Evalueserve is a **Knowledge Partner** of the **Club of Amsterdam Summit for the Future on Risk [May 3-5, 2006]**
www.clubofamsterdam.com/summit2006.htm

Asian Leadership in Trade and Associated Risks

World Trade: Emergence of Asia

Asia's journey from the 1997-98 financial crisis to being one of the world's most dynamic regions in terms of trade, development and investment activity, can best be termed as a 'Renaissance'. The world's centre of economic gravity is shifting towards Asia, as it currently accounts for 27 percent of international trade. This growth is mainly driven by the exemplary performance of the emerging Asian countries, including China, India, Hong Kong, Thailand, Malaysia, Singapore and Vietnam. The share of these emerging Asian countries in world trade increased from 13 percent in 1990 to 20 percent in 2004.

The Asian region is gaining significance in merchandise as well as commercial services trade. Asia's share in world merchandise exports and imports stands at 26.8 percent and 24 percent, respectively. The value of Asia's merchandise exports and imports shot up by 25 percent and 27 percent, respectively, in 2004. The growth in exports from the region can be attributed to strong demand from the US, and intra-Asian trade, stoked by a recovery in electronics trade.

Exports of commercial services increased at a fast rate of 27 percent in 2004, while imports were up 25 percent during the same period. Asian countries, such as India, China and the Philippines, are the most preferred destination today for outsourcing of business services, such as transaction processing, customer care centers, medical transcription, IT services and application development, high-end analytical services, R&D services, etc. Other commercial services, such as transportation services were strong in 2004, while travel receipts recovered by 31 percent during the year from exceptionally low levels in 2003 (due to the spread of SARS).

Intra-regional trade as a share of total trade went up sharply to 41 percent in 2004, primarily due to intra-industry trade as a result of greater vertical specialisation and relocation of production processes. This is evident in the electronics sector, where capital intensive processes (like production of microchips) are carried out in high-income economies like Singapore and Korea, and labour intensive processes (like assembly of personal computers) are located in low income countries, such as China. Asia has integrated into a global production chain with some cities like Hong Kong and Singapore becoming the hub of manufacturing and trade.

The dynamics of growth and development in Asia is a perfect illustration of how countries have used trade as a means of achieving greater degree of integration with the international economy. Region-specific factors have provided the stimulus for this growth.

Growth in Central Asia driven by energy sector
Central Asia witnessed an overall increase of 39 percent in exports in 2004, with the energy sector acting as the main growth driver. Kazakhstan, where substantial FDI has developed the oil and gas sector in recent years, accounts for about 60 percent of the aggregate exports of Central Asia. A notable feature has been the growing strength of the Kyrgyz Republic, Tajikistan and Uzbekistan.

© 2005, Evalueserve. All Rights Reserved

Structural reforms and booming manufacturing and services sectors drive South Asian economies

South Asian aggregate GDP grew by 6.4 per cent in 2004, with economies reflecting the impact of structural reforms, stronger domestic demand, stable exchange rates, high reserves and improved current account balances. Improved performances in manufacturing and services gave the sub-region, particularly India, one of the best economic performances in recent years. Measures such as construction of a pipeline to transport natural gas from Myanmar via Bangladesh to India reflect the steps towards economic integration that drive growth.

Consumption growth and business investment drives growth in Southeast Asia

With an economic growth of 6.4 percent in 2004, Southeast Asia experienced a pick-up in exports, which was particularly robust in Cambodia, Malaysia, Singapore, Thailand and Vietnam. The developments that augured growth in for the sub region have been the increase in consumption, upturn in electronics cycle, public infrastructure investments in Thailand and Indonesia, improvements in FDI flows, and growth in business and investment climate in Singapore, Malaysia and Thailand. There has been an upsurge in business investments following reduced political uncertainty because of peaceful elections in Indonesia, Malaysia and the Philippines.

China fuels growth in East Asia

The East Asian countries have contributed tremendously to world trade in recent years. The expiry of textile and clothing quotas has allowed China to gain a substantial share of 25 percent in both the US and EU textile imports in 2004, up from 17 percent a year ago. China has become the world's third largest merchandise trader after Germany and US; it is also gaining a substantial share in business services outsourcing. Increased FDI investment, improved infrastructure and declining import tariffs are driving growth in the economy. Korea is benefiting from the upturn in demand for electronics and motor vehicles. At the same time, the Japanese economy is showing signs of recovery with the end of deflationary pressures and continued financial restructuring.

