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China and Asia - The Forum and the Formula

As the Boao Forum for Asia Annual Conference (BFA AC) enters its second decade, the discussion and potential of Asia as an integrated economic region also are entering a new stage. While intra-Asian trade has grown at an accelerating rate since the global financial crisis and several aspects of integration have proceeded smoothly, the more developed trading blocs in the world, notably North America and the European Union, have confronted many challenges in sustaining growth and balance among their member nations. As a result, at the BFA AC and other important international gatherings of government, business, and academic leaders, it has become a commonplace to refer to Asia as the world's engine of recovery from the crisis and the epicenter of future growth.

But the discussion of Asia's regional integration has not really encompassed the challenges now being faced by other trading and common currency blocs. For example, the currencies that facilitate regional value chain integration in the developed regions of the world, primarily the US dollar and Euro, have linked together economies, like the US and Mexico or Germany and Greece, in complex and often politically challenging ways. The complex workings of regional integration are beyond the scope of this brief paper, but our goal is to look at the characteristics of Asian economic integration and identify characteristics and some ways in which the process differs from other parts of the world.

Regulatory reform sets the stage for regional integrations, and that is inherently a multilateral diplomatic process. What plays out on that stage is largely determined by market and demand drivers, the commercial determinants of what happens across national borders within the region.

Policy and regulatory enablers

Zhang Yunling, Director, Institute for Asia Studies at the Chinese Academy of Social Sciences, observed a few years ago that immediately after its accession to the World Trade Organisation (WTO) in December 2001, China adopted a regional approach to trade and began negotiating and implementing bilateral FTA across the Asian region. China's exports to the US and Europe had developed in such a way that major export categories contained very significant content from across Asia, including raw materials, manufactured components, and in some cases major sub-assemblies. China was the final assembler, the last stage of a long production line that stretched to Singapore, Malaysia, Indonesia, Thailand, Korea and even Australia. Post its WTO accession, China also immediately took the lead among emerging economies in promoting an emerging economy agenda. That agenda may have contributed to the slow progress of the WTO Doha Round. But it has created two defined and growing networks, an emerging economy trading group, best illustrated by China and Africa, and a regional trading group, best illustrated by China and the Association of Southeast Asian Nations (ASEAN).

In 2009, China became Africa's largest trader partner, and in 2010, China-Africa trade reached US$127 billion. Through the first three quarters of 2011, China-Africa trade grew at 30 percent, year-on-year.

In January of 2010, a number of FTAs opening the borders of China and other Asian nations went into effect, establishing the China-ASEAN Free Trade Area (CAFTA), the largest trading bloc in the world in terms of population and third largest in terms of GDP.

Table 1

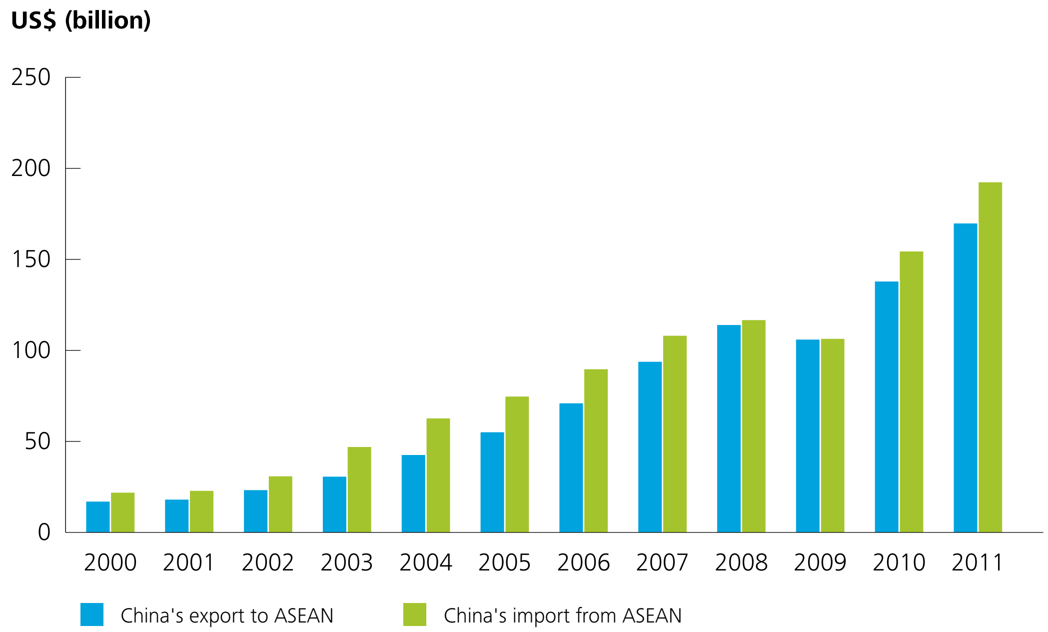
Country	GDP ($ Billion) 2010	Simple Average MFN Tariffs(%)	FTAs in effect (number) 2011	FTA under negotiation/ proposed (number) 2011
Northeast Asia				
People's Republic of China	5,926.61	9.6	12	12
Japan	5,458.83	4.4	12	9
Republic of Korea	1,014.48	12.1	8	22
Southeast Asia				
Philippines	199.58	6.3	7	5
Singapore	208.76	0	18	17
Thailand	**318.52**	**9.9**	**11**	**3**

