

# The South China Sea in the Broader Maritime Security of the Indo-Pacific: The Economic Context for Regional Conflict and Cooperation

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## Introduction

The long-running tensions in the South China Sea involve conflicting claims by regional economies (Brunei, China, Indonesia, Malaysia, the Philippines, Taiwan, and Viet Nam). The claims are to the rights to the control of passage in the South China Sea, to the small rocky outcroppings and sandbanks, and to the marine resources. The different national positions – lines drawn in the shallow sea – have sometimes been aggressively pursued, including by having coast guard and/or naval vessels harass vessels of other countries, or taking control of islands, or even constructing islands. While generally non-lethal, it has not always been so. The present low-level conflict has had identifiable if transitory impact on the existing patterns of trade. Moreover, we risk slipping into real conflict that could result in drastically limiting trade and economic growth throughout the region.

Over decades there have been aggressive acts between different pairs of countries. Currently the most severe involve disputes between China and members of the Association of Southeast Asian Nations (ASEAN), especially the Philippines and Viet Nam. This is due to many reasons, including China's geographic centrality and size, the nature and extent of the several nations' claims, and the huge growth of the Chinese economy and the fishing, coast guard and naval fleets.

Table 1 provides a framework to examine the disputes by listing some of the issues or problems nations grapple with in the South China Sea. The table is organised to make the point that some issues encourage competitive behaviour, some cooperative. Thus 'enforcing sovereignty, control of territory' means that you want to be acknowledged as the *sole* governor of some piece of sea or land and sharing would diminish your gains. In contrast, any action you take to combat piracy would likely be enhanced by cooperative actions with your neighbors.

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The notion that some national interests in the South China Sea can be met more effectively through cooperative behaviour can be put into perspective by reviewing the economic context within which the South China Sea claimants operate. These countries very much depend on the economic health and wellbeing of each other. As a corollary, the ongoing disputes that threaten to drift into military conflict are placing at risk the extraordinary record of growth and development seen during the past few decades.

**Table 1: Policy Issues Motivating National Behavior in the South China Sea**

<b>Zero-Sum Issues: Issues Encouraging Competition</b>
Providing strategic space for security forces
Enforcing sovereignty, control of territory
Projecting an image of strength
Accessing mineral, especially energy, resources
Disaster relief
Protecting the environment, reducing water pollution
Counterterrorism
Controlling illegal trade, trafficking in people, and smuggling of controlled goods and substances; enforcing sanitary and phytosanitary customs rules
Combating piracy
Appropriating fishery resources, reducing illegal, unsustainable fishing
Ensuring freedom of transit and travel
Preventing the spread of pandemic diseases
Increasing trade
<b>Positive-Sum Issues: Issues Encouraging Cooperation</b>

Source: Modified from David Jay Green, *The Third Option for the South China Sea: The Political Economy of Regional Conflict and Cooperation*, Palgrave Macmillan, forthcoming 3 Oct. 2016, Table 6.1 and Appendix B.

The paper argues three points:

- a. The economies of the South China Sea depend on regional trade flows that would not survive military conflict.
- b. The *wealth* – oil, gas, and fishery resources – that might be gained from waging and winning military conflict are largely illusory and pale in comparison to the economic costs of conflict.

- c. Regional economic cooperation programs, similar to those the South China Sea claimants currently participate in, could potentially enhance the benefits of waging peace through increased trade.

### *The Interdependence of the South China Sea Economies*

East and Southeast Asia have seen considerable economic growth over the past few decades. The pace of development in China has been virtually unprecedented, with millions of people being raised above severe poverty to a middle-class lifestyle. This outcome has resulted from national investments in human capital and infrastructure and policies that have encouraged business growth and trade. The last is important – these are countries that believe that international trade can be leveraged into national development.<sup>2</sup> This faith has been vindicated in the emergence of *Factory Asia* – the spread of global value chains (GVCs) across the region, providing assembly and intermediate manufacturing for a range of products destined for global markets. Initiated by Japanese foreign direct investment (FDI), the process was encouraged by technological changes that lowered oceanic freight costs. This uncoordinated, but cooperative international effort transformed the East and Southeast Asian economies. The willingness of businesses to invest in GVCs presupposes that trade can occur relatively unfettered. Serious conflict would not allow trade as usual.

