**PH-CHINA RELATIONS: DOING BUSINESS AS USUAL IN UNUSUAL TIMES**

**Remarks by Ambassador Roberto R. Romulo**

The Manila Times Business Forum

29 October 2014

 Those of you who may have come across my column Filipino Worldview (which appears in another daily I will not mention) will recall that I have been writing about the South China Sea/West Philippine Sea issue since it flared up in 2012. No issue challenges the nation more on a continuous basis. It is always a constant presence in the news headlines. It yields ground to the occasional political scandals or natural disaster but always resurfaces. Oftentimes it manifests itself in other areas of our bilateral relations with China, but more particularly our economic exchanges.

 Our Department of Foreign Affairs has been asserting that an agreement in 2011 between President Benigno Aquino and then President Hu Jintao is what guides Manila’s relations with Beijing.

 “Both countries should not let the territorial dispute affect the overall relationship. So on the part of the Philippines, we are willing to extract and isolate our territorial dispute and deal with this separately, but at the same time we try to promote and strengthen the other areas of our cooperation with China,” said the DFA. Finance Secretary Purisima said as much during the World Economic Forum held in Manila last May as has DTI Secretary Gregorio Domingo – I suspect both in hope rather than in fact.

 Based on what has happened over the last couple of years, the operative part of that statement has not been “both countries should” as fervently wished for but the phrase “on the part of the Philippines”. Take for example, the China’s recent decision to ban tourist travel to the Philippines citing the need to protect its citizens following a couple of incidents involving the kidnapping of Chinese nationals and a failed and ultimately comical plot to bomb the Chinese Embassy. But the safety of Chinese nationals is a perennial problem and has not drawn that harsh a reaction in the past. I for one believe that it is no concidence that the travel advisory came on the heels of the President’s visit to Europe to drum up support for our position in the dispute. Last week the 11th China-ASEAN Exposition, a huge trade show opened in Nanning, China, focusing on promoting ties between ASEAN and their largest trading partner, China. However, for the second year in a row, President Aquino is not joining his ASEAN counterparts, following another tense year in the South China Sea. Not all ASEAN members are able to have their leaders participate but last year the Philippines was the “country of honor” and as was the norm, the President was to act as “host”. However, at the last minute, in a pointed display of pique, the President was – depending on whose version - either disinvited or was not invited in the first place. In another telling show of irritation, another major event in Philippine-China economic relations, the annual joint trade and investment committee meeting which has been going on since 1977, while not formally suspended, has not been convened for the last two years.

**Status of Today’s Relationship**

 Clearly China is unwilling to separate territorial dispute – or more specifically the filing of an arbitration case with the UN Permanent Arbitration Tribunal – from other aspects of our bilateral relations. On the ground, business to business dealings will be as normal as possibly can – as several of your speakers with such daily exposure to China will attest to. Imports and exports volumes may indeed expand – but a closer look at the composition of that trade shows that much of that momentum is generated by the global value chain – intermediate inputs from various countries assembled into final product in one country. More than half of our exports to China is made up of electronic components where trade is governed by multinationals. Where the Chinese government has a say – such as in the imports of bananas – it will have no hesitation to place sanctions when it sees an excuse to do so, never mind if it is flimsy. As far as Philippine imports from China are concerned, the authorities will not place any barrier on their businessmen making a buck and so its pace will be determined by demand from the Philippines. But even in the best of times, the Philippines still lagged behind its ASEAN partners in the volume of two way trade ranking last among the ASEAN-5 with only a third of Malaysia’s total trade with China.

 In terms of investments, in 2013 the Philippines only captured less than 2% of Chinese investments in ASEAN, the second lowest after Brunei. Indeed, the last major investment by a Chinese company in the Philippines was the $1.6 billion stake by the State Grid of China in the National Grid Corporation of the Philippines which won the bid to operate power distribution in the country in 2007. Since then there has been sporadic participation by Chinese firms in various infrastructure projects though not of the same magnitude. Interest in investments have from time to time surfaced but so far nothing of siginifcant scale has been realized. On tourism, we may boast of the growth of Chinese tourists from virtually zero ten years ago to more than 400,000 in 2013. But this pales in comparison to the two to three million average of Chinese tourists to Malaysia and Thailand. Now they are down to a trickle. On scientific and technical cooperation and on agricultural technology transfer arrangements, new projects have virtually ceased.