These locomotives of growth have shifted the focus of world trade towards Asia. However, the opportunity is also coupled with risks that the Asian region is subject to. These risks can be major hurdles to the future growth and development of business in the region.

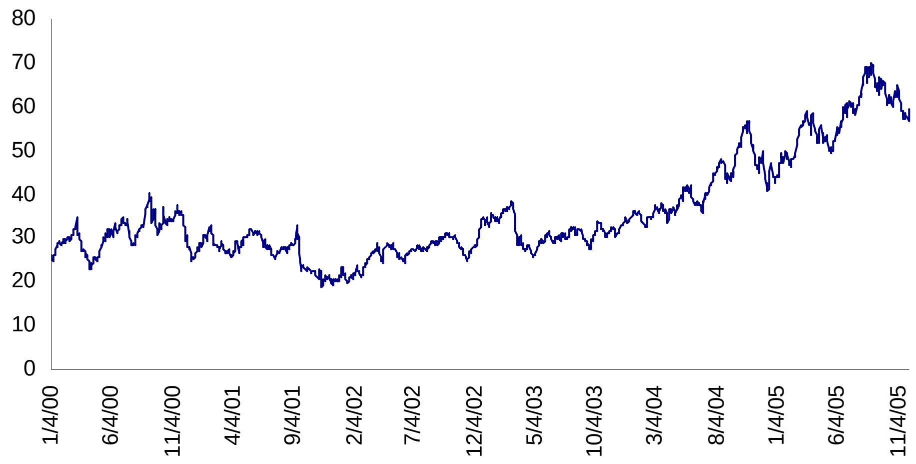
Risks to Trade in Asia

Asian economies being net importers of energy, will be hard hit by a rise in global oil prices

Crude oil prices have more than doubled since mid-2002, breaching USD 59 per barrel in November 2005. Asian economies are more vulnerable to such global oil price increases as they are manufacturing-intensive and, thus, highly dependent on oil. Asia produces about 11 percent of the world's crude oil, but consumes more than 20 percent. This region (excluding OPEC) accounts for roughly 80 percent of oil imports by developing countries, and is also the region where the ratio of oil imports to GDP remains the highest.

© 2005, Evalueserve. All Rights Reserved

Figure 1: Oil Prices Development



Source: Bloomberg (Brent Chicago Delivered Crude Oil Spot Index Price)

According to estimates, a USD 10 increase in oil prices for one year will reduce growth by around 0.8 percent. Higher oil prices have generated trade losses of 0.7 percent in 2004-05 in East Asia and 1-2 percent per year in net importer countries like the Philippines and Thailand. Countries like Indonesia, the Philippines, Malaysia and Thailand, which subsidise fuel costs, are facing big budgetary deficits. Another steep rise in oil prices would dampen export growth from Asian countries and amplify inflationary pressures.

The macro-economic performance of the region can be affected by transfer of income from oil-importing to oil-exporting countries, higher costs of production, and lower real incomes, which can further depress domestic demand and lead to rising unemployment.

Infrastructure gaps exist in growing nations in Asia

While their economies are growing rapidly, emerging Asian countries still face a major challenge in the provision of infrastructure. The resulting infrastructure gap, particularly in electricity, transport, telecommunications and water supply, threatens efforts aimed at reducing poverty and improving trade and investment facilitation. According to UNESCAP, East Asia has a massive need for infrastructure, amounting to USD 200 billion per annum for the next five years. Some 65 percent of this will be in the form of new investments and the remaining on maintaining existing assets. In addition, there are large unmet infrastructure investment needs in South, Central and West Asia. Infrastructure requirements for India are estimated at USD 27-45 billion per year over the next five years. Lack of infrastructure might restrict further flow of funds and prevent companies from off shoring/outsourcing their activities to the Asian region.

