BFA Annual Report 2016

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Progress of Asian Economic Integration

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ACRONYMS

AREAER	Annual Report of Exchange Arrangements and Exchange Restrictions
ASEAN	Association of Southeast Asian Nations
BEC	Broad Economic Classification
CPI	Consumer Price Index
EU	European Union
FDI	Foreign Direct Investment
GATS	General Agreement on Trade in Services
GVC	Global Value Chain
IMF	International Monetary Fund
M&A	Merger & Acquisition
NDRC	National Development and Reform Commission
OECD	Organization of Economic Cooperation and Development
NAFTA	North American Free Trade Association
P&C	parts and components
RCEP	Regional Comprehensive Economic Partnership
SDR	Special Drawing Right
TNC	Transnational Company
TPP	Trans-Pacific Partnership
UNCTAD	United Nations Council on Trade and Development
WTO	World Trade Organization
RTA	Regional Free Trade Agreement

FOREWORD

Since the outbreak of the financial crisis in the developed countries in 2008, Asia has been undergoing a series of structural changes in its trade, investment and finance and these changes are having profound impact on the progress of Asia's economic integration.

Not only Asia's trade is slowing down, but in contrast to the past norm that the growth of trade has led that of GDP, its trade is growing at a lower rate than GDP. The important role that trade has played as an engine of the region's growth is fading away. Over the last twenty years, the global value chain (GVC) was a main driver of Asia's industrialization progress and miraculous growth of trade. The GVC linked major Asian economies with the US and EU, sequentially through different stages of the production process such as design, purchase of intermediate inputs, final assembly and distribution, to form an efficient international production network. However, after the global financial crisis, the development of the GVC started to slow down, first in the developed countries and then in Asia. The growth of Asia's intermediate goods trade has been falling in recent years. In 2014, the growth turned negative and the shrinking of intermediate goods imports was particularly serious.

Asia is following the world to have achieved a rather rapid growth in the service trade. But compared to the strong growth momentum, Asia is still lagging behind with the growth of both service imports and exports below that of the world average.

Amid the complicated and uncertain global economic environment in the aftermath of the financial crisis, Asia's integration in trade and production shifted to low gears. Asia's intra-regional trade dependence fell from the historic high of 59.49 percent attained in 2012 to 53.01 percent in 2013. Though it recovered to 55.65 percent in 2014, it was still far below the record level attained in 2012, as most of the major Asian economies had been reducing the degree of their trade dependence on Asia. In addition, the intra-regional parts and components trade index, a measure of the depth of the region's international production network, remained stagnant in recent years, falling from 61.1 percent in 2012 to 60 percent in 2013 and, in 2014, it continued to fall to 59 percent.

Asia's post-crisis change is not limited to trade and the global value chain. The impact on finance should not be ignored. Asia has become very vulnerable to the fluctuations outside the region. In the past two years, with the shocks such as the exchange rate fluctuations of the US dollar, Euro as well as the Japanese yen, the downturn of the commodity markets and the stock markets volatilities, the Asian economies were more responsive to external fluctuations as evidenced by a lower degree of business synchronization among its members, more volatile short-term capital flows and reduced correlations among the region's stock markets.

Despite the above frustrations, Asia still possesses some advantages as reflected by some of its achievements in the past year. Though Asia's trade is slowing down, its export share in the world has increased. The importance of Asia in the global intermediate goods trade is also rising. A conclusion drawn from this Report is that Asia has not lost its long-established competitive advantage yet and China still remains as the "hub" of Factory Asia.

Under the challenge of the rapid growth of the global service trade, the Asian economies have placed more importance on the region's service trade liberalization as over 80 percent of the service related FTAs signed by the Asian economies focused on the internal liberalizations. This would help Asia to keep up with the rapid growth of the global service trade and add fuel to the region's service integration process.

Asia is a hot point of direct and indirect investment flows. In 2014, Asia's foreign direct investment (FDI) inflows improved substantially over the previous year and achieved 8.9 percent growth in contrast to the negative growth of -16.3 percent for the world. Notably, China's Hong Kong replaced Chinese mainland to become the largest FDI recipient in Asia while ASEAN's FDI inflows reached a new record level. Asia also became a hot point of international portfolio capital flows and the region is changing from a net capital outflow area to a net capital inflow area.