### *Trade between the ASEAN claimants and China has grown sharply*

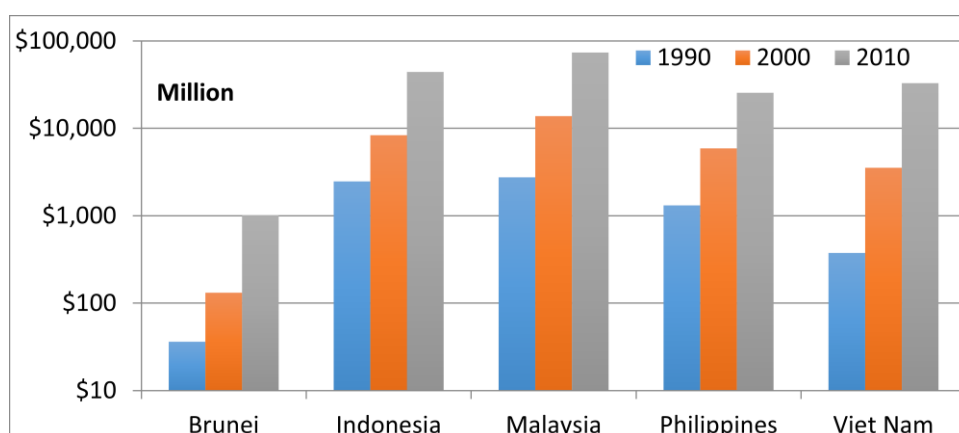
Much of the growth in trade in Southeast Asia has been directed to and from China. Figure 2 depicts this rapid growth. “China, the world’s second-largest economy, consistently appears among the top five trade partners for ASEAN members.”<sup>3</sup>

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<sup>2</sup> David Jay Green, ‘The Role of ASEAN Economic Community as a Commitment to Policy Certainty’, in *ASEAN Economic Bulletin*, vol. 25, no. 2, August 2008, pp. 209-227.

<sup>3</sup> Nargiza Salidjanova and Iacob Koch-Weser, ‘China’s Economic Ties with ASEAN: A Country-by-Country Analysis’, U.S.-China Economic and Security Review Commission, Staff Research Report, March 17, 2015; available from <http://origin.www.uscc.gov/sites/default/files/Research/China's%20Economic%20Ties%20with%20ASEAN.pdf>

Figure 2: Total Trade with China and Hong Kong



Notes: Asia Regional Integration Center website (<https://aric.adb.org/integrationindicators>) citing International Monetary Fund Directions of Trade. Values are the average of the reports from Hong Kong and China and from the trading partner for the sum of imports and exports.

This trade has continued in spite of occasional flare-ups in the South China Sea disputes. However, some clearly linked interruptions, though transitory, point in the direction events could take if tensions worsen. As one example, after the May 2012 standoff at the Scarborough Shoal between China and the Philippines, imports of fruit from the Philippines were held up in quarantine and scheduled airline flights from China to the Philippines cancelled, disrupting tourist travel.<sup>4</sup> More seriously, after the May 2014 deployment of a Chinese oil-drilling rig in waters claimed by Viet Nam, violent confrontations occurred between Chinese and Vietnamese vessels.<sup>5</sup> This was followed by protests in Viet Nam, resulting in deaths and looting and destruction of Chinese- and Taiwanese-owned factories.<sup>6</sup> (Similar experiences can be found in North Asia in disputes between China, Japan and South Korea, also reflecting maritime disputes.)

*The trade between ASEAN claimants and China is a significant proportion of the ASEAN Claimants' GDP*

Interruptions that might occur from increased South China Sea tensions could be immediately costly to ASEAN claimants. Table 2 indicates that the trade flows between

<sup>4</sup> Renato Cruz De Castro, 'China's Realpolitik Approach in the South China Sea Dispute: The Case of the 2012 Scarborough Shoal Stand-Off', for the conference Managing Tensions in the South China Sea, Center for Strategic & International Studies (CSIS), June 5-6, 2013, p. 7, available from [http://csis.org/files/attachments/130606\\_DeCastro\\_ConferencePaper.pdf](http://csis.org/files/attachments/130606_DeCastro_ConferencePaper.pdf)

<sup>5</sup> *The Economist*, 'Rigged: Vietnam and the South China Sea', 14 June 2014, available from <http://www.economist.com/news/asia/21604203-comradely-relations-go-bad-worse-rigged>.

