

# Impact of the South China Sea Conflict on Trade between China and ASEAN Countries

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Received 5.10.2024 (revision received 6.12.2024), Accepted (reviewed) 6.1.2025, Published 12.9.2025

Abstract

While territorial conflicts in the South China Sea (SCS) between ASEAN member states and China are escalating, their economic dependency and geographical proximity suggest trade will continue. This study examines the impact of the SCS conflict on China-ASEAN trade. The generalized method of moments (GMM) was used to examine data collected between 2005 and 2022 from China and 10 Southeast Asian countries. The primary variable in this study, the SCS conflict, had no impact on ASEAN countries' trade with China. This is due to several reasons: China has a long history of trade with the region, trade is primarily driven by economic factors that outweigh the potential disruption of SCS conflicts, not all ASEAN members are claimants in the dispute, and a lack of integration in ASEAN internal trade. The findings also highlight that ASEAN's GDP, China's GDP, and exchange rate have the potential to boost ASEAN countries' trade with China. On the contrary, the distance between ASEAN countries and China and the average duty reduce total ASEAN countries-China trade.

Keywords	DOI	JEL code
Territorial conflict, international trade, gravity model, GMM	<a href="https://doi.org/10.54694/stat.2024.62">https://doi.org/10.54694/stat.2024.62</a>	F10, F51

INTRODUCTION

In recent years, People's Republic of China (hereinafter: China) has become increasingly assertive in the South China Sea (SCS), raising worries among its neighbors (Chubb, 2021b; Fangyin, 2016; Feng and He, 2018). The Chinese government has claimed sovereignty over most of the SCS, which conflicts

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with the territorial claims of other countries in the region, including Vietnam, the Philippines, and Malaysia. The SCS disputes between China and several Southeast Asian countries have caused tension and uncertainty in the region for many years. These conflicts have focused on rival territorial claims, fishing rights, and access to strategic shipping lanes, among other issues (CFR, 2018; Lee, 2015; H. Zhang and Bateman, 2017). Despite this tension, China and the Southeast Asian countries are also engaged in economic partnership. Association of Southeast Asian Nations (ASEAN), where ten countries of the region unite, has now become China's biggest trading partner, and China is ASEAN's biggest trading partner. One example of their economic cooperation is the ASEAN-China Free Trade Agreement, which has increased trade and investment flows and led to a substantial reduction in tariffs (Sun et al., 2020; Yang and Martinez-Zarzoso, 2014).

Theoretically, conflicts between countries can have significant impacts on their trade relations. Realism, a mainstream theory in the study of international relations, suggests that international systems are inherently conflictual where every country struggles for their national interest, making cooperation among them difficult (Jervis, 1978). Countries prioritise power and security above all to maximise their influence for survival. Proponent of this theory like Morgenthau (2005) and Waltz (1979) maintain that countries would strengthen their military power to ensure their national interests are met. This situation causes growing distrust among countries, and when they are in conflict, trust between them becomes worse. Each action is viewed with suspicion, making it difficult to trust promises or intentions of cooperation. This creates a vicious cycle where cooperation seems risky and fuels further distrust and countries' efforts to restrict trade with their opponents (Waltz, 2001). Military hostility may discourage economic cooperation and the signing of preferential trade agreements (Glick and Taylor, 2005; Mansfield and Milner, 2018). Their government would likely possess various policy tools such as breach of contract, repatriation of profits, exchange controls, entry and exit restrictions, and embargoes, as well as other import and export controls (Barbieri and Levy, 1999; Brewer, 1993; Martin et al., 2008; Su et al., 2020). In a worse scenario, trade disruption during wars can result in significant economic losses (Jackson and Nei, 2014; Polachek, 1980).

Mearsheimer, another realist, asserts that in a world full of uncertainty, there is less chance for countries to build cooperation. This trust issue stems from the difficulty of predicting future actions and intentions. When the ground is constantly shifting, commitments seem less reliable, and countries become hesitant to make themselves vulnerable by trusting others (Mearsheimer, 2001). The fragility of trust in international relations stems from the unpredictable international arena. This international uncertainty prevents countries from establishing effective cooperation (Booth and Wheeler, 2008). At the same time-of-course- the hard predictability of international relationships increase the importance of stable, well-established bi-or multilateral relationships.

Recent theoretical developments in geopolitics further enhance our understanding of the trade-conflict nexus. For instance, Geoeconomic theory underlines how economic tools, such as trade agreements or infrastructure investments, are used for strategic geopolitical gains (Luttwak, 1990; Vihma, 2018). Hegemonic Stability theory upholds the role of a regional hegemon in ensuring continuity of the economy even when disputes are at their height (Kindleberger, 1986; Matthijs, 2022; Webb and Krasner, 1989). Smaller states, on their part, use strategies of bandwagoning or balancing to negotiate their economic and political vulnerabilities (Lobell et al., 2012; Walt, 1985; T. Y. Wang and Tan, 2021). Behavioral theories, such as game theory, explain state behavior in both conflict and cooperation (Bennett, 1995; Jervis, 1988; Snyder, 1971). The tit-for-tat strategy explains why states may be interested in sustained economic cooperation to avoid mutually damaging outcomes (Dluhosch and Horgos, 2013; Guttman, 1996).

