Ngo Xuan Lich visited China and later stated that both Beijing and Hanoi had agreed to resolve the South China Sea disputes through bilateral negotiations. In addition, they agreed that the South China Sea disputes shall not hinder their bilateral friendship. The above example demonstrates that China and Vietnam share friendship, and these two countries communicate each other through high-ranking official meeting, even between the tension intensifying. From this, Beijing obviously realized that there is some room for Hanoi for negotiation, but not in the Philippine case. However, for both the Philippines and Vietnam, the sovereignty challenge cannot be sacrificed by economic benefit and political negotiation, no words than compromising to China (Yang, 2014, p. 76). Both Vietnam and the Philippines protested strongly against China's redesign of its passport, which included the South China Sea in a map of its borders. In comparison with Manila, Hanoi went further in its objections, including submitting a diplomatic note to the Chinese Foreign Ministry that objected using or stamping this version of passport. This proved that the Sino-Vietnamese dilemma of economic development and territorial conflict remains unanswered.

China's strategy has been challenged by Hanoi, which limits China's economic power. Vietnamese political elites have debated China's influence over Vietnam for years. A group of elites urged Hanoi to maintain traditional relations with China. That is, Vietnam should follow the principle of 16 characters: "friendly neighbourhood, comprehensive, long-lasting stability, and future-looking orientation" (Minh, 2011). Another group of elites anticipated that China's good-neighbour diplomacy would boost bilateral trade and bring more capital. Domestic pro-China sentiments have not been eliminated with the Sino-Vietnamese tension over the South China Sea since 2009. The idea of "what Vietnam really wants is not a war but peace" is encouraged by the economic-security linkage between China and Vietnam, building on the premise that "peace and growth are important to both countries" (Yang, 2014).

The South China Sea disputes flared in 2011. On 9 May, after Manila submitted diplomatic document no. 00028 to the United Nations, Vietnam claimed that the Spratly Islands belonged to its territory and strongly objected to both China's and the Philippines' diplomatic document submitted to the United Nations. Furthermore, Vietnam held some political activities on the Paracel and partial Spratly Islands (Liu & Wu, 2012, p.144). In addition, Vietnam protested Chinese vessels catching Vietnamese fishing vessels, even

detaining their fishermen and taking their tools. Chinese and Vietnamese leaders were concerned that similar situations would replay themselves over and over. On 11 October, the Vietnamese President Truong Tan Sang visited Beijing and negotiated South China Sea disputes with Chinese President Hu Jintao. Undoubtedly, the two sides signed several agreements. Hu Jintao rendered some economic attraction, such as a five-year development plan of bilateral economic cooperation and cooperative plans for highways and infrastructure, along with the agreement of a guideline to resolve Vietnamese–Chinese marine issues.

In 2011, it was obvious that China's economic attraction did play its role in generating persuasion for Vietnam. As Yang (2012) indicated, Sino–Vietnamese conflicts were not easy to resolve. Vietnam's optimal choice was to maintain Chinese assistance in trade, investment, and infrastructure. In 2012, Sino–Vietnamese economic linkages were progressing. For instance, China and Vietnam established a new cross-border economic zone between Mong Cai City (Thành phố Móng Cái) in Northern Vietnam and Dongxing City, Guangxi (Rong *et al.*, 2010). Both governments signed agreements to construct bridges and infrastructure between Mong Cai and Dongxing. In spite of this bilateral border cooperation, Vietnam protested against China up to 12 times in 2012. In mid-May, Vietnam criticised the Chinese unilateral fishing ban. After a month, Vietnam objected to China's establishment of Sansha city and to CNOOC's public bidding. CNOOC's bidding included the nine oil fields of JY22, HY10, HY34, BS16, DW04, DW22, YQ18, RG03, and RJ27 (Yang, 2014, p. 72). This demonstrates that although Vietnam enjoys the fruits of prosperous border activities, these are obviously not enough to resolve South China Sea disputes.

### **2.3 Concluding Remarks**

Both Hanoi and Manila are pursuing hedging strategies. In contrast to Manila's focus on Washington, Hanoi seeks to establish ties with several countries. Although economic attraction did not generate as significant an effect as a high-ranking officials meeting, China's economic attraction remains substantial. Notably, after Xi Jinping and Le Keqiang successfully took over China's leadership, Li Keqiang visited Vietnam and signed 13 cooperation papers, demonstrating a second wave of China's charm offensive. During this visit, China granted these advantages for two reasons: to project that Beijing is willing to charm Hanoi and neglect Manila, and to keep a common understanding with Hanoi.

On the basis of these two cases, this study concludes that China's charm offensive was

not as effective as expected. Because providing economic attraction cannot achieve political purposes, China shifted to a coercive policy in the Philippine case, and used economic attraction together with economic coercion in the Vietnamese case.



### **Chapter 3. Vulnerability to Economic Coercion**

The political report of the 16<sup>th</sup> Party Congress noted China's strategic thinking of grasping "an important period of strategic opportunity"; the first twenty years of the new century would be China's strategic opportunity to develop itself (Li, 2010). Under this momentum, the abundant natural resources of the South China Sea are included in China's national plan. Internationally, because UNCLOS requested that claimants should submit a territorial sea baseline statement no later than 13 May 2009, disputes between China and ASEAN countries escalated after 2009 (Glaser, 2011).

From Chapter 2, China's economic attractions did not generate the effect of constraint, illustrating that China cannot employ sensitivity interdependence to achieve its political goals. Therefore, it switches to employing vulnerability interdependence.