<sup>6</sup> Vu Trong Khanh, and Jenny W. Hsu, 'Anger Over Oil Rig Turns Violent In Vietnam', *The Wall Street Journal*, 14 May 2014, available from <http://www.wsj.com/articles/SB10001424052702303851804579560923647957180>. Similar economic impacts stemming from north Asian maritime disputes can be found in Green, *The Third Option for the South China Sea*.

these countries and China are very large in relation to their GDP. In contrast, because of the huge size of the Chinese economy, none of these trade flows is as large as two per cent of the GDP of China. This picture sometimes lends itself to the impression that the ASEAN trading partners “have more to lose than” China if tensions become more pronounced.<sup>7</sup>

**Table 2: Total Bilateral Trade with China/Hong Kong as a Share of ASEAN Claimant GDP (2010)**

Brunei	9.4%
Indonesia	8.2%
Malaysia	36.6%
Philippines	15.2%
Viet Nam	31.1%

*The Chinese economy is vulnerable to South China Sea conflict*

This picture of China as better able to survive trade interruptions than its Southeast Asian partners fundamentally misrepresents the nature of the Chinese economy. The recent global recession is a reminder that market-based economies can experience horribly costly slumps and that policy tools cannot always reverse the impact of shocks. The relevance of this for China is illustrated below through several different perspectives, all reflecting the fact that China’s position as a vital player in the global economy is dependent upon the smooth operations of regional markets.

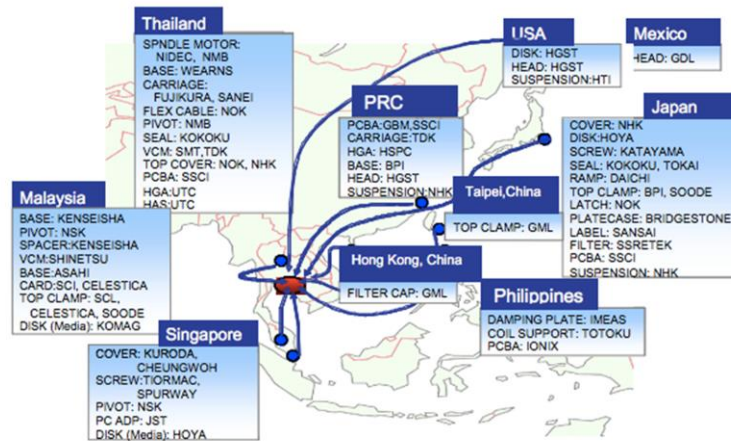
**1. Bilateral trade does not reflect the complexity of Factory Asia**

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<sup>7</sup> De Castro, ‘China’s Realpolitik Approach’, p. 7.

As rapidly as international trade has grown, the trade in *intermediate* goods has grown faster. “In 2011, nearly half (49 per cent) of world trade in goods and services took place within GVCs, up from 36 per cent in 1995.”<sup>8</sup> Figure 3 below illustrates this process, whereby the production of a hard disk drive is divided among a number of

Figure 3: The Global Value Chain for Hard Disk Drives, including Four South China Sea Claimants



Source: Figure A2, Hiratsuka, Daisuke, ‘Vertical Intra-regional Production Networks in East Asia: A Case Study of Hard Disc Drive Industry,’ IDE working paper 2005, available from <http://www.adb.org/sites/default/files/publication/156156/adbi-wp301.pdf>  
For this example, the final assembly is in Thailand.

suppliers, each *sharing tasks*, all organised through a supply chain. These trade flows are interdependent: the failure of any one segment may throw an entire GVC off track. An interruption in trade from Viet Nam to China might incapacitate complementary flows between other countries and China.