Inflation and interest rate rise would aggravate debt servicing burden and discourage investments

Inflation in some economies has been triggered by rising oil prices, and this might lead to severe inflationary pressure in the future. A sustained rise in inflation gives way to higher interest rates, thereby making the economies vulnerable to rising debt servicing burdens, possibly leading to an increase in default rates in some countries. Many countries in Central Asia, and some in Southeast Asia, might experience this phenomenon as they run high levels of external debt. An increase in interest rates might alter the consumption and savings behaviour of the people, thereby negatively impacting business and investment of non oil exporting economies.

© 2005, Evalueserve. All Rights Reserved

Exchange Rates volatility hinders private capital inflows
The varying degrees of volatility in cross currency exchange rates can widen the trade gaps and pose a threat to financial stability within the region. During August 2004-March 2005, a number of regional currencies appreciated significantly vis-à-vis the US dollar, with the Korean won rising by about 15 percent, the Taiwanese dollar by over 9 percent, and the Thai baht and Indian rupee by 7.5 percent and 6 percent, respectively. A depreciation of the US dollar would lead to Asia losing the cost advantage and hence will make exports to the west uncompetitive. Speculation on regional currency appreciation gives way to volatility of private capital inflows to the region, which compounds the problem of sterilisation.

Outsourcing business prone to information security risk
For Asian economies like India, China and the Philippines, outsourcing seems to be unequivocally beneficial for employment, exports, and economic growth. However, equally concerning are the risk factors, such as like weak intellectual property laws, less transparent and efficient courts, inefficient financial and public records mechanisms of employees, exposure to information privacy issues (like in the case of Mphasis in India) and the cultural divide between the East and the West.

Logistics bottleneck might inhibit outsourcing of manufacturing to Asia
Asia is emerging as an outsourcing destination for auto components by auto players. It is also a prominent sourcing centre for large retailers of the world. Delays and logistics challenges can translate into higher transportation costs for original equipment manufacturers and retailers, sourcing from Asia.

Epidemics can curtail the GDP growth of the region
The possibility of the outbreak of epidemics presents a potential setback to future growth in the region. Many epidemics have plagued the Asian region and dampened growth in the past. The occurrence of avian influenza or bird flu during late 2003 and early 2004 plagued the poultry in eight Asian countries, namely Cambodia, China, Indonesia, Japan, Laos, South Korea, Thailand and Vietnam. A sizeable loss to the potential world output is evident from its effect on poultry production, exports and consumption; tourism; industrial production; medical costs and supply shocks due to reduction in the size and productivity of the labour force.

The outbreak of bird flu in Asia since 2003 has killed more than 60 people so far. ADB estimates that a human influenza pandemic would cost Asia USD 283 billion and would reduce the region's GDP by 6.5 percentage points.

SARS, the respiratory infection that flared up in East Asia in 2003, had the greatest economic impact of USD 30 billion to USD 50 billion and loss of possibly 2 percent of GDP of the Asian region in one quarter. Tourist arrivals plunged 58 percent in Hong Kong, 62 percent in Singapore and 69 percent in Taiwan during the period. An epidemic of such magnitude could have a strong distorting impact and might lead other economies to look away from Asia for the supply of goods and services.

Ageing population in China, Japan and Singapore is a source of concern
Demographics play a pivotal role in terms of challenges to Asia's growth with China, Japan and Singapore facing ageing populations, while India, Indonesia and Vietnam have a growing number of young workers seeking gainful employment. The shortage of skilled and experienced professionals in China is forcing many companies to expand facilities elsewhere and has led to substantial wage inflation and increasing employee turnover.

Cultural differences can prove to be detrimental to growth
Historical and cultural disputes, such as the movements aimed at establishing Islamic concepts in South East Asia, will continue to be a risk to business and trade.

© 2005, Evalueserve. All Rights Reserved

Anti-Japanese demonstrations in China and South Korea can further threaten the growing economic ties. India's religious and linguistic diversity also present potential problems to an extent.