#### **3.1 The Philippine Case**

The Philippines' stance has remained strong since 2009, and the situation became particularly tense in 2011. China took coercive measures to interfere in Philippine resource development, such as fishing and oil exploration. In early March, two Chinese vessels demanded that a Philippine marine survey vessel stop activities and leave the waters of Reed Bank, or else they would collide. Against this incident, the Philippines Ministry of Energy declared that Manila would negotiate with Beijing, and would pause its seismic testing activities until the dispute was resolved (Liu & Wu, 2012, p. 143). This demonstrates the effectiveness of China's coercion. However, at the end of March, the Philippine General Secretary stated that Manila would repair its military camps and airports on the nine islands under its control to reinforce its influence in those areas of the South China Sea. Although the Philippines may have capitulated on the resource in early March, this demonstrated that they would not sit and wait for China's assertiveness. Hence, we see that Chinese coercion was effective for resource exploitation in the short term, but it did not resolve the root of the conflict.

Recently, China coerced the Philippines with an incident in the Scarborough Shoal. On 8 April 2012, the People's Liberation Army Navy and a Philippine fisheries administration ship had a confrontation. Neither side conceded and the situation lasted for approximately two months. In contrast to previous events, a large number of Chinese citizen ships participated in the standoff.

Regarding economic coercion, China adopted four reactive measures to respond to the Philippines, including increasing the difficulty of goods clearing customs, suspending tourism, putting off the progress of investment cooperation, and refusing to invite Aquino III to CAEXPO.

First, China increased the difficulty of goods clearing customs. In May 2012, the General Administration of Quality Supervision, Inspection and Quarantine of the People's Republic of China notified the Philippines of a partial suspension of bananas because Shenzhen quarantine officers discovered *Aonidiella comperei McKenzie*, a type of scale insect. In addition, China implemented new import requirements over concerns of the phytosanitary health of Philippine banana imports. Because bananas are one of the economic arteries of Philippine industries, China focused its boycott there. It caused a sharp decline of 40% in Philippine banana export volumes, directly affecting farmer revenues and entrepreneurial operations. According to the Philippine media, farmers of the Philippines concerned about territorial dispute may jeopardize bananas export to China. This quickly exhibited an intimidating effect.

Second, China suspended its tourism to the Philippines. In May 2012, China warned Chinese people against travel to the Philippines for security reasons. Travel agencies in Beijing and Shanghai suspended tours to the Philippines, which jeopardized tourism revenues in the Philippines. The Philippine economy depends on tourism, particularly on the growing number of Chinese tourists.

Third, China put off progress in investment cooperation. China's state-owned enterprises (SOEs) reduced their input to public-private partnerships.

Fourth, Beijing did not invite Aquino III to attend CAEXPO. In September 2013, China did not send an invitation to the Philippine President, Benigno Simeon Cojuangco Aquino III, for either the 10<sup>th</sup> CAEXPO or the China-ASEAN Business & Investment Summit. It was a way to deny the Philippines economic cooperation between China and ASEAN. China used international etiquette to give the Philippines special treatment, and it made clear to other ASEAN countries the outcome of arguing with China. The standoff finally ended with the Philippines withdrawing its vessels. China seems to have prevailed in the standoff. In July 2012, the Philippines attempts to handle the standoff at an ASEAN Foreign Ministers' Meeting but was not given permission by Cambodia, the chair country at the time. A Cambodian official expressed that China reveals it hands on ASEAN to isolate the



Philippines (Bower, 2012).

The way China refutes Philippine attendance to one of the major China–ASEAN conferences is to link the Scarborough Shoal dispute with CAEXPO. It revealed that the political wrangling between China and the Philippines had already extended to the arena of regional economic cooperation.

On the same basis of testing Hypothesis 1, the Philippines’ referral of disputes to the international arbitral tribunal clearly demonstrated that China’s economic coercion did not force it into submission in the long term. China’s reaction turned out to be tougher and resulted in the isolation of the Philippines. From 9 to 15 October 2013, China’s Premier Li Keqiang visited Brunei, Thailand, and Vietnam. The Diplomat, a Japanese magazine, analysed China’s behaviour as isolating the Philippines within ASEAN (Keck, 2013).

Table 4. **China’s Coercion against the Philippines**

| <b>Year</b> | <b>Event Description</b>  |
|-------------|---|
| 1999        | October: building a concrete foundation on Mischief Reef for sheltering fishermen.  |
| 2009        | Protesting the exploitation of oil in Reed Bank by Manila and the British company Forum Energy.                               |
| 2010        | March: maritime law enforcement ships expelled the Philippines’ oil-well drilling ship.                                       |
|             | April: Chinese and Philippine ships stand off at Swallow Shoal.   |
| 2011        | February: a Philippine fishing vessel accused a Chinese frigate of firing three shots at it.                                  |
|             | March: patrol boats demanded Forum Energy’s vessel to leave Reed Bank.  |
|             | March: two patrol boats threatened to ram a Philippine survey boat.   |
|             | December: patrol ships drove out a ship conducting exploitation with British Forum Energy in Reed Bank.                       |
| 2012        | April: Scarborough Shoal standoff.  |
| 2013        | September: China asked Philippine President Benigno Aquino III to postpone visiting China during the 10 <sup>th</sup> CAEXPO. |

Philippine economic development highly depended on Chinese trade, tourism, and consumer markets. When China uses these as leverage in coercion, it jeopardizes Philippine industries and hampers economic growth, particularly during global economic slowdown.

Another example of coercion is found in East China Sea disputes between China and Japan. When Japan detained a Chinese captain in 2010, China set import restrictions on Japanese rare earths as a punishment. Compared to Chinese measures against the Philippines, limiting goods to clear customs was a temporary measure.

Reviewing this event, this study tries to determine why China uses economic coercion when dealing with the Philippines. First, this beats the opponent's weakness. Diplomatic negotiations and the use of force cost time and money. Because the Philippines depends highly on China's economy, economic coercion may be a way to achieve the result that China expects. Second, it panders to Chinese public opinion. Chinese people are angry with the Philippines' attitude to the Scarborough Shoal incident. Therefore, China uses economic measures to counter the Philippines as a way to relieve public anger and decrease the pressure of public opinion on the CPC government. Third, it demonstrates that China owns the power of the determination. Although economic coercion may have negative effects on China's economic performance, it is a way to punish the Philippines as a warning to other countries.