## 2. Bilateral conflict between China and any ASEAN claimant would cost China influence with ASEAN

The emerging ASEAN Economic Community (AEC) – building Southeast Asia “as a single market and production base characterised by free flow of goods, services, and investments, as well as freer flow of capital and skills” – represents an unparalleled opportunity for China to build a partnership that will cement it as Southeast Asia’s premier economic partner.<sup>9</sup> China already participates in many ASEAN consultative processes, including dialogues over the future of the AEC. But ASEAN works on a consensus basis, and it is difficult to see this proceeding if China conducts military conflict with any ASEAN member.

<sup>8</sup> World Trade Organization (WTO), International Trade Statistics, 2015, p. 18, available from [https://www.wto.org/english/res\\_e/statis\\_e/its2015\\_e/its2015\\_e.pdf](https://www.wto.org/english/res_e/statis_e/its2015_e/its2015_e.pdf)

<sup>9</sup> Invest In ASEAN, Single Market And Production Base | ASEAN Economic Community, 2016 available from <http://investasean.asean.org/index.php/page/view/asean-economic-community/view/670/newsid/758/single-market-and-production-base.html>

### 3. Conflict between China and a member of ASEAN might become internationalised

Recently, Western nations have imposed economic sanctions against Russia for its actions in annexing Crimea. It is not far-fetched to suggest that a similar process might be triggered against China in the event of an action that is perceived as being unforgivably aggressive. Sanctions, and counter-sanctions, would have severe costs on both sides. The differential impact on the countries involved will depend on the nature of the sanctions and what is happening in the nations' economies; for instance, is the economy teetering on the edge of a slowdown or robustly growing? That said, over time, as China moves away from a command economy, liberalising and opening markets, it faces increasing risks that a shock will spark capital outflows and asset market slumps.

In sum, China's increasingly market-determined economy is vulnerable to shocks. "This is the double-edged sword of relying on external markets for development: it provides a tremendous boost to the efficiency of the economy and long-term growth, but increases short-term vulnerability to external shocks."<sup>10</sup>

#### The Narrow Economic Gains from Winning a Tussle in the South China Sea are Small

The sections above argue that in pressing for their perceived rights ASEAN governments are running risks of conflict occurring that would destroy trade and development. This section briefly looks at the narrow economic gains that might be won – the energy and fishery resources – at the expense of these risks.

Energy resources in the South China Sea, oil and natural gas, are sometimes said to be large – another "Persian Gulf".<sup>11</sup> Some Chinese authorities suggest sizeable reserves, whereas those from other sources, such as the United States Energy Information Administration (EIA), can be much lower.<sup>12</sup> Rogers explains that US estimates focus on likely recoverable resources rather than the total existing, while Chinese estimates do not make this adjustment. Moreover, the EIA suggests that most of the presumed reserves are in areas of the South China Sea that are close to the various coastlines and not in the disputed areas. Certainly in the current world of relatively low crude oil and natural gas prices there do not appear to be sufficient resources to be transformational to the nations in the region.

Competition over fishery resources has also prompted clashes in the South China Sea. The South China Sea is widely known for its extraordinary biodiversity.<sup>13</sup> But, as with many areas of the world, the fish stocks are being depleted as a result of unsustainable

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<sup>10</sup> David Jay Green, 'Southeast Asia's Policy Response to the Global Economic Crisis', *ASEAN Economic Bulletin*, April 2010, vo. 27, no. 1, p. 7.

<sup>11</sup> Zhong, Xinhui, *The Gaming Among China, the Philippines and the US in the South China Sea Disputes*, p. 10. Master Thesis, Development and International Relations, Aalborg University, Denmark. June 2013, available from [http://projekter.aau.dk/projekter/files/76994735/Thesis\\_final\\_edition.pdf](http://projekter.aau.dk/projekter/files/76994735/Thesis_final_edition.pdf)

<sup>12</sup> Will Rogers, 'The Role of Natural Resources in the South China Sea', p. 95, fn. 9, in P. Cronin, ed., *Cooperation from Strength The United States, China and the South China Sea*, Washington, DC: Center for a New American Security, pp.83-97, available from [http://www.cnas.org/sites/default/files/publications-pdf/CNAS\\_CooperationFromStrength\\_Cronin\\_1.pdf](http://www.cnas.org/sites/default/files/publications-pdf/CNAS_CooperationFromStrength_Cronin_1.pdf)

<sup>13</sup> Rogers, 'The Role of Natural Resources in the South China Sea', p. 90.



fishing practices and coastal development, damaging fish breeding grounds.<sup>14</sup> Winning these resources would be a Pyrrhic victory. The victors would need continually to be on guard against incursions by fishing boats, sometimes from very poor communities. Moreover, keeping poor folk from food is bound to risk inflaming already tense regional relations.