Source: www.aric.adb.org, World bank, WTO

China was not alone in promoting these agreements nor were FTAs limited to Asia. By the end of 2011, China had 24 such agreements either signed or under negotiation. Outside the ASEAN nations, Korea, which had the highest effective tariff rates in East Asia, had 22 under negotiation in 2011 alone. The pace at which previously protected markets were being opened to freer trade by virtue of these agreements underscores the spreading belief around Asia of the benefits of free trade.

And the agreements were being used. By mid 2010, surveys of PRC large scale enterprises demonstrated that 65 percent were already taking advantage of FTAs with ASEAN neighbors. The FTAs not only supported intra-regional trade, but they added a level of efficiency that helped Asia remain very competitive exporting goods and services outside the region. Investment flows, which had historically been from ASEAN countries to China reversed in 2008, and were growing substantially by 2010, as Chinese enterprises extended their marketing initiatives and production sharing networks into South East Asian countries.

Chart 1: China's trade balance with ASEAN



Source: NBSC (1994-2010), China Customs (2011)

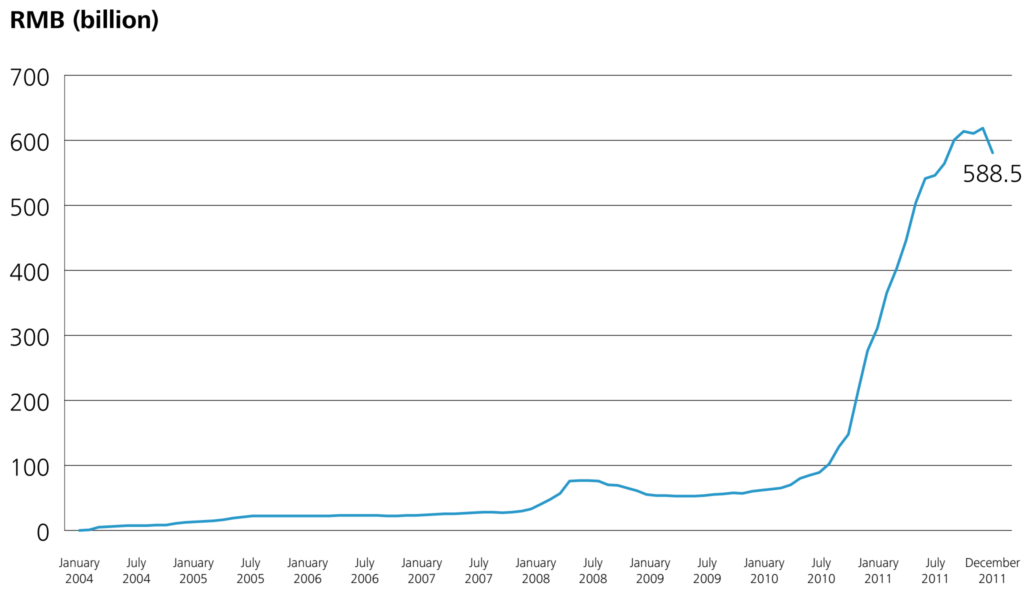
Although China has continued to maintain a sizeable export surplus, albeit now shrinking, as regional trade has developed, China has continued to import more from ASEAN neighbors than it exports to them. We will discuss the complementarities in resources and development models below, which suggest this is a sustainable trend that will stimulate the development of ASEAN partners with China in this trade.