China and the Philippines appeared to agree with that two states should withdraw from the Scarborough Shoal and resume the status quo; however, only the Philippine vessels withdrew. China finally took the victory. This shows that economic coercion was effective in generating payment during conflict. A scholar from Chinese Academy of Social Sciences, Jie Chang, mentioned a viewpoint of "the model of Scarborough Shoal" (Chang, 2013), demonstrating that using economic coercion may be a new development for China's strategic thinking under Xi Jinping. With a strong economic power such as China's, the coercion pushed Manila into referring the conflict to international arbitration.

Examining the effect of the Scarborough Shoal standoff, it generated only a temporary shut-down of the Philippine economy. The overall trade amount between the Philippines and China in 2012 remained similar to that of 2011. China's economic coercion already caught the eye of international opinion. In addition, Chinese SOEs in the Philippines were victims of China's economic coercion. From the perspective of opportunity costs, economic coercion may hurt Manila in the short term, but it also hurts Chinese investors and China's international image in the long term.

Tensions between Manila and Beijing did not end with China's victory in the Scarborough Shoal standoff. In fact, the Philippines moved it to the international arena and extended a new wave of legal proceedings. On 22 January 2013, the Department of Foreign Affairs of the Philippines submitted a notification to Beijing that it was convening an international press conference. Manila declared that it would file a lawsuit against China over the South China Sea disputes, according to UNCLOS. On 19 February 2013, Beijing claimed

that it would not participate in the arbitration because the Philippines' claim had no basis in fact or law. On the same day, Manila stated that they would conduct the arbitration unilaterally. In July 2013, the tribunal assigned the Permanent Court of Arbitration in the Hague as the secretariat and passed through the rules of procedure, asking the Philippines to submit a memorial before 30 March 2014. Hence, China did not achieve a victory in the long term.

### **3.2 The Vietnamese Case**

Vietnam was not deeply persuaded by Chinese economic attraction, and Beijing firmly objected to foreign countries conducting oil exploitation and fishing activities in the South China Sea. Beijing's coercive measures against Hanoi were harsher than those towards Manila, typically in marine enforcement activities. For instance, Chinese vessels cut the cables of Vietnamese vessels two or three times (Thayer, 2011). In addition, because Vietnam cooperated with many foreign energy groups and exploited oil and natural gas in the disputed waters, Hanoi became the main objective of Beijing's attraction. A Chinese spokesman of the Foreign Ministry stated that China firmly objected to any foreign countries exploiting the oil and natural gas reserves in the waters under Chinese jurisdiction. In 2006 and 2007, China harassed Vietnamese joint ventures with foreign countries 18 times.

#### **3.2.1 Fishing Activities**

In 2009, China detained or seized 33 Vietnamese fishing boats and 433 crew members (Deutsche Presse-Agentur, 2010).<sup>3</sup> China continued to harass and detain Vietnamese fishing boats in 2010, particularly in the waters near the Paracel Islands (Thayer, 2011). In the first quarter of 2010 alone, there were 30 cases of Chinese authorities seizing Vietnamese fishing craft and detaining over 200 fishermen (BBC News, 2010).

Vietnam protested China's behaviour six times in 2010, and bilateral relations became tenser than ever. However, Hanoi and Beijing held secret meetings five times to discuss a basic guideline as a framework for solving marine issues. In fact, several Vietnamese fishing vessels were still caught or detained by Chinese marine surveillance vessels and fishing enforcement vessels (Yang, 2014, p. 75). To resolve the impasse, Vietnam sent its Vice Minister as a special envoy to China in June 2011. Hanoi and Beijing issued a joint statement

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<sup>3</sup> (2010, April 19). China seizes Vietnamese fishing boat. *Deutsche Presse-Agentur*. See also (2010, May 4). China releases Vietnamese fishermen but keeps boat. *Deutsche Presse-Agentur*.

that reiterated they would resolve the disputes peacefully through friendly negotiation (Ministry of Foreign Affairs of Vietnam, 2011).

Notably, the Vietnamese media only reported two incidents related to fishing in response to China unilaterally announced its fishing ban in 2011. Vietnamese authorities may have limited the number of news reports to maintain relations with Beijing. This shows the effectiveness of Chinese economic coercion.

### **3.2.2 Oil Exploitations**

On the case of Vietnam–Russia cooperation in the Blocks no. 127 and 128 in 2011, China did not criticise it primarily but implied they did not hope regional foreign power interfered in to the South China Sea issue. However, Vietnam still claimed that it had the right to cooperate with foreign companies to exploit resources within its territory (Yang, 2012, p. 75). China’s diplomatic expression did not generate friendly responses from Vietnam.

Events intensified in 2012. In March, Vietnam and India’s state-owned oil firm ONGC planned the resource development of two oil fields in the South China Sea. The Chinese foreign ministry suggested that India not be involved in the dispute. In April, ONGC Videsh Ltd. submitted a letter to the Chinese Foreign Minister, announcing that it withdrew from resource development in Block no. 128 with Vietnam because of technical and business concerns. China’s statement effectively paused the cooperation between Vietnam and India. In July, Vietnam extended the contract with ONGC in Block no. 128 for the exploration of hydrocarbons.

At the end of 2012, PetroVietnam posted messages from Vietnamese people on its website, signalling deep complaints rooted in nationalism, demanding that the Vietnamese authorities do something against China. To avoid over-reliance on China, Vietnam aimed for more cooperation with other foreign powers.

ONGC finally accepted Vietnam’s proposal to maintain its investment in Block no. 128 in April 2013, and signed an MOU in November 2013. PetroVietnam and ONGC Videsh Ltd. signed a letter of intent to participate in the exploration of oil and gas in offshore Vietnam in September 2014 (Oil and Natural Gas Corporation Limited [ONGC], 2014). After a month, Vietnam signed an agreement with India for oil exploration in the South China Sea. Vietnamese Prime Minister Nguyen Tan Dung declared that Indian ships would be allowed

into the area despite Chinese protestations (The Economic Times, 2014). Although China's statements has once made India withdraw, Vietnam and India were cooperating together again after several months. This shows that coercion only generates a very short-term effect.