 The poor performance of Philippine economic relations with China relative to our ASEAN neighbors in the past can be attributed to a combination of hesitancy in trusting our economic future in China and our own anemic economic growth. But it does point out the huge potential for us. Unfortunately, now that we are in a position to take advantage of China’s potential, our diplomatic relations are at a historic low. Achieving the level of engagement of the other ASEAN economies with China will just have to wait until another day.

 We can expect that until relations return to normalcy, that from time to time China will impose sanctions on trade and on tourism. Anything that is government driven or supported – like concessional loans, major investment decisions or technology transfer projects in agriculture and the sciences - will be placed on hold or at least significantly scaled back. While careful not to harm people-to-people relations and allow Chinese business to go where they can make profits, they take the cue from government and will also be constrained from being more aggressive in investing in the Philippines.

 Doing business in China even in the best of times has not been as straightforward as one is accustomed to in other parts of the world. Yet you, the business community have demonstrated that this is possible to do business and indeed even thrive under the present circumstances. I think in addition to your excellent insight into the Chinese business mindset it also helps that it serves China no purpose to damage people-to-people relations. So the subject of my remarks is not so much how you can continue to do business in China inspite of the parlous state of our relations. Rather, given the Chinese government’s ability to determine the state of our economic relations with them when and under what circumstances can our political relations be restored to even the modest goal of what they were before the Scarborough/Panatag Shoal incident in 2012. It will probably take more time to reach the so far high water mark of Philippine-China relations when in 2009 when the two sides signed the Joint Action Plan for Strategic Cooperation between the Philippines and China, an action-oriented five year roadmap covering almost all areas of cooperation, from political, economic and trade, cultural and people-to-people relations. The two sides declared that the Plan would also serve as “a guide for all agencies of both countries in the implementation of policies and programs to elevate bilateral cooperation in all areas to a higher and more comprehensive level”. The love fest by the two governments seemed so long ago when it has only been three years since.

**The Future: Facing The Realities of China’s Pre-eminence**

 Why should we care to bring our relations to normalcy? China’s inexorable rise as the preeminent power in East Asia is a reality that we have to accept and hence engagement and mutual-accommodation is unavoidable. With China becoming a global economic superpower, it will have enormous influence on our economic well-being – as a market for our products, as a crucial source of investments, and of technology. And so while it is correct to evoke principles of international law to condemn China’s perceived “bullying” behavior, it must not be forgotten that the goal of diplomacy is not about gaining moral victory but rather achieving an outcome that promotes the national interest. Given the importance of China to us means following a course that allows us to manage tensions, re-build ties, and envision a future marked by cooperation rather than conflict.

 Why should China care to avoid tension and bring our relations back to normal? Violent confrontation and bullying behaviour will damage the image it has carefully nurtured over the years as a good neighbor focused on developing its economy. It will have a chilling effect on relations with ASEAN and will certainly make China in the eyes of the U.S. and Japan a hostile nation that cannot be trusted to follow international norms of behaviour and therefore needs to be contained. This in turn will do great harm to China’s economy and threaten its leadership’s longevity in office.

 So how do we go about creating an environment where compromise is possible and nobody loses face? My view is that the first step is to clarify the issues that are driving the competing claims of sovereignty over these rocks and shoals. Only by understanding the dynamics in place can appropriate responses be developed. For China, there are two outstanding issues here: one is access to energy resources and the other is strategic concerns. The recent crises in northern Africa and the Middle East have raised concerns about supply stability. Distance from sources also means the long shipping route makes them vulnerable to disruption. Under these circumstances, it has become imperative for China to search for oil closer to “home”.

 The strategic concerns have to do with guaranteeing China’s unhampered access to the Pacific and Indian Oceans where ships carrying its exports pass on their way to markets and where tankers and bulk carriers laden with its imports of oil and minerals sail through on their way to Chinese ports. China wants to have the ability to control passage through the South China Sea rather than leaving it to the de facto guarantor of freedom of navigation there – the United States with its 7th Fleet. States adjacent to the South China Sea are wary of China’s intention and see that of the U.S. as more benign.

 The Philippines likewise needs the hydrocarbon believed to be under the waters of the South China Sea. But since the extent of this resource is still unproven it is driven more by the more immediate goal of protecting its territorial integrity and preserving its traditional fishing grounds. For the Philippines, it sees China’s aggresive actions in the area as one of invasion and occupation thus stoking high emotions and patriotic fervor. Vietnam shares the same aspirations and fervor but with one important difference. What complicates our position is that because of our lack of military wherewithal to defend our claims, we have unabashedly invoked the American mantle of protection, thus inconveniently placing us squarely on the U.S. side of the freedom of navigation equation. That is a just and popular cause as I mentioned earlier except that from Chinese view we have become an accomplice of what they perceive as part of a strategy to bottle them up - with us in the south and with Japan in the north – thus giving them another angle to justify their actions. Vietnam is not similarly encumbered and so having the luxury of not taking sides it has the flexibility to tailor its response to China’s actions in the disputed waters.