Those theoretical developments complement the realism framework, which has been bolstered by a number of studies. For example, a study by Anderton and Carter (2001) employed an interrupted time-series methodology to investigate the impact of war on trade. Their analysis, which encompassed trade data for both 14 major and 13 minor power dyads, revealed a significant decline in trade between

major powers during wartime compared to pre-war and post-war periods. While the evidence for minor powers was less conclusive, it did suggest a similar trend of trade disruption during wartime. In the case of SCS, the application of realism indicates that anarchic actions among the parties in the region are unavoidable when they turn into military build-ups and standoffs, arms race, and assertiveness (Ciociari and Weiss, 2012; De Castro, 2015; Grossman, 2018; Hashim, 2016; Heiduk, 2017; Yahuda, 2013) as well as political mistrust (Emmers, 2017; Heiduk, 2017). Although ASEAN, as a regional body, has hitherto been tackling some diplomatic approaches, the issue remains unresolved and, in some cases, escalates into military conflicts (Austin, 2018; Balakrishnan, 2019; Buszynski and Hai, 2020; McCoy, 2016). Yet, from the perspective of economic development, ASEAN and China have been growing gradually through some cooperation. ASEAN's economy, in particular, has benefited from its strong relations with China (Li et al., 2016; L. Zhang et al., 2018). Chiang (2018) especially studies that since the establishment of the China-ASEAN Free Trade Area, China's investment has provided the majority of business services, telecommunication, information services, and constructions in the region. China is ASEAN's largest trading partner and occupies an important role in the region's production networks (Raghavan and Devadason, 2020). In this case, however, the share of imported products from China to ASEAN countries has increased significantly, while the percentage of Chinese imports from ASEAN has only slightly increased (Tien and Van, 2020). In short, the ASEAN and China are economically interdependence.

Several studies show that SCS disputes bring adverse effects on trade. A study by Imam & Panennungi (2021) employs differences-in-differences (DiD) and regression tests to examine the impact of territorial conflicts in the SCS on ASEAN countries' exports to China within the ACFTA framework. Using panel data from ten ASEAN countries between 2004–2015, the findings indicate that the rising intensity of conflicts in the SCS has significantly reduced exports from those countries to China. Drawing from a literature review on the economic consequences of maritime and territorial disputes, Mendoza et al. (2019) illustrate how the SCS conflict could have a detrimental effect on bilateral trade among the countries engaged in the dispute. They estimate that the lost average potential trade between the countries involved might range from US\$ 909.3 million to a substantial US\$ 98.8 billion.

Wang (2015) examines the impact of territorial disputes in SCS on trade between China and the Philippines. The study concludes that territorial disputes have harmed bilateral trade, resulting in a decline in trade volume and an increase in trade costs. As a supporting example of this, a study by Luo et al. (2021) found that Philippine banana and pineapple exports to China significantly dropped by 42% and 88%, respectively after China imposed import restrictions following a naval clash in the SCS in 2012.

However, some studies challenge the mainstream expectations that conflict harms trade. Using a Synthetic Difference in Difference (DiD) method to examine the negative effects of the conflict, Huang and Yang (2023) found no decline in the Philippines' exports to China during 2012–2016. In the same vein, using the Dynamic Multilevel Latent Factor Model, Kong et al. (2023) find that the conflict has no significant negative influence on trade flows, either in the immediate aftermath of the dispute or over the long-run.

From the mentioned studies, we see the gap of the study that while some assessed the negative impacts of SCS issues on trade, others showed no significant detrimental effects. Some studies focus solely on bilateral trade relations, such as those between the Philippines and China, while others attempt to analyze the broader picture of ASEAN-China trade. This study aims to investigate the overall impact of the security conflict on ASEAN-China trade.

The DiD approach, the Synthetic DiD method, and the Dynamic Multilevel Latent Factor Model have been employed in some of the research. They do offer various analytical perspectives. While these approaches have merit, our work utilizes panel data from 2005 to 2021 and analyzes it using the gravity model and generalized method of moments (GMM). The gravity model is commonly used by economic

scholars to analyse bilateral trades. Meanwhile, GMM's flexibility is crucial because the relationship between trade and conflict might be complex. Instrumental variables can address potential endogeneity if political ties influence both trade and conflict. More importantly, GMM is well-suited for panel data analysis, allowing us to exploit information over time (Wooldridge, 2001).<sup>5</sup>

The significance of this study lies in the fact that the ASEAN & China are dependent on each other. Any disruptions or changes in trade patterns due to the conflicts can have a significant impact on their economies (Bhowmik et al., 2021). The SCS disputes have been a major flashpoint in the region and have the potential to hinder the development of ASEAN-China relations and contribute to regional instability. As both represent major trading partners for each other, disruptions in trade resulting from the conflicts could have serious consequences for their economies (Hu, 2021). By focusing on total trade, we can assess the potential damage caused by the conflict from an economic perspective.

## 1 LITERATURE REVIEW AND HYPOTHESIS

The main focus of this study is on how international disputes affect trade values. Hence, the literature review focuses on two points: how trade values are mainly determined and how conflict and trade are correlated. We examine the literature that has already been written to comprehend their dynamics.

Economists employ a variety of methods to analyze trade flows between two countries, one of which is the gravity model of international trade. Similar to physics, trade volume is influenced by the GDP (economic mass) of both countries and inversely relates to their distance from one another (Poyhonen, 1963; Tinbergen, 1962). In other words, larger economies trade more with each other, while greater distance acts as a barrier that reduces trade (Anderson, 1979; Bergstrand, 1985; Helpman and Krugman, 1985).