Complementing the FTAs, another key and distinct policy enabler is the push to make RMB a regional trading currency. The pace of RMB growth outside China has had a material effect on integration and appears destined to continue its growth. For the last several years at BFA AC, the international role of the RMB has been a major discussion topic. The global financial crisis triggered more interest in alternatives to the US dollar for trade settlement, and after the discussion of Special Drawing Rights to be established by the International Monetary Fund failed to gain traction, rules for the use of RMB outside of China were liberalised. The RMB abroad began to take off.

In a highly integrated Asia-wide supply chain and market, the advantages of a common currency and reduced currency exchanges for trade and investment settlement are obvious. And they are significant. FOREX risk is eliminated if trade agreements are denominated in RMB, and that reduces the cost of transactions and eliminated hedging costs. The use of a common currency helps keep bilateral trade and investment flows in balance, and that contributes to stability in transactions and trade balances overall.

The growth of the RMB as a trade settlement currency is impressive but not surprising. Remember it was only in the second half of 2010 that the RMB was approved for trade settlement in a wider range of geographies, clearing agreements were expanded, and an adequate network of interbank facilities was made available to support trade. It was at this time that RMB deposits in Hong Kong banks began to grow steeply, and trade settlement followed. By the end of December 2011, RMB deposits in Hong Kong stood at RMB600 billion and trade settled in RMB for 2011 is estimated at 2 trillion, or approximately 9 percent of China's total. Deutsche Bank forecasts for 2012 RMB trade settlement will reach a remarkable RMB3.7 trillion, 15 percent of China's total trade.

Chart 2: RMB deposit in Hong Kong



Source: HKMA

With the August 2011 visit to Hong Kong of vice-Premier Li Keqiang, the RMB abroad initiative was expanded to include investment activities. The premier promised further liberalisation of cross border capital transactions, in particular opening up equity markets to cross-border investment. He also stressed the potential positive impact of offshore RMB in the outbound investment activities of Chinese enterprises.

Financial products and services were already proliferating. The Hong Kong Dim Sum bond market is well-known, and expanded bond and equity markets in Hong Kong and Singapore are being contemplated. Several types of capital transactions are now permitted under rapidly evolving guidelines, and these will expand cross-border investment activity between the Chinese Mainland and Hong Kong and between Hong Kong and ASEAN and Asian neighbors. Over time, as RMB growth continues, it will be an important global currency, but in the mid-term, the benefits of RMB use for trade and investment will primarily be felt in the Asian region and will be a distinct factor in regional integration.

Market and demand drivers

Chinese leaders in previous BFA Forums have mentioned the massive size of the emerging consumer market in Asia, taken as a whole. There is no debate that with huge populations across the region, strong regional growth and improved standards of living are a win-win for all nations that participate in regional trade and investment growth. Beyond the predictable growth of Asian consumption, well-balanced complementarities in resources and development stages among nations within Asia provide the foundation for many win-win outcomes of increased cross-border trade and investment within the region.

A compelling analysis of China's growth in the reform era attributes rapid economic development to low cost labour in the decade from 1985-1995, then low cost capital and infrastructure investment from 1995-2005. While productivity gains have kept China's labour competitive, even as salaries have increased sharply, China is no longer a low cost labour country, and that creates a push for labour intensive activity to move to ASEAN countries that are at earlier stages of development. This is, of course, already underway, and the process promises to strengthen the links in region-wide production sharing networks, under the FTAs and with improved logistics to support the growth of modern, optimised supply chains.