Regarding the contesting of energy resources, the HYSY-981 oil rig incident is a notable example of China's economic coercion. On 2 May 2014, a Chinese company's HYSY-981 drilling rig started its drilling operation for the purpose of oil and gas exploration. The two locations of operation were 17 nautical miles from both Zhongjian Island of the Paracel Islands and the baseline of the territorial waters of the Paracel Islands, approximately 133 to 156 nautical miles away from the Vietnamese coast. The drilling operation carried out by the HYSY-981 was a continuation of the routine process of exploration, and fell within China's sovereignty and jurisdiction (Ministry of Foreign Affairs of PRC, 2014).

Vietnam sent vessels, including armed vessels, to the site, and illegally and forcefully disrupted the Chinese operation. These vessels also rammed Chinese government vessels on escort and security missions in the area. Furthermore, Vietnam sent frogmen and other underwater agents to the area, and dropped large numbers of obstacles, including fishing nets and floating objects, into the waters. At its peak, 63 Vietnamese vessels attempted to break through China's cordon and rammed Chinese government ships a total of 1,416 times (Ministry of Foreign Affairs of PRC, 2014). From a domestic viewpoint, this incident caused a Vietnamese anti-Chinese campaign to counter China's coercion. The Vietnamese government initially allowed the Vietnamese people to protest against China, to relieve domestic pressure and nationalism. However, because an unstable political environment is deleterious to the domestic investing market, Hanoi would not sacrifice its economic interests to protest against China. The more Beijing gradually withdrew its oil drilling facilities, the more Vietnam decreased its force to contain Beijing legally. Therefore, the relationship between economic coercion and payment during conflict did exist in Vietnam's case.

**Table 5. China's Economic Coercion against Vietnam**

| <b>Year</b> | <b>Event Description</b>  |
|-------------|---|
| 2005        | January: arresting Vietnamese fishermen in Beibu Bay.   |
| 2006        | Protesting against Petroleum joint ventures with Korea, the United States, India, and the United Kingdom.                             |
| 2007        | April: protesting Vietnam publicising the concession and bidding to BP.   |
|             | Protesting against Petroleum joint ventures with the United States, the United Kingdom, Russia, France, Japan, Norway, and Australia. |
|             | July: patrol vessels attacked Vietnamese fishing boats.   |

|      |   |
|------|---|
| 2011 | May: cutting cables of PetroVietnam's oil exploration vessels.            |
| 2012 | March: demanding India not to be involved in developing oil with Vietnam. |

Table 6. **Chinese Protests against Vietnamese Petroleum Joint Ventures (2006 - 2007)**

| Date              | Country     | Company        | Block   |
|-------------------|-------------|----------------|---------|
| (no date) 2006    | South Korea | KNOC           | 11-2    |
| May 15, 2006      | US          | Pogo           | 124     |
| May 15, 2006      | US          | Chevron        | 122     |
| November 1, 2006  | India       | ONGC           | 127/128 |
| November 6, 2006  | UK          | Premier Oil    | 12      |
| December 26, 2006 | UK          | BP             | 117     |
| May 16, 2007      | US          | Conoco Philips | 133/134 |
| June 3, 2007      | UK          | BP             | 05-2    |
| June 18, 2007     | Russia      | Gazpro         | 112     |
| June 26, 2007     | Russia      | Gazpro         | 112     |
| June 27, 2007     | France      | CGGVeritas     | n/a     |
| July 10, 2007     | Japan       | Idemitsu       | 05-1    |
| July 27, 2007     | France      | CGGVeritas     | n/a     |
| August 2, 2007    | France      | CGGVeritas     | n/a     |
| August 6, 2007    | Norway      | PGS            | n/a     |
| August 6, 2007    | UK          | Pearl Energy   | 06-94   |
| August 6, 2007    | US          | Chevron        | 122     |
| November 6, 2007  | Australia   | Santos         | 123     |

Source: Fravel, M. T. (2011). China's Strategy in the South China Sea. *Contemporary Southeast Asia*, 33(3), 302.

On coercing Vietnam, harassing fishing activities and oil exploitation directly affected Vietnamese vulnerability interdependence. However, it did not achieve the result of submission. Furthermore, Vietnam outdone on the event of HYSY-981 oil rig in 2014. China publicly announced its withdrawal of the oil rig one month early. Afterwards, although there were some signals that Vietnam would follow the Philippines in referring the case to international arbitration, it did not take any further action. Vietnam's attitude reveals that international arbitration is an active bargaining chip for Vietnam, whether it takes action or not; it is unnecessary to rush to cross the bottom line.

### 3.3 Concluding Remarks

Economic attractions under ordinary situations strengthen the bilateral relationship of economic interdependence. That is, economic attraction is also part of China's coercive instruments. Economic attractions have a function of employing economic coercion. Symbolically, China transmits some signals without providing economic incentives or

excludes the opportunity of economic cooperation in the foreseeable future; in practice, China interferes in fishing activities and oil exploitation. The symbolic and actual measures are used in different combinations under different types of conflicts. With nonmilitary actions such as economic coercion, China fights back strongly against crossline behaviour and then creates a new status quo that makes the disputed waters under its jurisdiction.

Although economic coercion cannot directly achieve the outcome of compromise, the way China employs it has expanded its realistic existence and has gradually persuaded the Philippines and Vietnam. China's real ambition was to win without a war.

For fishing activities, the degree of vulnerability interdependence is higher for the Philippines than for Vietnam. Therefore, China chose to coerce the Philippines using fisheries. In the case of the Scarborough Shoal standoff, economic coercion generated restraint in the short term. It signals that the Philippines is more vulnerable than Vietnam. For resource exploitation, the degree of vulnerability interdependence is higher for Vietnam than for the Philippines. Therefore, China frequently chose it in its coercive behaviour against Vietnam. However, Vietnam's joint ventures in oil exploitation did not cease, signalling that Vietnam's vulnerability was insufficiently high.