The relationship between GDP and trade is well developed. Kakkad and Ray (2023) confirm the correlation by analysing the six highest GDPs in the world. Some studies find that the more a country's trading partner's economies grow (higher GDP), the more it exports to them (Vido and Prentice, 2003; Vieira and MacDonald, 2016). When a country's GDP is high, there is more money to spend. In most cases the increasing of export necessitate the involvement of additional material and intellectual resources for the enhancement of production capacities. This leads to increased demand for imported goods and services. As a result, countries with higher GDP per capita tend to import a wider range of products (Bergstrand, 1985; Dutta and Ahmed, 1999). In simple terms, larger imports correlate with a stronger economy and higher income levels. An illustration of this can be seen in Feenstra's research on global trade trends ranging from 1962 to 2000 (Feenstra et al., 2005).

As a general rule, distance is a major factor influencing international trade flows. Generally, countries tend to trade more with their closest neighbors due to lower transportation costs. Transportation costs, including freight charges and insurance, rise as the increasing distance. This phenomenon discourages trade between geographically distant nations, making the trade with closer neighbors more economically viable (Håkanson, 2014). Of course, the level of development of infrastructure (e.g. the capacity of harbors to receive large-scale ships) considerably influences the transport costs. But in general even nowadays the distance also plays a crucial role in the volatility of international trade flows. During periods of the 2007–2009 financial crisis, trade is observed to be more susceptible to fluctuations between geographically distant countries (Mehl et al., 2023).

<sup>5</sup> The choice of an appropriate analytical method is, therefore, important to ensure the statistical models are reliable since a number of methods exist in statistics. For instance, methods such as Fixed Effect Vector Decomposition are suitable for studies that do not have theoretical underpinnings while Multilevel Mixed Models work best with datasets which are balanced and show a hierarchical structure. Because this study has a theoretical basis and the data set is short and unbalanced, the best suit would be the GMM. GMM effectively handles difficulties such as sampling bias, autocorrelation, heteroscedasticity, and endogeneity, while accommodating unbalanced panels and incorporating theoretical constraints.

**Hypothesis 1:** The total GDP of both ASEAN member countries and China will increase ASEAN's total trade with China.

**Hypothesis 2:** Distance reduces ASEAN's total trade with China.

Many studies maintain that trade values are affected not only by GDP, but also by consumer price index, and exchange rate (Arora and Vamvakidis, 2005; Aziz and Horsewood, 2008; Ekanayake et al., 2010; Hibbert et al., 2012). Fluctuations in the Consumer Price Index (CPI) have a direct impact on total trade values. When the CPI is high, it indicates inflation, which can raise the prices of imported products. Hence, countries may experience increased trade costs due to inflation, potentially leading to reduced trade volumes (Gaulier et al., 2008; L. Goldberg and Campa, 2006). A high CPI can increase import costs, affecting a country's trade balance and the affordability of imported products (L. S. Goldberg and Campa, 2010; Vo, 2023).

Another aspect that could positively contribute to trade is exchange rate. Exchange rate fluctuations can have an impact on import prices (Jayasekara, 2022; Y. Wang and Li, 2011). For instance, when the local currency's value rises, it may take less of the currency to buy the same amount of imported products. This can lead to a rise in import costs and certainly an increase in import values (Bakhromov, 2011; Choi and Lee, 2021; Kost, 1976; Krishnan and Dagar, 2022; Schuh, 1974).

**Hypothesis 3:** The consumer price index of both ASEAN member countries and China, as well as the exchange rate of ASEAN country currencies to China's official currency (RMB) will increase ASEAN's total trade with China.

Certain there have been research indicating an additional element that plays a role, namely average duty rate. Average duty rates, which are taxes imposed on imported products, can affect the cost of imports and, consequently, trade value (Pelikan and Brockmeier, 2008). Higher import tariffs would serve as a barrier to imports, potentially lowering import values (Bach and Martin, 2001). An example can be found in the study conducted by Handley et al. (2020), which delves into the repercussions of the tariff increases on U.S. imports between 2018 and 2019.

Similarly, studies indicate that there is a negative correlation between trade and conflict, with higher levels of conflict resulting in lower trade. This happens even when conflicts occur at a lower-level like militarized disputes (Keshk et al., 2004; Kim and Rousseau, 2005) and diplomatic tensions (Keshk et al., 2004; Kim and Rousseau, 2005; Long, 2008; Pollins, 1989a, 1989b; Reuveny, 2001). If there is an expectation of future conflict, companies and governments will be hesitant to engage with potentially violent partners (Gowa and Mansfield, 1993; Morrow et al., 1998).

An economic model by Polachek (1980) reveals that countries with high trade volumes tend to avoid conflict with their trading partners because conflicts disrupt economy. Many studies support this. Long (2008) finds that long-standing rivalries significantly reduce bilateral trade volume. A study analyzing countries involved in wars between 1870 and 1997 suggests that wars clearly led to large losses in trade income (Glick and Taylor, 2005). Martin et al. (2008) found that trade acts as a deterrent to military conflicts, but when conflicts do arise, they disrupt trade and have an impact on economic activities. Similarly, Park (2020) showed that the US-China trade conflict negatively affected both their economies and the global economy. An IMF study revealed that conflicts could significantly reduce official trade, with imports potentially decreasing by 34% ten years after the conflict begins (Novta and Pugacheva, 2020).

**Hypothesis 4:** Simple average duty and Conflict with China will reduce ASEAN members' total trade with China

## 2 METHODS

This study uses panel data that combines cross-sectional and time-series data. These data were obtained mostly from the International Monetary Funds (IMF, 2023, 2024a, 2024b), World Bank (2024), World Trade Organization (2024), DistanceFromTo.net (2024) and CEPII (2011), and Harvard Dataverse. This study used cross-sectional data from China and 10 Southeast Asian countries (country level): Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam, and the time-series data ranged from 2005 and 2022. We used EViews software to perform the statistical analysis.