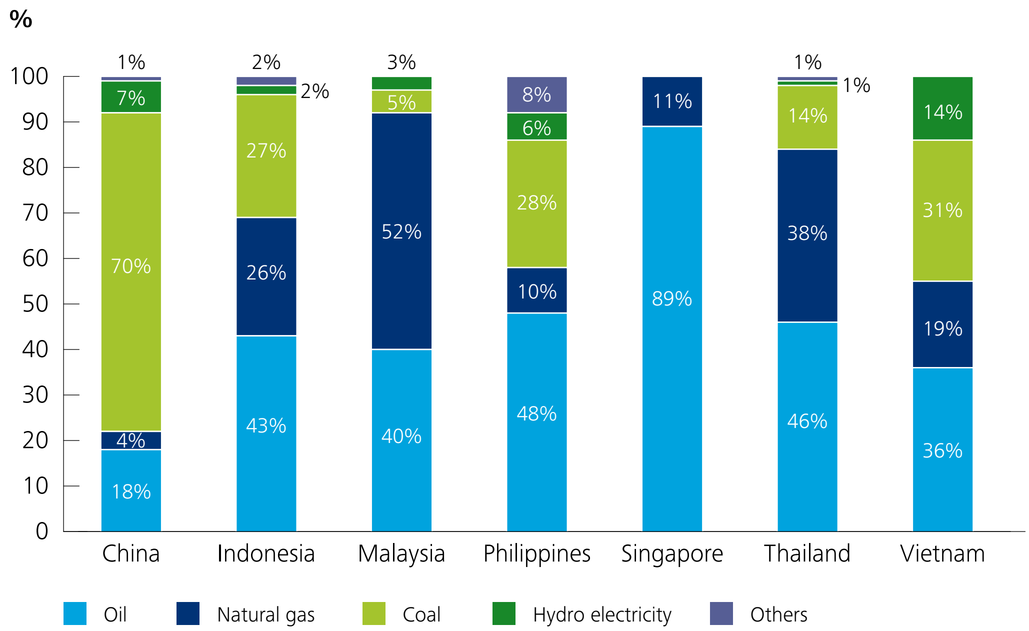
Perhaps even more influential than labour arbitrage are the resource complementarities among the countries of Asia. China faces a rising food import bill. Some 80 percent of its soy bean consumed in 2011 were imported, a number that will grow in 2012. And China's annual oil and liquified natural gas (LNG) import bill is reaching US$200 billion, even the outlook for more volatility in oil prices becomes all but certain. The obvious pattern that defines Chinese bilateral trade, regionally and globally, within Asia and between China and Africa and China and Brazil, is the exchange of raw materials for manufactured goods. The volume and value of this basic trade equation, not to mention the growth rate, are unprecedented in global commerce.

Looking at the 12th Five-Year Plan, we can see the importance placed on increased agricultural productivity, reduced energy intensity, and shifts to reliance on energy sources other than imported oil and gas. But realistically, China will continue to import large quantities of food and oil and gas, regardless of what happens on-shore. Net imports of crude oil grew by 6.4 percent in 2011, and that growth rate is officially expected to slow to only 5.93 percent in 2012. While China presses ahead on the development of on-shore energy resources, notably new coal and non-conventional gas, it is likely to remain the world's largest energy user and see a steady increase in oil and LNG imports.

For such critical imports, trade within the region is preferable, including regional food products like palm oil and the critical energy resources of oil and gas. Logistic security and efficiency are among the obvious reasons. Trade in RMB is preferable, and imports that can be balanced against rising exports with the same trading partner are preferable, also for both efficiency and security reasons.

Food and energy trade will be important components of Asian regionalisation. The energy profiles of Asian countries reveal their resource profiles and in turn reveal potential trade complementarities in the near term future.