## **Chapter 4. Theoretical Reflections**

Findings in Chapters 2 and 3 do not support Hypotheses 1 and 2 of this study. That is, neither economic attraction nor economic coercion could make the Philippines or Vietnam comply with China's intents in South China Sea disputes. For instance, Manila referred the dispute to international arbitration in 2013, and people in Hanoi held anti-China riots to protest the presence of CNOOC's HYSY-981 oil rig in the waters near the Paracel Islands in 2014. It seems that the notions of sensitivity and vulnerability suggested by Keohane and Nye are insufficient to measure power and interdependence.

### **4.1 Review of This Study**

Using its good-neighbour policy, China hopes to share its economic benefits with its neighbours, in particular Southeast Asian countries, to stabilise its peripheral relations. Being located in the Asia-Pacific region, a stable development environment is beneficial for China to accumulate economic advantages. Hence, China launched its charm offensive to repair historical wounds. Regarding the South China Sea disputes, China continues to follow Deng Xiaoping's principle of setting aside disputes to pursue joint development.

The relationship between China and the Philippines, and between China and Vietnam, comprise asymmetric economic interdependence. According to the theoretical framework by Keohane and Nye, China's economic attraction to the Philippines and Vietnam constructs a sensitivity interdependence. Under the sensitivity interdependence concept, persuasion is created through economic gains to finally make the Philippines and Vietnam compromise in South China Sea disputes. However, when economic attraction does not achieve the expected outcomes of avoiding conflict, China turns to economic coercion. Under the vulnerability interdependence concept, it forces the Philippines and Vietnam to consider the payment.

This study suggests that the original analytical framework may have missed the trust factor as the linkage between economic instruments and political purposes. That is, economic attraction cannot transform the power of persuasion unless there is trust; similarly, economic coercion cannot transform the power of payment without trust. Furthermore, this study attempts to provide a new perspective for observing China's employment of economic instruments to handle South China Sea disputes.

### **4.2 Economic Attraction**

Through testing Hypothesis 1 in Chapter 2, this study found that China's economic



attraction did not play the expected role of sensitivity as Keohane and Nye argued. In examining how quickly changes in Beijing resulted in changes in Manila and Hanoi, and how costly the effects were, this study finds a sensitivity of economic attraction in both the Philippine and Vietnamese cases. Although China shares economic benefits with the two countries, benefits originating from commercial cooperation cannot spill over to territorial sovereignty issues. Referring to the existing literature, other than the Philippines' and Vietnam's vital economic and security interests in the South China Sea, other reasons to explain why economic instruments do not decrease the possibility of conflict are as follows.

First, the pro-American political attitude in the Philippines plays a key role in Manila's decision making. The Philippines fears that China will use economic attraction as leverage to pull Manila from Washington (H. Zhao, 2013). The distrust escalated as the Chinese economic power gradually projected its regional influence. To better adjust to China's rising, Manila is eager to take action to maintain the status quo (Hong, 2012, p.87). Second, Filipinos criticised Arroyo's soft decisions in the South China Sea disputes as well as a number of China's corrupt investments. In addition, many family businesses and oligopolistic firms refuted the facilitation of an FTA with China, causing the Philippines to be less eager in appealing China's support, to protect their original business benefits. Third, scandals in some infrastructure partnerships with China produced a negative image of China's economic diplomacy.

In the Vietnamese case, Premier Tan Dung Nguyen warned that Hanoi should be concerned about the serious degree of economic interdependence with China. Vietnam depends on the trade imbalance, such as the trade deficit, for economic development. To avoid increasing of both degrees of sensitivity interdependence and vulnerability interdependence, Vietnam positively manages its relations with the major powers and attempts to offset China's economic impact. Reflecting Keohane and Nye's concept of asymmetric economic interdependence which explains Vietnam's case:

If one actor can reduce its costs by altering its policy, either domestically or internationally, the sensitivity patterns will not be a good guide to power resources (Keohane & Nye, 2001, p. 10).

Second, as Vietnamese academia has observed, China's economic diplomacy aims to use its advantage in labour-intensive industry and its endowment of natural energy resources.

Vietnam's problems of unemployment and technological backwardness have not been improved and irreparable environmental damage has been caused (Ha & Do, 2008).

In summary, a clear concept appears between the two cases. When China manipulates asymmetric economic interdependence, it does not consider the importance of building mutual trust. Historically speaking, before pushing its charm offensive, China used to use military power to acquire its position in South China Sea disputes. For example, the cases of Fiery Cross Reef in 1988, the Paracels in 1994, and Mischief Reef in 1995. Together with the fear of a rising China, negative perceptions have long been rooted in Manila and Hanoi. Furthermore, both countries acknowledge that China's economic diplomacy of going out is meant to stabilize its economic position through the use of foreign markets and resources. Ostensibly, China's economic attraction is altruistic, but in actuality it is self-serving.

If a government seeks to make a gain on issue X by linking it to issue Y, it is in effect exchanging some of the good involved in issue Y for that in issue X (Keohane & Nye, 2001, p. 275).

We can use this concept to elaborate on China's behaviour: Beijing aims to achieve its political purpose in the South China Sea by linking it with sharing economic benefits (*jing ji fa zhan hong li*, 經濟發展紅利) with the Philippines and Vietnam. The relationship between territorial disputes and economic attractions implies an exchange. Using Keohane and Nye's framework, the relationship between economic interdependence and the power of persuasion is designed to probe specific issues. Because the South China Sea disputes involve challenges to sovereignty, they may be beyond the scope of Keohane and Nye's framework. Hence, this study provides some views to supplement the existing literature. Despite Beijing's superior position in the relation of asymmetric economic interdependence, the stronger party cannot eliminate anti-China concerns when significantly using economic instruments. This study infers that trust may be one of factors that links economic power with asymmetric interdependence. The stronger party should improve its relationship with peripheral countries by building trust, gradually removing its image of a threat and improving bilateral relations. The trust factor can be a linkage to effectively formulate sensitivity interdependence and vulnerability interdependence, transform economic power into the potential for more leeway in political issues, and finally achieve the preferred outcomes of the stronger party.