Nine variables were analyzed in this study (Table 1): 1) ASEAN's total trade with China: the sum of exports and imports of goods and services between ASEAN member countries with China in a year (current million US\$); 2) distance between ASEAN member countries with China: the shortest distance between the capital of ASEAN member countries and the capital of China (km); 3) ASEAN member country total GDP: the standard measure of the value added created by production of goods and services in ASEAN member countries in a year (current million US\$); 4) China's total GDP: the standard measure of the value added created through the production of goods and services in China in a year (current million US\$); 5) ASEAN member country consumer price index: the overall change in ASEAN member countries' consumer prices based on a representative basket of goods and services over time; 6) China's consumer price index: the overall change in China's consumer prices based on a representative basket of goods and services over time; 7) exchange rate ASEAN country currency to RMB: the value of one currency of ASEAN member countries for conversion to China's currency; 8) simple average duty: the unweighted average of the effectively applied rates for all products subject to tariffs (%); and 9) conflict with China: data from Harvard Dataverse: "PRC Assertiveness in the South China Sea" (Chubb, 2021a) covering events through 2015 and "South China Sea Data Initiative" (Sexton and Ravanilla, 2022) for news-based data up to 2022.<sup>6</sup> The data is 'bilaterally' made, e.g. which Southeast Asian countries experienced the conflicts with China.

**Table 1** Variable of the study

Variable	Symbol	Source	Expected sign.
ASEAN's total trade with China (current million US\$)	TRA	IMF	
Distance between ASEAN member countries with China (km)	DIST	DistanceFromTo.net & CEPII	–
ASEAN member country total GDP (current million US\$)	GDP	WB	+
China's total GDP (current million US\$)	CGDP	WB	+
ASEAN member country consumer price index (2010 = 100)	CPI	IMF	+
China's consumer price index (2010 = 100)	CCPI	IMF	+
Exchange rate ASEAN country currencies to RMB	EXC	IMF	+
Simple average duty (%)	DUT	WTO	–
Conflict with China (frequency)	CCF	Harvard Dataverse	–

Source: Own elaboration

What we mean by the conflict variable (CCF) in this study is when China disputed with some Southeast Asian countries in the SCS. We follows Chubb's framework (2021b) in classifying the disputes, namely: declarative, or symbolic claims through statements or maps; demonstrative, or shows

<sup>6</sup> Both datasets are hosted on Harvard Dataverse available at: <<https://doi.org/10.7910/DVN/3Y7NRU>> and <<https://doi.org/10.7910/DVN/GCBWA6>>.



of military power or strategic moves without direct confrontation; coercive, or actions involving threats or force, such as vessel confrontations; and use of force, or direct military engagement or clashes. This study focuses only on "coercive" and "use of force" actions because these concrete incidents, which include blockades, vessel confrontations, and armed clashes, pose an imminent risk of escalation and have the highest potential impact on the strategic choices of Southeast Asian states. By contrast, "declarative" and "demonstrative" actions, such as diplomatic statements or symbolic military activities, are not included because they are unlikely to result in immediate confrontation. Emphasizing high-intensity actions, this study analyzes events with substantial implications for regional geopolitical dynamics. The indicator is marked by the number (or frequency) of conflicts that occurred in the course year.

### 3 DATA ANALYSIS

To assess the key determinants of trade between China and ASEAN countries, we employ the gravity model of international trade. Determinant factors of China-ASEAN trade is assessed using the model:

$$TRA_t = \beta_0 + \beta_1 DIST_t + \beta_2 GDP_t + \beta_3 CGDP_t + \beta_4 CPI_t + \beta_5 CCPI_t + \beta_6 EXC_t + \beta_7 DUT_t + \beta_8 CCF_t + \varepsilon_t. \quad (1)$$

The empirical analysis begins with the Levin Lin Chu (LLC) unit root test before the estimation. The stationarity test was performed to eliminate spurious regression caused using nonstationary time-series data throughout the period:

$$\Delta Y_{it} = \alpha Y_{it-1} + \sum \beta_{it} \Delta Y_{it} - j + X_{it} \delta + v_{it}, \quad (2)$$

where:  $Y_{it}$  is the pooled variable,  $X_{it}$  is an exogenous variable,  $v_{it}$  is the error term.

The unit root test reveals that CPI, CCPI, EXC, and CCF are stationary at the level but other variables are not stationary at the level (Table 2). The non-stationary variables must be transformed into first or second differences to be stationary. As a result, TRA, GDP, CGDP, and DUT are stationary at the first-difference level. Based on the findings of this analysis, the generalized method of moments (GMM) can be employed in this study.

**Table 2** LLC Unit root test

Variable	Level	Significant
TRA	1 <sup>st</sup> difference	-4.7644***
GDP	1 <sup>st</sup> difference	-3.391***
CGDP	1 <sup>st</sup> difference	-9.234***
CPI	At level	-2.000**
CCPI	At level	-3.579***
EXC	At level	-2.241**
DUT	1 <sup>st</sup> difference	-6.536***
CCF	At level	-1.777**

**Note:** \*\*\* significant at 0.01, \*\* significant at 0.05.

**Source:** Own computation

Additionally, the Panel Cointegration Model is used to determine the relationship between the explanatory variables and the TRA. The long-term economic link frequently observed in macroeconomic data with several subjects over a long time (cross-section) was overcome by this regression model (Baltagi, 2005). Cointegration in panel data models generally includes the following, (i) heterogeneity, (ii) unbalanced panels, (iii) cross-sectional dependence, (iv) cross-unit cointegration, and (v) N and T which asymptotic (Im et al., 2003). The following is the Engle-Granger cointegration equation:

$$y_{i,t} = \alpha_i + \delta_i t + \beta_{1i} X_{1i,t} + \beta_{2i} X_{2i,t} + \dots + \beta_{Mi} X_{Mi,t} + e_{i,t}, \quad (3)$$

where: T is the number of observations over time for  $t = 1, \dots, T$ , N is the number of cross-sectional units in the panel, M is the number of regressors,  $\alpha_i$  is the member-specific intercept or fixed-effects parameter, which varies across the individual cross, and  $\delta_i$  is the slope coefficient and member-specific time effect. The hypothesis of the test:

$H_0 : \beta_i = \beta_0$ , there is no cointegration,

$H_a : \beta_i \neq \beta_0$ , there is a cointegration.