Terrorism can lead to decreased FDI, decline in tourism, fiscal imbalances and unemployment

The impact of terrorism on Asia's trade and investment flow and GDP cannot be undermined. Social instability due to fear of terrorism can lead to decreased FDI, increased security expenditure, decline in tourism, fiscal imbalance and unemployment. In the recent past, the Bali bombing incident reduced Indonesia's GDP by up to 0.56 percent. The volatile security situation due to terrorist groups in Indonesia, Malaysia and the Philippines can continue to place a drag on the economic growth of the region. The continued tension and uncertainties around the Korean Peninsula and Taiwan Straits, Maoist insurgency in Nepal and India, the Kashmir issue between India and Pakistan, can have a great impact on the developing countries of the region.

Asia is prone to various kinds of natural disasters

In Asia, natural disasters wield an enormous toll on development. Each time a region is struck by a calamity, growth, investment activity, tourism and foreign exchange reserves have to bear the brunt of lost businesses and reconstruction costs. The most severe disasters in the recent past have taken place in the Asian countries, including Indonesia, China, Bangladesh, the Philippines, India, Maldives, Malaysia, Sri Lanka, Thailand, Vietnam and Japan.

The 2005 earthquake in Pakistan led to infrastructure losses worth USD 5 billion; the severity of losses from earthquakes in Indonesia and Gujarat (India) are not far behind. Central Asia is prone to disasters like earthquakes, landslides, floods, avalanches and drought, with Tajikistan being the most vulnerable.

The human and economic loss from the tsunami disaster in late 2004 is visible in Indonesia, where the GDP forecast for 2005 is 5.4 percent down from 5.7 percent. Sri Lanka faces economic challenges due to its already mounting budget deficits coupled with setbacks to the tourism and fishing industries. The economic impact on Thailand will be evident from damages inflicted on the tourism industry, which contributes 6 percent to GDP. After the disaster, the country's GDP growth fell by 0.3 percentage points.

However, despite the risks and challenges faced by the region, trade in Asia is yet to reach its full potential. The emerging Asian region is expected to grow 6.6% in 2006 according to ADB estimates. The recent acceleration in growth promises to propagate further restructuring and reforms, which would create rich opportunities for stimulating faster trade growth within the region. In order to boost the growth momentum, Asia has to ensure that appropriate measures are taken to eradicate the risks prevailing in the region through economic cooperation amongst the Asian countries and continued structural reforms within individual economies.

© 2005, Evalueserve. All Rights Reserved

Sources of Information

1. Asian Development Outlook 2005: Promoting Competition for Long term Development
2. International Monetary Fund: Regional Outlook September 2005(Asia and Pacific Department)
3. The International Bank for Reconstruction and Development/The World Bank:
4. Global Economic Prospects 2005
5. Asia Pacific Foundation of Canada: Asia Pacific Bulletin dated October 14, 2005
6. The World Bank: East Asia Update, November 2005
7. The Pacific Economic Cooperation Council: Pacific Economic Outlook 2005-06
8. World Economic Forum: Asia Roundtable 2005, Singapore
9. Economic and Social Survey of Asia and the Pacific 2005: Key Developments and Prospects
10. Economic Scenarios for Asia: Higher Global Oil Prices-Implications for Developing Asia in 2005
11. World Trade Organization: World Trade Development for 2004 and Prospects for 2005
12. Deutsche Bank Global Markets Research: Demographics, Savings & Hyper-Growth
13. United Nations: World Economic Situation and Prospects 2005
14. Research and Information System for Developing Countries (RIS): Policy Brief-Role of Infrastructure Investments in Asia
15. ADRC Natural Disasters Data Book 2004
16. The Economist Intelligence Unit: Special Report on Asia’s tsunami-the impact
17. World Trade Organization: International trade statistics 2005
18. Singh, N.K Speech on The Asian Dynamo
19. International Monetary Fund: IMF sees strong growth globally in 2005, 2006
20. The Japan Research Institute, Limited: Asia Monthly February 2005
21. JETRO, New York : Article on Asian Economic Integration
22. EXIM Bank, India Seminar on Regional Economic and Financial Cooperation in Asia
23. Centre for Disease Control and Prevention, US Department of Health and Human Services
24. International Development Economics Associate: Developing Countries and the Dollar
25. Institute for International Economics: Paper on Global Economic Prospects-On Track for Strong Growth in 2004 but Worries About 2005
26. Asia Today International and Asia Today Online: Article on New price shock to come

© 2005, Evalueserve. All Rights Reserved