### 4.3 Economic Coercion

In testing Hypothesis 2 in Chapter 3, this study found that China's economic coercion of the Philippines and Vietnam did not make both countries compromise in South China Sea disputes. Because the charm offensive did not work as anticipated, China altered its policy from providing economic attraction to employing economic coercion. However, under the concept of vulnerability interdependence, economic coercion does not transform into payment to make both countries consider potential economic losses.

Reviewing Keohane and Nye's framework of asymmetric economic interdependence, the emphasis is placed on vulnerability interdependence.

Policymakers and policy analysts, however, must examine underlying patterns of *vulnerability interdependence* [emphasis added] when they decide on strategies.... Coherent policy must be based on an analysis of *actual and potential vulnerabilities* [emphasis added]. (Nye & Keohane, 2001)

Although China's economic coercion in handling South China Sea disputes did not achieve its preferred outcomes for either the Philippines or Vietnam, this study found that Beijing demonstrated clever political manoeuvring to separate economic coercion into substantive and symbolic measures during the Scarborough Shoal standoff with the Philippines. This provided a new lens to observe China's economic influence. Substantive measures of coercion cause actual and immediate loss to the weaker states; symbolic measures anticipate future losses. The former includes limited imports, cancelled tourism, and decreased investment; symbolic measures include coercion, which causes an expected loss. For example, China refused the participation of the Philippines in the 10<sup>th</sup> CAEXPO, which caused Manila to lose some commercial opportunities. China's employment of symbolic measures implied a punishment strategy. This trend shows Beijing's peripheral governance strategy has moved beyond commercial implications and serves the purpose of political friendship (Yang, 2014).

The peace and stability of the South China Sea concerns regional development and prosperity and the well-being of the people, hence serving the common interests of all the countries in the region (Wenweipo, 2014).

From the statement by Chinese Vice Premier Zhang Gaoli at the CAEXPO, Beijing's response to Manila also transmitted a clear warning signal to other claimants such as Vietnam. Reviewing the HYSY-981 oil rig incident, anti-Chinese protests generated bad influence of Vietnamese investing environment. It also made Hanoi take a cautious attitude in handling the protests. In fact, room for generating compromise did exist with Vietnam.

The CAEXPO case represents China's strategy of creating close relationships. For Beijing, if the Philippine president attended CAEXPO in China without revoking the arbitration, then Aquino III would represent the disharmony of cooperation between China and ASEAN, no matter whether he states this opinion publicly or not. Beijing does not want to see Aquino III challenging the core interests of the South China Sea. This incident demonstrates that China was more confident in dealing with peripheral relations. In addition, China gradually lost its patience with Aquino III's administration. In the future, Beijing may use this case as a template to manage peripheral relationships. If other countries challenge Chinese national interests, they will be denied Beijing's agenda of commercial cooperation (Yang, 2014).

This study suggests some implications behind Beijing's manoeuvred gradations of economic coercion. Taking substantive measures is a double-edged sword; it not only hurts Chinese entrepreneurs investing in the Philippines but also produces a negative international opinion of China and the image of a Chinese threat. Both substantive and symbolic measures generate similar effects: coercion generates loss avoidance effects in the very short run that are insignificant in the long run, as shown by the Philippine case. Considering Manila's higher degree of sensitivity interdependence, China did not need to manipulate substantive measures towards the Philippines.

According to Professor Shicun Wu, Dean of South China Sea Institute of Oceanology, China takes different measures against the Philippines and Vietnam. For Manila, using economic measures is preferable; towards Hanoi, Beijing prefers negotiation (Huaxia, 2014). Thus, China uses different strategies to make the Philippines and Vietnam avoid payments, considering their potential vulnerability. First, considering their history of bilateral disputes, a negotiating channel exists between Sino-Vietnamese authorities. In addition, referring to Vietnamese media, their report signal that Hanoi controlled news disclosures to ease tensions. Hence, communications cost less than economic coercion from Beijing's perspective. Second, if Beijing treated Hanoi as it does Manila, it may cause the two states to cooperate in

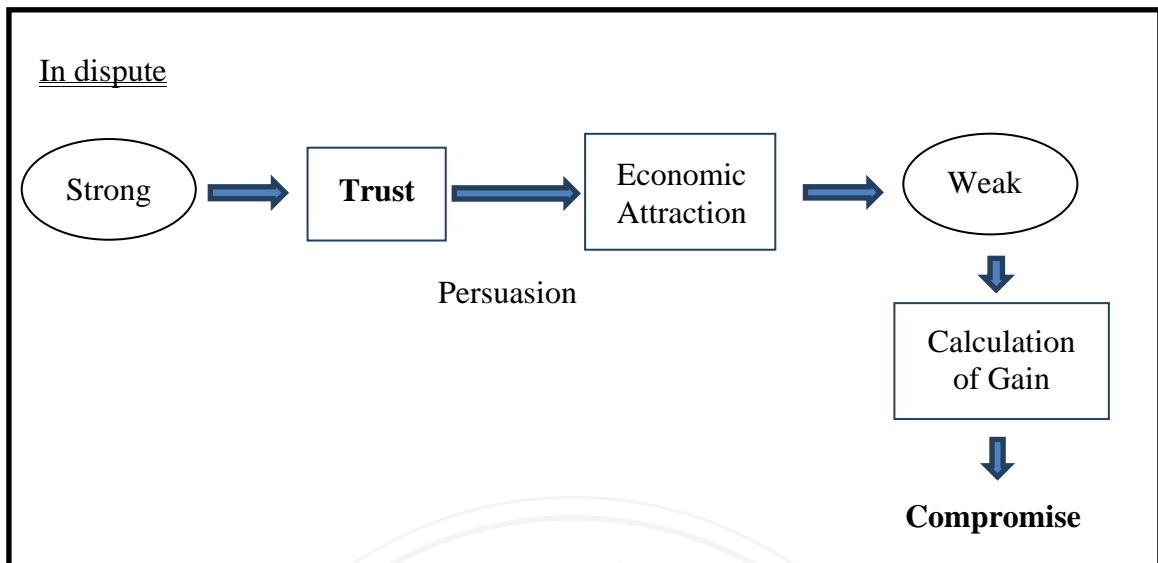
protesting against China, and may even initiate international opinions that do not conform to China's interests.