Following that, we performed dynamic panel data analysis to avoid serial correlation and heteroscedasticity issues that lead to biased and inconsistent estimates, commonly known as endogeneity problems (Baltagi, 2005). There are two types of dynamic panel data: Generalized Method of Moments (GMM) and system GMM (sys-GMM), but we utilize sys-GMM. The GMM estimator has a weak instrument, namely inefficient if the finite sample size (Arellano and Bond, 1991; Blundell and Bond, 1998). Blundell and Bond (Blundell and Bond, 1998) developed the sys-GMM estimator to solve a weak instrument of the GMM estimator. The simulations of Monte Carlo made by them showed that the system estimator is the most efficient. Sys-GMM uses two approaches. First, it imposes an additional restriction on the initial conditions process, allowing a linear GMM estimator in a system of first-differenced and levels equations to exploit all the moment conditions available. Second, the observed initial values obtain a system that can be estimated consistently by error components GLS under certain conditions.

Formula (1) can be re-written as a dynamic model:

$$TRA_{it} = \beta_0 + \beta_1 TRA_{it-1} + \beta_2 GDP_{it} + \beta_3 CGDP_{it} + \beta_4 CPI_{it} + \beta_5 CCPI_{it} + \beta_6 EXC_{it} + \beta_7 DUT_{it} + \beta_8 CCF_{it}, \quad (4)$$

where:  $\alpha_i$  is TRA time-specific fixed effect,  $\eta_i$  is the country-specific effect, and  $v_{it}$  is the error term.

The coefficient on the lagged dependent variable,  $\beta_1$ , is likely to be biased upward since it is positively correlated with  $\eta_i$ . Arellano and Bond (Arellano and Bond, 1991) suggest that GMM estimator first-differences eliminate the country-specific effect and use all possible lagged levels as instruments. But the first-differenced GMM estimators are likely to perform poorly when the time series are persistent and the number of periods is short. Thus, the sys-GMM estimators is used in this study and may be defined as follows using a system of equations (Arellano and Bover, 1995; Blundell and Bond, 1998):

$$TRA_{it} = \beta_0 + \beta_1 TRA_{it-1} + \beta_2 GDP_{it} + \beta_3 CGDP_{it} + \beta_4 CPI_{it} + \beta_5 CCPI_{it} + \beta_6 EXC_{it} + \beta_7 DUT_{it} + \beta_8 CCF_{it} + \alpha_i + U_{it}, \quad (5)$$

where:  $U_{it}$  is the random term and  $U_{it} = \eta_i + v_{it}$ .

$$\Delta TRA_{it} = \beta_0 + \beta_1 \Delta TRA_{it-1} + \beta_2 \Delta GDP_{it} + \beta_3 \Delta CGDP_{it} + \beta_4 \Delta CPI_{it} + \beta_5 \Delta CCPI_{it} + \beta_6 \Delta EXC_{it} + \beta_7 \Delta DUT_{it} + \beta_8 \Delta CCF_{it} + \Delta U_{it}. \quad (6)$$



The estimate of the equations system in (5) and (6), using two sets of instruments  $Z_i = Z_D + Z_L$  is known as the sys-GMM estimation.  $Z_D$  is an instrument for the model in the first difference and  $Z_L$  is an instrument for the model at a level.

There are two steps of analysis in sys-GMM. The one-step test identifies whether the residuals data at the level are autocorrelated or not by detecting the presence of second-order serial autocorrelation. The test uses the Arellano-Bond for autocorrelation, with a null hypothesis of no autocorrelation. The two-step is the test of exogeneity of all instruments as a group (Baltagi, 2005), and Hansen and Sargan created a test statistic with the null hypothesis that all instruments are exogenous or valid as a group (Sargan, 1958). Thus, a higher test statistical probability value favors the null hypothesis. If the Sargan or AR(2) tests are violated, sys-GMM estimations are likely unreliable.

#### 4 RESULTS AND DISCUSSION

As shown in Table 3, every 1 unit (km) increase in DIST is associated with 7 300 679 US\$ decrease in TRA. This suggests a negative relationship between distance and total trade. A higher GDP is associated with a rise in TRA (0.91947 million US\$ per unit/US\$ increase in GDP). Similarly, a rise in CGDP is linked to a slight increase in TRA (0.002397 million US\$ per unit/US\$ increase). Every 1 unit increase in EXC is associated with 4 837 654 US\$ increase in TRA. DUT has a negative impact, though very minimal, where 1 unit (%) increase in DUT is associated with a -0.000000002 million US\$ decrease in TRA. CPI, CCPI, and CCF are not statistically significant. Hence, we cannot be confident that these variables have a real impact on TRA.