Despite the weakening trend of its trade integration, Asia's integration in FDI significantly strengthened as major Asian economies, particularly China, China's Hong Kong and Republic of Korea, substantially increased their investment within the region. It is important to mention that the FDI dependence of the members on RCEP exceeded 50 percent.

If Asia were to sustain its growth it has to remove some roadblocks on the way forward. The problems such as slowing trade growth, weakening global value chain and vulnerability in financial sector to outside fluctuations might be addressed by a formal and comprehensive integration approach. Under the pressure of the post-crisis structural change, it is important for the Asian leaders to build consensus so as to steer the region in the right direction. Attention should be given to the three ongoing integrations in Asia, namely trade and investment integration, financial integration and infrastructure connectivity. The Asian leaders should give priority to the ongoing RCEP negotiations and fully realize that TPP are not to solve all Asian problems, if not worsen the current problem of Asia's vulnerability to outside fluctuations and undermine the stability of Asia's GVC. In view of the lessons of Asia's vulnerability to external shocks and negative impact on the financial markets, the Asian leaders should adopt a formal and cooperative approach to the financial integration as the Pacific Alliance has done. It is undoubtedly true that trade and investment liberalization is an important means to promote growth, but it is not the sufficient condition. The role of infrastructure connectivity is also essential or more effective as high quality infrastructure can substantially reduce trade costs and facilitate trade and investment. The "One Belt and One Road" (OBAOR) initiative proposed by the Chinese leadership represents a brand new approach to development. Trade and investment liberalization in combination with infrastructure connectivity would prove to be the core of Asia's institutional framework to secure the sustained growth. The Asian leaders should work together to lead the region in this direction.

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1.1 Asia's Trade in 2014

1.1.1 Unchanged Comparative Advantage?

Following the weak recovery of the world economy, Asia' trade grew only slightly in 2014. For merchandise trade, the exports and imports increased by 2.5 and 1.1 percent, respectively, on a year-to-year basis while the global merchandise exports grew by 1.05 percent. On average, Asia's trade still performed better than the world, but with very limited advantage. For service trade, the Asian economies followed the global trend to register rather rapid growth. Its exports and imports increased by 6.3 percent and 7.7 percent, respectively. However, given the fast growth of global service trade, the shares of the Asian economies in the trade of global commercial service actually declined slightly in 2014.

Despite the above changes, it is still too early to say that Asia is losing its comparative advantage in trade. In 2014, Asia has maintained its position in the global merchandise trade since the outbreak of the global financial crisis in 2008. Figure 1.1 shows the value and shares of the Asian economies in the world trade over the last 10 years. The bars represent the value, with numbers shown on the left axis, while the points connected by lines represent the shares of the Asian economies in the world trade, with the value shown on the right axis.

Asia's total merchandise exports were USD5,917 billion in 2014, accounting for 32 percent of the world total as compared to 31.5 percent attained in 2013. Specifically, the exports increased by 2.5 percent, whereas the growth rate of the world was only 1.0 percent in 2014. The total merchandise imports by Asia were USD5,485 billion in 2014, accounting for 29.7 percent of the world total imports, basically constant as compared to 29.6 percent obtained in 2013.

2015 seemed to be a tough year for the global economy. Trade in merchandise goods declined in the first eight months of 2015 for both the world and many Asian economies. The first 10 rows of Table 1.1 shows the merchandise trade of top Asian economies ranked by the size of their trade in the first eight months of 2015. In contrast to the impressive growth rates in the past, *none* of these top 10 economies showed positive growth rates in their exports. For the merchandise imports, all the top Asian economies saw a substantial decline, a situation similar to that of the world where the merchandise exports and imports dropped by 11.6 percent and 11.5 percent, respectively. However, Asia's export still performed better than that of the world, except for India, Australia, and Singapore. With regard to the imports, most of these top Asian economies saw more drastic declines than the world. In particular, Japan's imports contracted by 20.5 percent and Singapore by 19.4 percent while for China and Korea, the drop both exceeded 15 percent.