#### **4.4 Modification**

Keohane and Nye developed the concept of asymmetric economic interdependence in 1977. They posited that sensitivity interdependence is closer to asymmetric economic interdependence; however, vulnerability interdependence plays a critical factor for a country that takes responsive action. The study finding does not meet with the assumption of neoliberal institutionalism: both sensitivity interdependence and vulnerability interdependence do not lead to compromise in political issues.

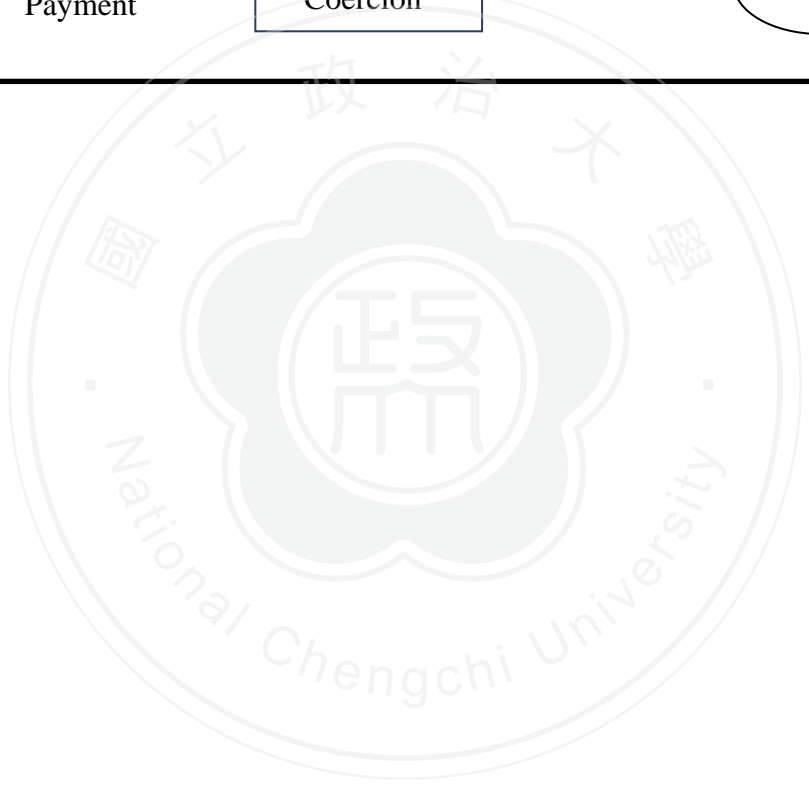
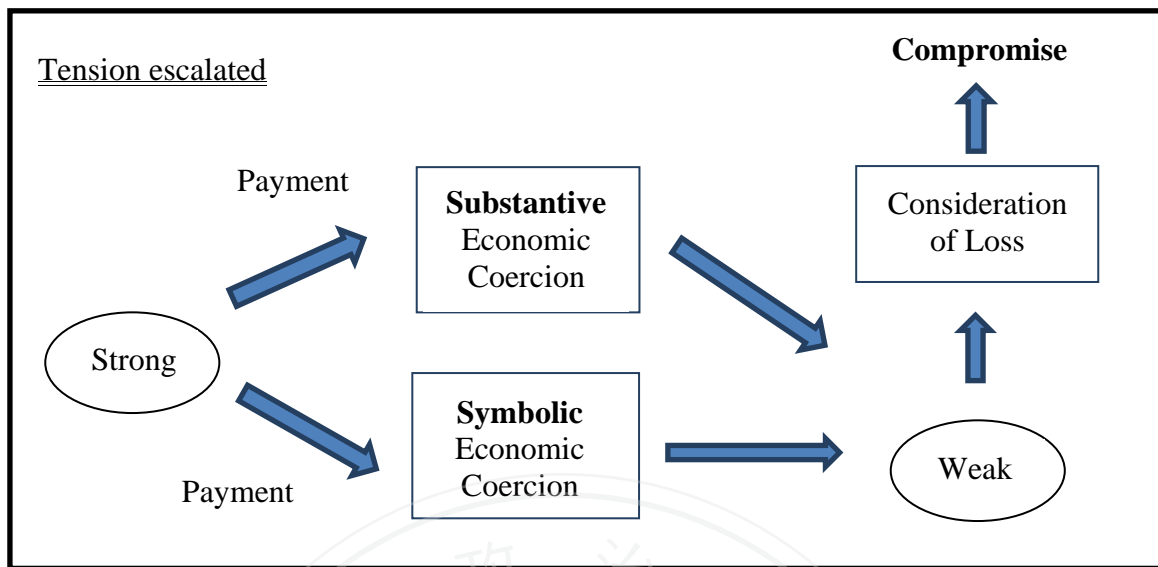
This study observes that economic attractions cannot achieve political purposes if they are missing a trust factor as a linkage. Zhao Hong suggests that to move beyond South China Sea disputes, Beijing, Manila, and Hanoi should focus on how to increase their mutual trust and strengthen economic cooperation, to replace the use of tough measures or military power (H. Zhao, 2013). As Duartea and Davies (2004) stated, trust was not affected directly by the level of power asymmetry but rather by the way power was used, either coercively or noncoercively, raising or lowering trust. Trust was found to mediate the effect of how power is used on an agent's perception of cooperation, satisfaction, and conflict, emphasising the pivotal role of trust in understanding the behavioural aspects of channel (Duartea & Davies (2004, pp.2-3). Rubin and Brown (1975) hypothesised that equal power and high-trust situations would induce participants to choose more cooperative strategies and to attain more satisfactory outcomes than low-trust or unequal power situations. As Davidson, McElwee, and Hannan (2004) stated, the effect of a power differential was direct and not based on an increased use of a particular conflict resolution strategy. These results suggest that enhanced trust might be considered one marker of success for conflict resolution training in a particular social context, such as the workplace (Davidson *et al.*, 2004). This study thus suggests that a trust factor may be the linkage between economic attractions and political purposes, as a supplement.