**Table 3** Determinant factors of ASEAN total trade with China

Variable	Coefficient	Std. error	t-statistic	Prob.
Const.	7.62E+10*	4.44E+10	1.716222	0.0879
DIST	-7 300 679*	4 093 054.	-1.783675	0.0762
GDP	0.091947***	0.012633	7.278239	0.0000
CGDP	0.002397**	0.000966	2.480929	0.0141
CPI	-37 227 389	1.72E+08	-0.216407	0.8289
CCPI	-4.10E+08	4.32E+08	-0.950249	0.3433
EXC	4 837 654*	2 870 393.	1.685363	0.0937
DUT	-2.23E+09***	6.82E+08	-3.268639	0.0013
CCF	-9.35E1+08	3.20E+09	-0.292385	0.7703
R-squared	0.509367	Mean dependent var		3.57E+10
Adjusted R-squared	0.486413	S.D. dependent var		3.81E+10
S. E. of regression	2.73E+10	Sum squared resid		1.28E+23
Durbin-Watson stat.	0.051930	J-statistic		1.14E-21
Instrument rank	9			

**Note:** \*\*\* indicates significance at the 0.01 level, \*\* at 0.05 level, and \* at 0.1 level.

**Source:** Own computation

## 5 IMPACT OF THE SOUTH CHINA SEA CONFLICT ON ASEAN COUNTRIES' TRADE WITH CHINA

The SCS, as part of the Southeast Asian region, is China's economic lifelinesphere of interest. Over 60% of China's trades cross the sea, including important the vital imports of energy resources and exports of manufactured goods (Cohn, 2024; CSIS, 2019). Disruptions to trade flows in the SCS could indeed have a devastating impact on China's economy. The SCS is strategically located at the crossroads of major shipping lanes connecting the Pacific and Indian Oceans. The Strait of Malacca, a vital chokepoint within the SCS, carries an estimated one-third of global maritime trade. Control over this strategic waterway allows China to exert significant influence on regional trade flows. This is one of the driver of military fleet development of China (Caverley and Dombrowski, 2020).

China's assertive actions in the SCS, such as land reclamation and militarization of islands, have significantly heightened tensions with ASEAN claimant countries, particularly with the Philippines, Vietnam, Malaysia, and Brunei. These heightened tensions have resulted in numerous military stand-offs, primarily between China and Vietnam, as well as the Philippines (Center for Preventive Action, 2024).

Nevertheless, conflict in the SCS does not really impact the overall trade volume between China and ASEAN. There are several main reasons that explain this phenomenon. First, China has a long history of trading with ASEAN. China and Southeast Asia have traded since the 3<sup>rd</sup> century BC, with the maritime Silk Road connecting their coasts (Stuart-Fox, 2021). As the name implies, silks were the primary trading commodity. During the Sui Dynasty (960–1280 AD), the government "tribute trade" disguised commercial exchange as diplomatic missions. The 15<sup>th</sup> century saw Ming Dynasty voyages led by Zheng He for the display of power and treasure collection, but trade still continued within formal tribute systems. Although private maritime trade began later in the 15<sup>th</sup> century, the overall trade value remained limited. Despite China's efforts to strengthen economic relations with Southeast Asia in the 1950s and 1960s, the Cold War and China's self-reliance policy kept trade volumes modest. Indirect trade existed through Hong Kong and its border trade (the Greater Mekong Subregion). The trade boomed again following improved relations and China's economic reforms in the 1970s. For example, the total trade jumped from \$763 million in 1950 to \$1.9 billion in 1980. China's improved relations with Southeast Asia opened the door for rapid trade growth. Between 1991 and 1995, trade increased by more than 20% annually, and this trend continued into the twenty-first century, spurred by China's WTO membership and deeper economic integration (Swee-Hock, 2007).

Second, "business as usual" becomes apparent, where economic ties persist despite political tensions. Economic activities continue largely uninterrupted despite political or geopolitical friction (Davis and Meunier, 2011). Trade between China and ASEAN countries seems to be primarily driven by economic factors like GDP size and distance, outweighing the potential disruption from the SCS conflict. Countries like Myanmar and Laos heavily rely on China as their primary market for selling their products. Meanwhile, China predominantly requires raw materials and agricultural products from ASEAN countries. Cambodia, Indonesia, Vietnam, and Myanmar depend on China for imports (Marks and Yau, 2019).

In the last decades, the most important products traded between ASEAN and China are manufactured products, especially electronics and machinery (Table 4). In 2022, most of what ASEAN bought from China (around 80%) were industrial supplies for manufacturing, construction, and technology. This included electronics, machinery, chemicals, plastics, and aluminium. As the biggest partner to ASEAN, China keeps the region's factories, building sites, and tech companies running smoothly by supplying them with what they need. On the other hand, over half of ASEAN exports to China in the same period were electronic equipment and metals like ferronickel and stainless steel. Other important exports included coal, plastics, rubber, and even some agricultural products such as palm oil and fruits. The economic ties between China and ASEAN reached new heights in 2023, with bilateral trade ballooning to a remarkable USD 911.7 billion. This significant trade volume solidifies their positions as each other's largest trading

partner for the fourth year running (Asean-China Mission, 2024). This mutually beneficial trade relationship fosters interdependence, potentially serving as a strong incentive for maintaining stability between the regions. Economic integration offers advantages for both parties. ASEAN countries gain access to the vast Chinese market, facilitating export growth and potentially attracting foreign direct investment. China benefits from a reliable source of raw materials and a growing consumer base within ASEAN (Z. Hong, 2013).