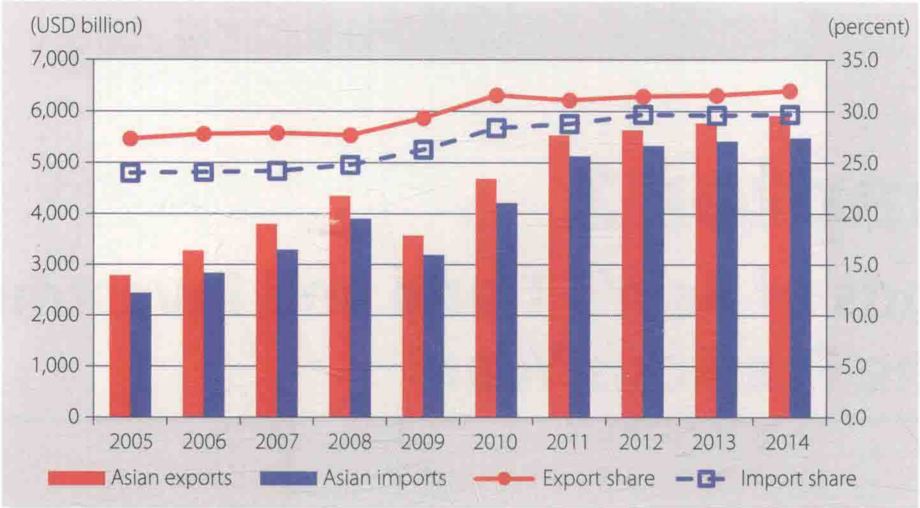

Figure 1.1 Shares of Asia's Merchandise Trade in the World, 2005-2014

Source: *International Trade Statistics 2006-2015*, WTO.

Table 1.1 Merchandise Trade of Major Asian Economies in the First Eight Months in 2015

Economy	Exports		Imports	
	Value (USD billion)	Growth Rate (percent)	Value (USD billion)	Growth Rate (percent)
China, People's Republic of	1,463.1	-1.4	1,053.7	-17.9
Japan	416.3	-9.1	437.7	-20.5
Korea, Republic of	353.6	-6.4	296.0	-15.9
China's Hong Kong	302.8	-1.0	341.2	-2.4
India	182.0	-15.0	265.4	-11.7
Singapore	238.3	-13.9	201.2	-19.4
Thailand	140.3	-6.0	137.1	-8.8
Australia	128.3	-22.0	146.4	-12.2
Malaysia	139.4	-10.5	124.3	-11.0
Indonesia	107.6	-8.4	108.5	-8.7
Russia	234.8	-31.3	118.3	-38.6
US	1,007.9	-6.3	1,493.0	-3.4
EU	3,413.6	-14.1	3,367.8	-15.3
World	10,830.4	-11.6	11,093.5	-11.5

Source: Direction of Trade Statistics (DOTS), IMF, accessed in January 15, 2016.

The bottom of Table 1.1 shows the merchandise trade of Russia, the US, and EU from January to August in 2015. During the period, the US exports contracted by 6.3 percent and the imports by 3.4 percent compared to the same period in 2014. However, the US trade performed better than the average of the world in general. Meanwhile EU's recovery was still fragile in the first eight months of 2015 as its exports and imports both dropped by more than 14 percent, lower than the world average of 11.6 percent. Russia's trade dropped most drastically of all the economies in Table 1.1 in the first eight months of 2015, partly due to the world oil price collapse and partly due to the tensions with the West arising from the Ukraine crisis in recent years, with both exports and imports contracted by more than 30 percent.

Figure 1.2 shows the merchandise exports of selected Asian and emerging economies in the first eight months in 2015. The dashed lines in the figure represent the exports of Brazil, Russia and India, members of the BRIC countries and the solid lines represent the trends for some Asian emerging economies.