**Chinese Public Support**

 Aside from these substantive issues, it would also be well to understand China’s current internal political dynamics. We don’t need to accept it but recognizing them helps to calibrate our response. First, we should not make the mistake that the notion of indisputable sovereignty over the South China Sea is solely attributable to China’s leaders or ideologues. To quote one Sinologist: “There is near-universal support among China’s public for its claim over this large area , with little understanding of the principles of contemporary international law, continental shelves, or exclusive economic zones. Instead, Chinese public support for these claims has developed through the education system, where students are taught that Chinese authority over this area extends back to the Chin Dynasty. Despite the weakness of historical claims, they have a strong hold over the imagination of the public and this support makes it impossible for any Chinese government to make concessions on what are considered issues of sovereignty. Compromise in this situation would be perceived as a betrayal of national sovereignty.” China President Xi Jinping is quickly consolidating his power since he took over from Hu Jintao in 2013. Given the current state of the public mindset on the Spratly Islands issue, it would be difficult to imagine a major shift in China’s position on this issue until the new leadership is confident enough to make bold decisions that run counter to long held beliefs without being run out of office.

**The Challenge of Our Leadership**

 This mindset is not uniquely Chinese. Although President Aquino has little danger of being run out of office, he still has to keep in mind that the majority of the Filipino people as well as the legislature and civic society want him to stand fast and resists resist Chinese bullying. For the public, this resonates as an issue of safeguarding our sovereignty from foreign occupation more than a fight for oil or for fish.

 Joint development seems to offer a feasible alternative. Chinese leaders in the past, from Deng Xiaoping to Jiang Zhemin and to Hu Jintao, have all proposed shelving the sovereignty issue and pursuing joint development of resources. President Xi Jinping himself has been quoted as saying that claimants “should work together to strengthen dialogue and communication, advance maritime cooperation and joint development to maintain peace and stability in the South China Sea".

 Joint resource development could mitigate conflict and reduce tensions, and bring about an environment conducive to constructive resolution over the long term. For the Philippines, the benefits would also include attracting much needed investment and obtaining the necessary technologies – China has deep sea drilling capability - to fully exploit its resources. For China, this would provide a readily available source of energy at its own backyard. By engaging in joint development with a neighbor with whom it has maritime and territorial disputes, China can shore up its image as a good neighbor and a responsible [regional and world power](http://www.eastasiaforum.org/2012/05/07/asias-geo-political-future/). This collaborative approach will also allay the fears of other claimants and those who use the water for passage that China is out to gain complete and exclusive control of the South China Sea.

 Will this work in practice? In 2005, China and the Philippines (joined later by Vietnam) signed a Joint Marine Seismic Undertaking (JMSU) agreement that coordinated "pre-exploration" of possible hydrocarbon reserves in the Spratlys. The JMSU was not extended when it expired because of nationalist sentiments in the Philippines - which coincided with the corruption scandals involving Chinese projects in the country.

 In 2012, Manuel V. Pangilinan went to China to dialogue with the state-owned China National Oil Corp. (CNOC) regarding a potential joint exploration and development arrangement for his company’s – Forum Energy - concession in the Recto Bank. Pangilinan earlier explained that the partnership with CNOC could boost financial and technological support for the project and, at the same time, serve to “depoliticize” the concession area. This commercial arrangement made between corporations and bypassing direct government to government talks seems like a promising start to a model for a win-win solution. Such a joint venture is an option that China has consistently supported. China’s ambassador in Manila told a local newspaper it would be better for Forum and CNOC to get to work, instead of letting the reserves sit untouched while the two countries sort out their differences.

 However, the devil is in the details. The Philippines has said it would support a Philippine-Chinese partnership in the region, provided it conformed to Philippine law, meaning parties would have to follow the 60 percent locally owned-to-40-percent foreign owned rule, among other requirements. President Aquino said recently he supports a joint partnership as long as royalties would go to the Philippines. It is this question of royalties that poses the biggest challenge to a joint drilling partnership. From the Chinese perspective, the implications are that if it follows Philippine laws and regulations, then to some extent, it is conceding the sort of sovereign right to the Philippines in what it considers their waters. The proposed joint venture has been on hold up to now and with the arbitration case expected to last several years, now finds itself in limbo. Forum’s earlier attempt to drill in its concession in 2011 was disrupted by Chinese vessels and while it has announced it will drill again in early 2016, the question remains as to whether it will have the capability to do so and whether it will not invite Chinese interference unless the joint venture comes into existence by then.