**Table 4** Top ten traded products between China and ASEAN in 2022

HS	Top ten ASEAN export commodities to China	Million US\$
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers; television image and sound recorders and reproducers; parts and accessories of such articles	89 361.7
27	Mineral fuels; mineral oils and products of their distillation; bituminous substances; mineral waxes	29 205.2
72	Iron and steel	20 255.1
84	Nuclear reactors; boilers; machinery and mechanical appliances; parts thereof	20 029.2
39	Plastics and articles thereof	12 158.8
40	Rubber and articles thereof	10 309.2
15	Animal or vegetable fats and oils and their cleavage products; prepared animal fats; animal or vegetable waxes	9 184.9
8	Fruit and nuts; edible; peel of citrus fruit or melons	8 012.5
29	Organic chemicals	7 906.9
90	Optical; photographic; cinematographic; measuring; checking; medical or surgical instruments and apparatus; parts and accessories	7 712.6
	Top ten exports	214 136.3
	Others	76 630.2
	Total exports	290 766.5
HS	Top ten ASEAN import commodities from China	Million US\$
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers; television image and sound recorders and reproducers; parts and accessories of such articles	136 656.0
84	Nuclear reactors; boilers; machinery and mechanical appliances; parts thereof	68 016.9
27	Mineral fuels; mineral oils and products of their distillation; bituminous substances; mineral waxes	19 458.2
39	Plastics and articles thereof	19 288.9
72	Iron and steel	17 135.2
73	Iron or steel articles	14 025.1
29	Organic chemicals	13 109.7
38	Chemical products n.e.c.	10 871.1
87	Vehicles; other than railway or tramway rolling stock; and parts and accessories thereof	10 251.1
76	Aluminium and articles thereof	8 566.7
	Top ten imports	317 378.9
	Others	113 957.7
	Total imports	431 336.6

Source: ASEAN Secretariat (2023b), aggregated for all ASEAN countries

Third, it should also be noted that while the disputes directly involve several member countries, not all are claimants. China always emphasises that the SCS issue is not a dispute between China and ASEAN, but rather a dispute between individual claimants. Vietnam and the Philippines are the most vocal claimants, with Brunei and Malaysia also having territorial claims. Indonesia occasionally gets involved due to Chinese activities in the Natuna Sea, which it considers its territory. The remaining ASEAN members, geographically distant from the contested waters, do not have claims (Center for Preventive Action, 2024; N. Hong, 2012). Thus, the dispute should be resolved bilaterally between China and individual ASEAN claimant countries, rather than through ASEAN as a whole (Wen et al., 2016; Yan, 2024). This allows China to offer economic benefits, such as increased trade or investment, to individual countries in exchange for concessions on maritime claims. This tactic can be particularly effective for smaller ASEAN member countries heavily reliant on Chinese trade.

This diversity in interests hinders the formation of a singular ASEAN voice to criticize China. Member countries with no direct stake in the disputes may prioritize maintaining good economic relations with China. China, on the other hand, has been accused of exploiting it by offering economic incentives to non-claimant countries in exchange for their support. A prime example is Cambodia, a close political and economic partner of China. China's significant investments in Cambodian infrastructure and its promotion of production capacity cooperation are believed to influence Cambodia's stance on the SCS issue (Ciorciari, 2013; Ziwen, 2024). This was evident, for example in 2016 when Cambodia, following the Permanent Court of Arbitration's ruling in favor of the Philippines, blocked any mention of the ruling in an ASEAN foreign ministers' meeting (Martina and Blanchard, 2016).

The varying territorial claims of ASEAN member countries with China create obstacles for the organization to adopt a cohesive stance on the SCS disputes. China's strategic leveraging of economic influence on non-claimant countries adds another layer of complexity, hindering ASEAN's efforts to present a unified front. Consequently, ASEAN encounters a substantial challenge in achieving consensus in its approach towards disputes (Ian, 2023; O'Neill, 2018).

Fourth, the final reason is a lack of integration in ASEAN trade relations. The ASEAN Economic Community (AEC), which was formed in 2015, is expected to create a more integrated economic region in ASEAN. Previously, ASEAN already established ASEAN Free Trade Agreement (AFTA). At the time, the challenges remained in addressing non-tariff measures. Thus, the AEC aims to reduce both tariffs and non-tariff barriers to enhance regional trade integration featuring a single market and production (Duval and Feyler, 2016). The AEC has created a larger market in ASEAN, thereby strengthening trade and competitiveness in member countries. However, the AEC also failed to reduce ASEAN countries' trade with non-member countries (Jamhari et al., 2021). For example, intra-ASEAN trade would reach 22.3% by 2022, whereas China accounted for 18.8% of overall ASEAN trade, or only 3.5% more (ASEAN Secretariat, 2023a).

The Association upholds the ASEAN way, a main norm in ASEAN that prioritizes non-intervention among members and non-binding consensus. Yet, with this non-binding principle, ASEAN is a weak institution. With an agreement that has no force, members with different opinions will not face any repercussions. Indeed, the emphasis is on maintaining regional unity despite differences of opinion. Personal relationships between leaders are more influential than formal rules. This consensus norm is good rhetorically but comes at the expense of strong institutions. When this turns into the economy, intra-ASEAN, and extra-ASEAN economic practices show that this norm hinders deeper integration within ASEAN. Fellow ASEAN member countries continue to compete – rather than cooperate – to attract investment from external partners. This creates a limited and bureaucratically rigid pattern of interaction between governments (Das, 2013; Jones and Mei, 2019).