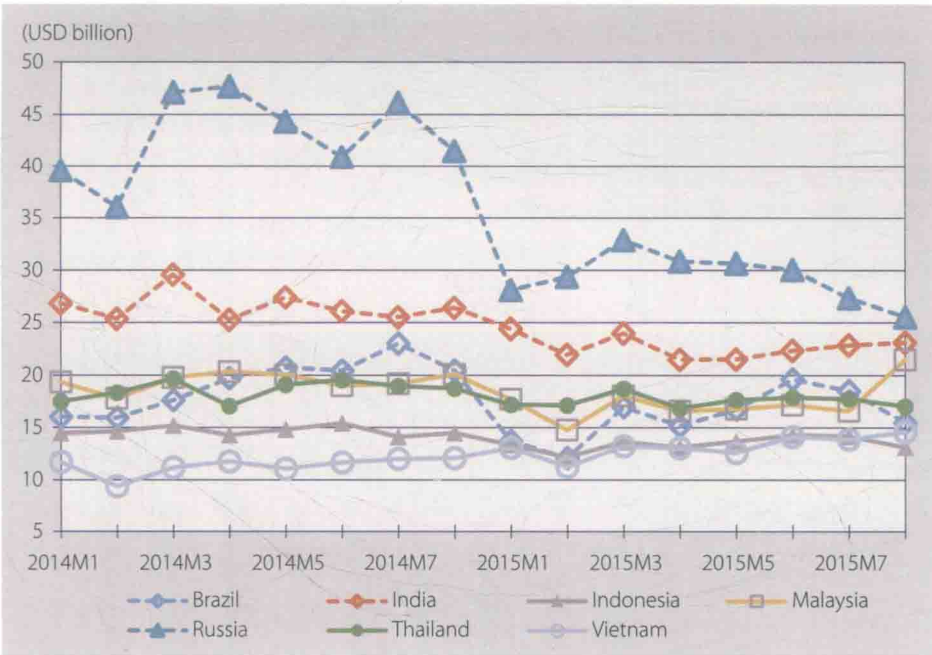

Figure 1.2 Merchandise Exports, Selected Asian and Emerging Economies

Source: Direction of Trade Statistics (DOTS), IMF, accessed in January 15, 2016.

Three observations could be made according to Figure 1.2. First, in contrast to all the other economies, Vietnam showed a stable positive growth rate. In the first eight months of 2015, Vietnam's exports reached USD105.5 billion, and the imports USD137.7 billion.[1] In 2014, its exports rose by 16.5 percent and imports by 53.4 percent, compared to the same period in the previous year. As most of the economies suffered from slowdowns, Vietnam's performance is really outstanding. Second, among the BRIC countries, Russia, India and Brazil seemed to be losing growth momentum in international trade. As mentioned above, Russia's exports and imports contracted by more than 30 percent during the first 8 months of 2015. During the same period, India's exports dropped by 14.4 percent, and Brazil's by 16.7 percent.[2] Third, Indonesia, Thailand and Malaysia showed a downward trend in the first eight months of 2015, but with better performance than the world average during the period.

The Trans-Pacific Partnership (TPP) agreement promised unprecedented reductions in trade

1 Direction of Trade Statistics (DOTS), IMF, accessed in January 15, 2016.

2 Direction of Trade Statistics (DOTS), IMF, accessed in January 15, 2016.

barriers particularly on the part of developing TPP economies. It is expected that Vietnam as a low-wage country may take advantage of this opportunity to export more to other TPP economies, particularly to the US. Malaysia may also gain from TPP in the exports of electronics, chemical products, palm oil and rubber. Japan may have better access to the US market for its auto industry. Australia and New Zealand may gain more export opportunities in the US and the Japanese markets for their dairy products and beef. Consequently, the non-TPP Asian economies need to be more competitive to maintain their export market share in the TPP economies. In general, the trade diversion effect caused by TPP may promote other economies to take counter measures to attenuate the negative effects on them, basically to strengthen the quality of large scale regional trade negotiations, such as the Regional Comprehensive Economic Partnership (RCEP).

1.1.2 Trade in Services: Keeping in Pace with Global Growth but Widening Deficit

In 2014, Asia has kept in pace with the world's fast growth in commercial service trade. Both exports and imports of commercial services increased steadily in 2014. As shown in Figure 1.3, Asia's commercial service exports were USD1,258.1 billion in 2014, accounting for 25.5 percent of the global total. However, Asia's export share in the global commercial service trade remained stagnant in the year despite the significant gains in value terms, due to even faster growth of the world's exports. On the import side, Asia's commercial service imports reached USD1,384 billion in 2014, an increase of USD99.2 billion over the previous year. However, with 9.2 percent growth of the world's commercial service imports in 2014, Asia's share in the world actually dropped by 0.4 percent, accounting for 28.9 percent of the world's total service imports. The commercial trade deficit of the Asian economies has enlarged in 2014 following the trend since 2007.