Thus, while there are energy and fishery resources in the South China Sea, these are not treasures worth risking the hard-won economic development that depends on regional trade.

### The Alternative of Cooperation

Why don't countries in the South China Sea cooperate more? There would appear to be several reasons:

- There are a number of national interests, such as providing strategic space for the military, that do not lend themselves easily to cooperative behaviour.
- Some areas that potentially could be well-served by cooperation, such as husbanding of fishery resources, do not appear to offer large benefits.
- Once set in place, territorial ambitions become draped in nationalistic rhetoric and are difficult to change.
- Not all actors in national decision-making have the same interests or set the same priorities; for instance, some will weigh interests of national security well above those of economic growth.

Can this political calculus be altered? An answer can be found by examining existing regional cooperation initiatives (Table 3) that specifically target strengthening economic growth, initiatives that might provide sufficient benefits to encourage more generally cooperative rather than rivalrous behaviour.

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<sup>14</sup> Eva Pejsova, 'The South China Sea's commons: Behind and beyond sovereignty disputes', European Union Institute for Security Studies, June 2014, available from [http://www.iss.europa.eu/uploads/media/Alert\\_30\\_South\\_China\\_Sea.pdf](http://www.iss.europa.eu/uploads/media/Alert_30_South_China_Sea.pdf) and Rachael Bale, 'One Of The World's Biggest Fisheries Is On The Verge Of Collapse', National Geographic, Aug. 29, 2016, available from <http://news.nationalgeographic.com/2016/08/wildlife-south-china-sea-overfishing-threatens-collapse/>



Perhaps the most pertinent regional cooperation experience is that of the Greater

*Table 3: Regional Cooperation in the South China Sea*

Acronym	Initiative
BIMP-EAGA	Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area
GMS	Greater Mekong Subregion
IMT-GT	Indonesia-Malaysia-Thailand Growth Triangle
PBG	Pan-Beibu Gulf Economic Cooperation (Gulf of Tonkin)
SIJORI / IMS-GT	Singapore-Johor-Riau Growth Triangle / Indonesia-Malaysia-Singapore Growth Triangle

South China Sea	Brunei	China	Indonesia	Malaysia	Philippines	Viet Nam
Membership						
BIMP-EAGA	X		X	X	X	
GMS <sup>a</sup>		X <sup>b</sup>				X
IMT-GT			X	X		
PBG <sup>c</sup>	X	X <sup>d</sup>	X	X	X	X
SIJORI/IMS-GT			X	X		

Mekong Subregion (GMS), founded in 1992 when political conditions on the mainland of Southeast Asia were unsettled. With support from the Asian Development Bank, the GMS sponsored many collaborative projects, notably more than \$16 billion during 2013 in investments, especially in transport infrastructure. This effort has been transformational for mainland Southeast Asia. Today all-weather roads link most of the major economic centres and have facilitated the increase in trade, including between China and Viet Nam.

Similarly, the Indonesia-Malaysia-Singapore Growth Triangle (IMS-GT) has leveraged Singapore's capital and logistics resources to support manufacturing and assembly plants in the state of Johor in Malaysia, and on the nearby islands of Indonesia, where nearly one-third of a million workers find employment.

Neither the GMS nor the IMS-GT have convinced the members to abandon rivalry or even conflict in all areas. We should not expect this: the nature of inter-state relations is complicated and different people see different priorities. However, the benefits of participating in GMS appear to influence Government decision-making, in some cases moderating otherwise aggressive behaviour. For example, the mid-2014 tussle over oil exploration in the South China Sea weighed generally on relations between China and Viet Nam. However, both countries participated in the GMS Leaders' Summit in December in Bangkok, with some observers noting that both governments appeared to use the meeting to build better relationships.