## 6 IMPACT OF THE OTHER VARIABLES ON ASEAN COUNTRIES' TRADE WITH CHINA

GDP have significant impact on trade, especially exports. Exports and GDP have a reciprocal relationship where a rise in exports boosts a country's GDP. A panel analysis of ASEAN countries found that a 1% increase in exports leads to a 0.479% increase in GDP (Pheang et al., 2017). However, GDP expansion will boost ASEAN and China exports volume, continuity, and duration. The higher a country's GDP, the steadier its exports will be over time. This is because income increases in partner countries, which will consequently increase the demand for imported products (Badreldin and Abdulrahman, 2021). Another factor is that high GDP levels are typically utilized to subsidize local companies in developing countries. For example, cases in other countries, Kenyan coffee businesses benefit from export subsidies. A 10% export subsidy has a substantially higher influence on coffee production, potentially reaching 26.3% in the short-run. Export subsidies could have a significant impact on coffee exports, whether green (32.3%) or roasted (7.9%) (Aragie, 2018). A rise in GDP will also result in higher employee salaries and, as a result, higher labor productivity.

The price volatility can create uncertainty for both producers and buyers, affecting product trade. As consumer prices or inflation rise (CPI), domestic products in ASEAN become more expensive than imported products. Hence, imported products will more easily enter a country and be liked by consumers. However, product inputs and outputs have gone up in price, making products more expensive. As a result, production costs are greater than usual, and overall demand is lower. CPI increase has slowed output and income growth, making it difficult for producers to buy inputs in sufficient amounts. Inflation also discourages investment in China-ASEAN, particularly across all sectors (Nugroho et al., 2022).

The effects of a country's currency volatility (EXC) may generate swings in product demand on the worldwide market over time. Hence, a country is projected to be resilient in the foreign exchange market, with its currency remaining stable. This will boost investment in domestic sectors and the TRA (Singh et al., 2021). The depreciation would enhance export volume and value-added, replacing imports. The depreciation also makes ASEAN and China products relatively cheaper, resulting in increased exports due to higher foreign demand. Meanwhile, the appreciation leads import volume to rise but the export volumes will fall if the currency appreciates because exporters' revenue would be lower (Touitou, 2015).

Import tariffs (DUT) have no substantial impact on TRA. Changes to DUT between China and ASEAN boost aggregate output and added value. This occurs when tariffs for intermediate inputs shift, enabling more and cheaper access to inputs and foreign raw material suppliers (Chao et al., 2006). However, lowering import duties on finished products will have the reverse effect. Total imports will expand faster than exports, causing the real trade balance to worsen (Evtееva et al., 2019). The second issue is that the DUT used by China-ASEAN swings so much that it fails to achieve the effective rate of protection (ERP) and hence cannot boost TRA. The final reason is that developing countries do not properly regulate DUT since they require these products. For example, to meet its domestic food demands, China must import soybeans, wheat, dairy products, and processed meat. Instead of imposing import charges, China prefers to import as many agricultural products as possible (Qiang et al., 2019).

## CONCLUSION AND RECOMMENDATION

The South China Sea presents an interesting paradox: the sea is a crucial economic link for China but also has the potential to cause unrest. The volume and nature of commerce, together with the long history of commercial exchange, have incentivized both parties to emphasize cooperation. ASEAN member countries have become customer bases and raw suppliers for China. China is the source of ASEAN's manufactured products.

This study examines the impact of the SCS conflict on China-ASEAN countries' trade. The Generalized Method of Moments (GMM) was used to examine data collected between 2005 and 2022 from China

and 10 Southeast Asian countries. The findings show that the SCS conflict had no impact on ASEAN countries' trade with China. This is due to the fact that China has a long history of trade with the Southeast Asian region, trade is primarily driven by economic factors that outweigh the potential disruption of SCS conflicts, not all ASEAN members are claimants in the dispute, and a lack of integration ASEAN internal trade especially in the ASEAN Economic Community.

From the gravity model perspective, the distance between ASEAN member countries with China diminishes ASEAN countries' trade with China. Import tariffs also have a negative impact, but not significant. Meanwhile, the ASEAN member country's total GDP, China's GDP, exchange rate of ASEAN country currency to RMB raise ASEAN countries' trade with China. The other three explanatory factors that do not affect ASEAN countries' trade with China are China's consumer price, ASEAN's consumer price, and conflicts in the Sea.

As this study highlights that the trade remains strong despite the ongoing disputes, it challenges the realism theory which views that international conflict hinders economic cooperation. This may emphasize the fact that China and ASEAN are interdependent, where economic ties are more important than political disputes. For the sake of economic cooperation, policymakers should consider a specific policy to reduce the distance cost: 1) strengthening transport infrastructures to promote efficiency of product distribution (an example would be through the current Belt and Road Initiative); 2) given their reliance on labor-intensive sectors, ASEAN governments should emphasize raising labor force productivity to further expand exports and accelerate GDP; and 3) ASEAN and China must collaborate to maintain exchange rate stability.

One limitation of this study is the lack of an in-depth analysis of the South China Sea dispute's impact on China-ASEAN trade. The dataset is also limited to data up to 2022. Future research should use Difference in Difference analysis to determine this impact, extending post-2022 data. This could also help to explore, for example, COVID-19's long-term impacts and integrate trade sentiment indices to assess perceptions and risks in ASEAN-China trade.

The territorial issues are subordinated to economic pragmatism. The future of this cooperation is indeed uncertain, particularly given how dynamic the current global political economy is. But to ensure the continuity of the ASEAN-China trade relations in the long run, policymakers from both parties should work on developing frameworks with harmony in trade objectives and sustainable conflict resolution strategies. Deepening economic integration through consolidating bilateral or multilateral trade agreements should be one of the efforts. Maintenance of already existing frameworks would have a soothing effect and make the trade relations resilient against continuous geopolitical tensions.

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