**China’s Insatiable Demand: Abuse of Small Scale Mining**

 Our experience as a recipient of Chinese investments also points to another potential pitfall. As everyone knows, China continues to reach out overseas for minerals needed to fuel its dramatic economic growth, and long-term prospects show that it will only become more aggressive in its pursuit of mining deals abroad. Our estimated US$1 trillion-worth of untapped mineral reserves has seen a notable influx of Chinese mining investments in recent years. For the Philippines, Chinese money from legitimate mining companies has been a welcome relief for its troubled mining industry that has seen a flight of investment from Western mining giants on top of a growing list of stale and frozen projects. Unfortunately, most of these investments have been in small-scale mining and substantial evidence points to unaccountability, misconduct, and corruption in many Chinese mining deals. Most Chinese mining firms operate under the cover of domestic small-scale miners to bypass Philippine mining laws and protocols, as well as to avoid the large capital requirements, fees, and taxes associated with large-scale mining. The Chinese firms circumvent the enormous time and expense of complying with large-scale mining requirements by co-opting a Philippine proxy and purchasing small-scale mining permits or special ore extraction permits for a minimal fee.

 These activities may seem like penny ante but the volume is staggering. The Philippines is already the largest provider of nickel ore imported into China, and the leading provider of gold imported into Hong Kong. Few experts believe the volume of gold and nickel ore going into these territories could be achieved by legitimate mining operations. For example, the volume of gold exported to Hong Kong recorded by Philippine government agencies is only 3% of that recorded by Hong Kong authorities meaning that there is enormous amount of smuggling going on resulting in massive tax losses for the Philippines. This also means that because these operations are largely unregulated, these result to the degradation of the environment and only made possible with the help of corrupt government officials.

**Conclusion**

 In conclusion, I have no magic solution to this issue other than to preach the virtues of patience, perseverance, recognize the importance of “face” and appreciate what is going on internally in China. Avoiding harsh rhetoric and maintaining a level of subtlety and restraint even when addressing domestic audience would be helpful. Aligning ourselves with the U.S. and Japan and getting world opinion makes a great deal of sense but should not be done in a public and provocative manner that will arouse hawkish reaction and fuel nationalism from the other side. Flexibility is also called for – in our position and in our mode of negotiations - something which Vietnam has done very well with. We should be careful not to paint ourselves into a corner much as China has done with its nine-dotted line argument. Finally, we should speak with one voice but we must also use alternate channels of communicating with the Chinese side. This means that plurilateral fora should not be the sole means of negotiating with China – bilateral talks serve a purpose including providing as a stepping stone and confidence builder for multi-party talks needed to guarantee compliance.

 The offer of leaving the sovereignty issue aside and pursuing joint development seems the best way out at this point in time. The use of commercial arrangements as a device to go around politically sensitive issues should be explored. Nationalist sentiments must give way to pragmatic solutions – such as on the issues of royalties - that address immediate economic and security concerns without giving up our claim which international law supports. While this approach will directly resolve the energy issue for China, it also paves the way for an atmosphere conducive to addressing its strategic concerns relating to freedom of navigation.

 The arbitration case presents an obstacle and an opportunity at the same time. With the current dynamics, there is little likelihood that the Philippines will withdraw its arbitration case nor of China participating in the process. The Philippines says it will abide by the ruling of the Tribunal. But China has already said it will not even if the tribunal rules against the legitimacy of its nine-dash line. It has shown time and again that while it will prevent it to the extent possible, it is prepared to sacrifice global condemnation to preserve its domestic agenda. The timing of the arbitration process presents an opportunity for both sides to save face. A ruling is not expected until 2016, about the time of the Philippine Presidential elections. The Chinese have cast President Aquino as chief architect of the Philippine policy in the South China Sea and his diplomat-in-chief, Foreign Secretary Albert del Rosario as his chief advocate. The question arises: With their exit from the scene will both sides find an opportunity to change tack (as in sailing terms) to counter the headwinds and move forward. Unfortunately, my crystal ball doesn’t look that far. Or as Tonto said to the Lone Ranger :”Quimo Sabe” Who Knows???