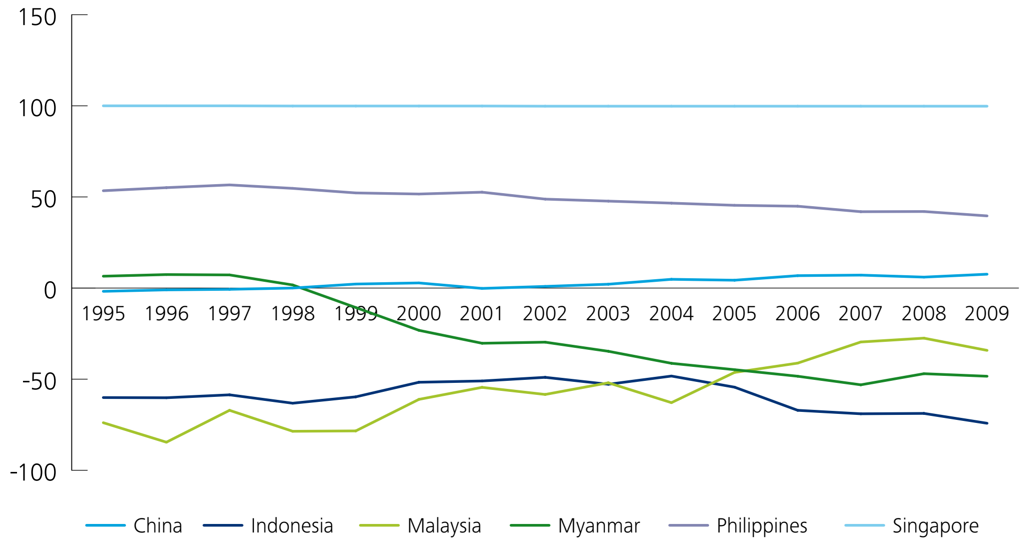
Chart 3: Energy consumption by fuel type 2010



Source: BP Statistical Review of World Energy 2011

Natural gas is a good example of market-driven China-ASEAN trade growth for a critical commodity. China began importing natural gas in 2005. China's appetite for imported natural gas is expected to grow, driven by increased need for environmentally friendly but portable energy sources and industrial feed stock. Major natural gas producers and exporters in ASEAN are Indonesia, Malaysia and Brunei, which together occupied more than 50 percent of Asian LNG production and exports. Indonesia, as the world 3rd largest LNG exporter, shipped 27.9 bcm LNG to the rest of world in 2010, with leading importers such as Japan, China, and South Korea. According to China Customs, the country's LNG import was 9.63 million tons in 2010, soaring by 69 percent compared to 2009. Australia, Indonesia, Malaysia and Qatar are China's major LNG trading partners.

Chart 4: Net energy imports (% of energy use)

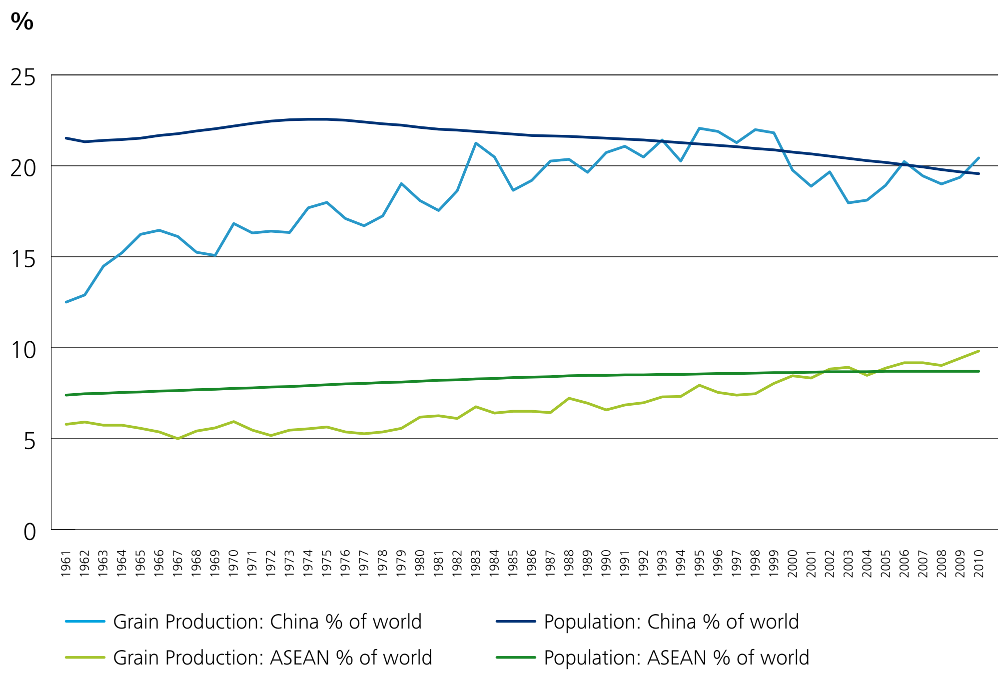


Source: World Bank, Deloitte analysis

In terms of maintaining positive trade balances with the rest of Asia, China alone is in line to import an increasing percentage of its energy needs from ASEAN neighbours.