Neither the GMS nor the IMS-GT eliminates disputes between countries. Indeed, these initiatives create their own *conflicts* – conflicts over the division of the benefits, such as the location of manufacturing centres. But trading over the division of these benefits allows for the possibility of bargaining over other issues, such as control of disputed territory.

In contrast to these two initiatives, the other three listed have not had much obvious impact on the participating economies. None of these supported either a large infrastructure program or strong private investment, and they have not provided an alternative to rivalrous behaviour. Indeed, unlike what has been seen in the GMS and IMS-GT, likely because there are fewer clear benefits from BIMP-EAGA, the Philippine Government has been willing to slow down some aspects of the initiative's operations in defence of its territorial claims to the Malaysian state of Sabah.

### The Alternative of Cooperation: Lessons

Distilling the lessons learned from the existing experiences of regional cooperation in Southeast Asia provides guidelines for future efforts that could shift the national calculus towards cooperation and away from rivalrous behaviour in the South China Sea.

1. Focus on providing shared benefits between China and the Philippines and between China and Viet Nam.

This is where the consequential threats to regional peace are to be found – where the effort must be made to find alternatives to present behaviour.

2. Provide clear and substantial economic benefits by raising the potential for trade and cross-border investment.

An initiative to assuage the South China Sea disputes would need to be convincing in the potential for provision of broad economic gains – gains sufficient to allow political leaders to champion cooperative behaviour. This would likely mean activities that would encourage Chinese investment in Indonesia, the Philippines, and Viet Nam – investment that would stimulate trade and growth on all sides of the Sea.

3. While trade promotion and growth enhancement are the highest priority, the goals of the initiative cannot be limited to this.

There are many regional problems, including the suppression of piracy, that could be managed more thoroughly through cooperative behaviour. Efforts in some of these areas could be folded into new initiatives. But, while it is important to rise above the focus on growth, if there is no observable impact on trade and local growth the initiative will have little overall impact.

4. Ensure that the program results in infrastructure investment – infrastructure that improves connectivity

The lack of infrastructure has stymied growth in BIMP-EAGA and IMT-GT localities; conversely GMS and IMS-GT have been successful partly through adding transport and logistics infrastructure.

5. Ensure that business investment will flow.

For regional cooperation to yield significant benefits there must be trade-generating private sector investment. Policy changes and infrastructure, for example, can encourage foreign and domestic business investment that exploits cross-border resource complementarities. In the South China Sea, regional cooperation could

provide for increased agricultural or aquaculture exports from Indonesia, the Philippines and Viet Nam to China.

6. Hold in abeyance territorial claims to the seas and the resources, and
7. Jointly harvest, in a sustainable fashion, the resources, using the revenues for common development, especially in coastal areas.

The Chinese Ministry of Foreign Affairs maintains a web page observing that more than three decades ago, Deng Xiaoping called for “setting aside dispute and pursuing joint development”.<sup>15</sup>

8. Obtain multilateral support for administering the regional project.

ADB’s support for the GMS was one crucial factor in the success of the initiative. Conversely, the Chinese-led Pan Beibu exercise suggests how difficult it is for any one country to take the lead and administer such an activity.

## Conclusion

With the progressive establishment of Factory Asia, with China and Viet Nam becoming more integrated into the global economy, tensions in the South China Sea present considerable risks to the trade and capital flows that have underwritten East and Southeast Asian development. Against these, the possible economic rewards of exploiting energy and fishery resources are small – there is little in the nature of treasure.

Regional cooperation initiatives capable of raising growth rates and living standards could provide incentives to put aside current behaviour and the risks of conflict. The experiences of existing efforts show that this is not simple – while some programs appear to encourage peaceful dispute resolution, others appear to have little demonstrable impact. Distilling these experiences suggests some principles for an initiative that would give life to this option of peaceful development in the South China Sea. These principles must further be placed in the context of complex national decision-making that has resulted in locking national policy in a continuing and risky game of maritime aggression.

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