Figure 4. **Modification of the Analytical Framework: Economic Attraction.**



In addition, economic coercion can be separated into substantive and symbolic measures when taking actual and potential vulnerability interdependence into account. This study suggests two new models of economic attraction and economic coercion as follows (Figures 4 and 5). Establishing mutual trust is the very basis of the linkage between economic attractions and preferred political outcomes. Under dispute situations, providing economic attraction generates persuasion. As tensions escalate, employing economic coercion considers actual and potential vulnerability interdependence to manipulate substantive or symbolic coercion. This finding provides new lens of observing how China manipulates its economic influence.

Figure 5. **Modification of the Analytical Framework: Economic Coercion.**



## **Chapter 5. Conclusion**

This study uses the concept of asymmetric economic interdependence and observes how Chinese economic power generated effects leading the Philippines and Vietnam to compromise in South China Sea disputes between 1997 and 2013. Beginning from China's charm offensive, Beijing acted as a friendly ambassador during the Asian financial crisis. Since then, China's economic diplomacy has become increasingly stronger. Although China constructed economic ties with Southeast Asian countries, South China Sea disputes continued to flare. China used economic coercion in dealing with the Scarborough Shoal standoff with the Philippines in 2012. However, this did not resolve tensions. Observing China's use of both economic attraction and economic coercion in handling territorial disputes, there have been some changes in its economic coercive measures.

### **5.1 Research Findings**

#### **5.1.1 Trust Linkage**

This study suggests the trust linkage as a supplement to the original framework. Without trust to link economic interdependence and political purposes, China's economic attractions failed to make the Philippines and Vietnam compromise, regardless of the tension situation. Main reasons why economic instruments cannot yield the power of persuasion and avoidance of payment were summarized. Without taking trust into account, China could miscalculate the degrees of sensitivity interdependence and vulnerability interdependence in dealing with the Philippines and Vietnam.

For weaker parties, it is preferable to gain economic attractions, but this is insufficient to justify themselves for compromising in territorial disputes. In other words, considering the sensitivity, economic attractions provided by Beijing did not generate the power of persuasion in South China Sea disputes. In the relationship between economic coercion and avoidance of payments, China's economic coercion did damage the two states' interests in the short term but did not generate enough influence for the two states to compromise to sovereignty issues.

The threat of a rising China has deep roots in Southeast Asia. With these negative perceptions from historical experiences, it is difficult for Southeast Asian countries to link China's economic diplomacy with positive intentions. China may create bona fides with the



Philippines and Vietnam by providing economic attractions; however, China has also had wars with these two countries. In particular, economic instruments are a direct way to affect people's livelihoods. If the weaker is affected the more, it makes the weaker fear the more. Therefore, the stronger party should cultivate bilateral relationships by building mutual trust. By examining South China Sea disputes, this study found that neither economic attractions nor economic coercion generated effects that achieve political purposes, because of a lack of mutual trust.

### **5.1.2 Symbolic Measures Provides a New Lens for Observation**

This study found that China has resumed her economic coercive behaviour and demonstrated that Beijing has accumulated enough confidence to handle sovereignty challenges. With China's economic power growing rapidly, its neighbouring countries would pay a higher cost if they do not comply with China's demand. Hence, China is more likely to use symbolic measures more frequently than substantive measures.

In particular, with the assertion of Xi Jinping, China now plays a smart economic game with great strategic significance. Following China's concept of comprehensive national security, Beijing has proposed several plans of economic development, including an updated version of CAFTA, a "diamond ten years," the 21<sup>st</sup> Century Maritime Silk Route, the Asian Infrastructure Investment Bank, and the Eurasian Economic Union; nearly every country hopes to nurture its economy together with burgeoning Chinese opportunities. Clearly, ideas similar to China's charm offensive may play the dominant role in economic diplomacy and serve as economic instruments in realizing the concept of comprehensive national security.

China's charm offensive in economic diplomacy demonstrates the transformation of Beijing's concept of national security. With China's national power continuing to grow, its political strategy in dealing with territorial disputes changes. Dating back to 28 November 2014, the first time Xi hosted the Central Committee on Foreign Affairs Conference, which is detrimental to China's peripheral diplomacy reveals China's new direction. Xi emphasized that during this period of strategic opportunity, China's is to move from economic cooperation towards economic security. Economic development is crucial for the development of a state; economic construction is the only way to achieve a peaceful rise with low risk. Hence, China should embrace new specialties and trends when the tides of national security change. In addition, China should maintain its goal of comprehensive national

security. That is, economic integration is China's bargaining chip in negotiating security and cooperation, and connecting external security issues (Guo, 2015, p. 81).

## **5.2 Future Research Agenda**

This study mainly explores China's economic power in handling South China Sea disputes with the Philippines and Vietnam in the framework of asymmetrical economic interdependence. Because of time limitations, this study did not cover certain dimensions in the research process. For instance, from the perspective of regional economic integration, the role of the CAFTA and its implications for sensitivities and vulnerability to South China Sea tensions could be another aspect to examine. In addition, this study selected two Chinese economic coercive measures, interference in fishing and oil exploitation, are limited. The effect of other economic coercive measures should not be overlooked

The complexities of South China Sea disputes require multiple research methods to cover the topic comprehensively. This study examined the disputes from the lens of economic security. International politics and defence strategies are other essential perspectives that can be considered in the future. Furthermore, another limitation of this study is that it neglects to discuss other economic powers, such as Japan and the United States. Their aid and funds may generate a trade-off effect to China's.

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