Food is an interesting example of trade complementarity for two reasons. Trade in food within Asia is growing rapidly, and is reasonable balanced, with China maintaining a long import surplus, which is only now showing some signs of moderating.

Chart 5: China and ASEAN grain production vs. population



Source: Food and Agriculture Organisation of the United Nations

But overall, if we look at population and food production, China and the ASEAN nations as a group are well balanced, with both showing a more rapid growth in food production than population. This is a formula for stable, intra-regional food trade that suggests the China and ASEAN will be increasingly self-sufficient, as a region, in meeting its food needs, and driving more trade to achieve balance of specific products. Nonetheless, Chinese enterprises continue to shop the world for investment in food productivity assets, from mined fertiliser components to land for primary agriculture production.

FDI from outside the region is another driver of regionalisation. Even prior to the full expression of the global financial crisis, investment funds were accumulating in record numbers at China's door. China has remained a favoured investment destination throughout the crisis and its aftermath, but most recently we have witnessed the regionalisation of major investment flows as well.

There are two interesting trends to point out. While China dominated FDI after joining the WTO in 2001, ASEAN nations have been receiving a rapidly growing fraction of the FDI reaching emerging markets since 2007. Secondly, after a downtrend in the wake of the crisis, China and ASEAN taken together have seen a steep rise in FDI since early 2009.

Chart 6: Inward and outward foreign direct investment flows, annual, 1990-2010

Source: UNCTAD

In another way, global investors are reflecting the growing importance of the region and a regional perspective in their choices of targets and destinations.

The future of trade and investment blocs

The data leads to an optimistic assessment of the future of the Asian regionalisation trends and to the benefits regionalisation could bring to many Asian nations at all stages of development. And yet this story in Asia is unfolding as the European Union faces the potential of a stalled recovery or recession, and, in the eyes of some, the Euro as a viable regional currency is under threat. The political consensus about free trade agreements in the United States is increasingly a subject of debate, and throughout the developed world, protectionist policies appear to be gaining public support.

At this stage in our analysis, we can ask more questions than we can answer. Is smooth and productive regionalisation something that appears at a certain point in the history of regional development but cannot be sustained? Or are there differences in the nature of Asian regionalisation that suggest a different future?

Regional structures suffer serious strains during times of global economic stress, and nothing need to be said about the on-going economic stress the developed world is under. Sustained high growth in Asia, led by China, creates an opportunity for regionalisation that is primarily viewed as positive by leaders across Asia and their public. While there is no easy formula for success, some of the features we have seen in Asia's regionalisation dynamic are features that can support sustained benefits from increasingly open trade and investment in Asia.

Asia has large populations and many countries are on fast growth tracks. As we have discussed, the complementarities between development stages and resource profiles are strong, and the dynamics of trade seen regionally and bilaterally within the region are reasonably in balance. The trend for the last several years is clearly toward more open trade and investment policies, and the RMB as a regional trade and investment currency has gotten a warm reception in most Asian nations.

The contrast in the nature of the RMB as a regional currency and the Euro is clear. The expanding use of the RMB is enabled and permitted by regulatory change, but its adoption by both central banks and enterprises is largely market driven, not mandated by policy. So while the RMB is on track to become a regional currency, its market-driven proliferation across Asia does not engage Asian countries in negotiations and agreements with each other about sovereign debt, central bank practices, taxation, and social investment, nor does it require at this stage an Asian Central Bank. The stability of the currency and its utility for trade, investment, and wealth management will determine its popularity, and it will coexist alongside national currencies and the other major global trading currencies as a competitive option. Depending on the regulations of each nation and its perceived reliability, the RMB's role could well grow as an alternative street currency and wealth management currency in several Asian nations.

Based on our analysis to date, we believe that there are differences in the nature of Asian regionalisation that suggest a sustainable path for the foreseeable future. Having said that, we also believe that policy makers and large enterprises in the region should not turn a blind eye to the experiences of other trading blocs in the world, because sustaining the benefits of regional integration will require the same kind of hard work and quality policy decisions that have brought the region to its current strong position.

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