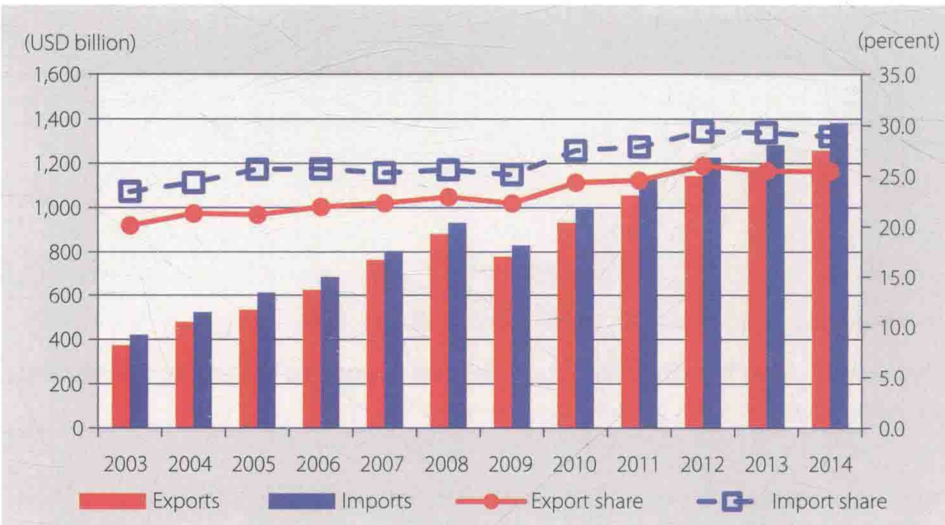

Figure 1.3 Shares of World Trade in Commercial Service Taken by Asia and Value

Source: *International Trade Statistics 2006-2015*, WTO.

Table 1.2 below shows the decomposition of Asia's trade in commercial service.[1] Compared to 2013, two observations could be made. First, Asia's export of other commercial service declined by 2.8 percent, whereas that of the world recorded a positive growth of 1.4 percent during the same period. Given the fact that trade in other commercial services usually takes more than half of the total service trade, the significant decline in Asia's other commercial service exports should be looked at seriously. Second, the Asian economies demonstrated high growth rates on imports of service trade. The growth rate of transportation and travel far exceeded that of the world. In particular,

1 The decomposition is based on Tables III.3, III.5, and III.7 contained in *International Trade Statistics*, 2015, WTO.

Asia's travel was growing at a rate of 14.3 percent. While Asia's commercial service imports were growing at 8.7 percent, it was still below the world's 9.8 percent growth.

Table 1.2 World Trade in Commercial Service by Regions, 2014

Exports	Transportation		Travel		Other Commercial Services		Total
	Value (USD billion)	Growth Rate (percent)	Value (USD billion)	Growth Rate (percent)	Value (USD billion)	Growth Rate (percent)	
World	**955**	**5.5**	**1,240**	**4.6**	**2,585**	**1.4**	**4,780**
North America	104	4.0	212	3.9	458	0.2	774
South and Central America	29	-3.3	55	7.8	58	-7.9	142
Europe	468	8.1	483	5.2	1,364	4.8	2,315
EU (27)	414	5.1	425	5.5	1,243	3.5	2,082
CIS	41	0.0	23	-11.5	42	-10.6	106
Africa	29	7.4	43	10.3	26	8.3	98
Middle East	30	7.1	52	8.3	43	-10.4	125
Asia	253	2.0	372	4.5	594	-2.8	1,219
Imports							
World	**1,225**	**5.2**	**1,165**	**8.9**	**2,290**	**9.8**	**4,680**
North America	132	0.8	155	10.7	295	0.0	582
South and Central America	54	-3.6	51	6.3	89	-3.3	194
Europe	403	7.2	422	6.0	1,124	15.2	1,949
EU (27)	366	4.9	379	6.5	1,029	13.3	1,774
CIS	28	-9.7	65	-4.4	77	2.7	170
Africa	71	9.2	26	0.0	74	8.8	171
Middle East	113	2.7	87	14.5	68	7.9	268
Asia	423	6.8	360	14.3	562	8.7	1,345

Note: EU: European Union; CIS: Commonwealth of Independent States.
Source: *International Trade Statistics 2015*, WTO.

Table 1.3 shows service exports and imports of major Asian economies in 2014. China is the top trade nation in service trade in Asia, followed by Japan and India. The top five economies could account for about 20 percent of Asia's service exports and 16 percent of the service imports, while the top ten economies accounted for 24 percent and 20 percent, respectively. It means that service trade is quite evenly distributed among most of the Asian economies except several largest traders.

The composition of Asia's service trade had remained rather stable with transport and travel being the leading sectors. The export of transport services accounted for 21 percent of Asia's total service exports while travel accounted for 30 percent of the total in 2014. The export of transport and travel grew at 2.0 percent and 4.5 percent respectively in 2014. The imports by these two service sectors grew faster, with the transport up by 6.8 percent and travel by 14.3 percent.