FOREIGN TRADE GROWTH, PREREQUISITE FOR ECONOMIC DEVELOPMENT OF EMERGING ASIA

Professor Octavian-Liviu OLARU, PhD
Christian University „Dimitrie Cantemir”, Bucharest,
International Economic Relations Faculty,
livolaru@yahoo.com

Livia-Irina OLARU, PhD
Master Candidate,
Christian University „Dimitrie Cantemir”, Bucharest
livia_irina@yahoo.com

Abstract: To boost their growth prospects through international trade, countries in developing Asia need to pursue different strategies depending on their circumstances. For economies in East Asia and Southeast Asia, the key challenge is for production and trade networks to undertake the adjustments necessary to accommodate increased domestic consumption and expand the volume and scope of intraregional trade. In particular, these economies may need to shift from vertical specialization and network trade to product-based horizontal specialization and intraregional trade in final goods.

For non-Indian South Asia, the priority is to continue down the track of further economic integration with the sub-region’s dominant economy; for the sub-region as a whole, to reduce excessively high trade costs and integrate more closely with the rest of Asia. Trade facilitation and regional integration are critical to speed up South Asia’s participation in regional production networks. In this endeavor, India stands out as a huge market for exports from neighboring countries and as a sub-regional springboard for pan-Asian integration.

Key words: international trade, economic growth, trade costs, regional integration.

JEL Classification: M16;
International trade has been the engine of growth of developing Asia. Its significance in raising living standards across the region has been widely substantiated. Through integration with the global economy, many countries in the region achieved prolonged periods of rapid growth, lifting millions of their citizens out of poverty.

Still, such growth was far from uniform among sub-regions. East Asia and Southeast Asia stand out as being very open to trade. Their shares of exports to GDP increased significantly from late-1990 levels, and were instrumental in raising the average for developing Asia as a whole. Jointly, East Asia and Southeast Asia accounted for almost the entire region’s share of world exports. In addition, their export products were the most diversified, and they scored well on the World Bank’s Logistics Performance Index (LPI), which gauges the costs of poor logistics to country competitiveness.

By contrast, South Asia’s trade share contracted and its export share is still far below the regional average, despite the leaven in the form of a fast-rising Indian economy. Moreover, its tariff barriers remained the highest in the region, and it ranked poorly on the LPI.

An analysis of the recent trade performance of developing Asia is not complete without any mention of the region’s two emerging giants. As may be expected, the economic indices register the very impressive strides made by India and the Popular Republic of China (PRC) in trade.

In little more than a decade, India almost doubled its exports’ share in GDP and in global markets.

The PRC recorded higher shares of exports in both GDP and global markets, almost doubling the former and more than doubling the latter in the last decade. Its exports were also more diversified, its average tariff rates were lower, and it had a higher LPI score. By all measures, the PRC’s economy is thus more integrated with world markets than India’s, and not coincidentally, its growth performance has been the highest in developing Asia.

The foregoing findings on trade performance are consistent with trends that suggest that the sub-regions of developing Asia can be grouped into three subsets, depending on the key challenges they face in international trade.

First, there is the cluster of highly interdependent, open, and vibrant economies in East Asia and Southeast Asia that include the NIEs (Newly Industrialized Economies), the PRC, and the more advanced countries of ASEAN. With the PRC at the center of the assembly process and with exports going mainly to the US and Europe, production in and trade among these economies have been increasingly organized through vertical specialization in networks, with intense trade in parts and components, particularly in the ICT and electrical machinery industries. Against the prospects of an extended post-crisis period of reduced demand from developed-country markets, the key challenge for these countries is to adjust their production structures to be more responsive to domestic and intraregional demands.

Second, there is South Asia, which has remained relatively isolated trade-wise from the rest of the region. Limited participation in Asia’s production networks, exacerbated by high protection and elevated trade costs, has hampered South Asia’s integration with the vibrant economies of developing Asia. Even for India, deeper regional integration and further efforts at trade facilitation are crucial to fully leverage the potential of closer economic ties and network trade with East Asia and Southeast Asia. To pave the way for broad regional integration across developing Asia, the key challenge for South Asia is to integrate more strongly as a sub-region, by removing the remaining trade barriers and substantially lowering the cross-border costs of trade.

Third, there is the vulnerable group of countries. A highly heterogeneous subset, their common characteristic is that they are the region’s least developed economies. Although some of them have managed to diversify their exports into higher value-added manufactures and services, these countries generally remain...
vulnerable to commodity price fluctuations and to sudden demand disruptions. Any such shock carries the risk of setting back development.

The key trade challenges differ by circumstances. East Asia and Southeast Asia need industrial restructuring to accommodate a gradual shift in the distribution of demand toward domestic consumption and regional trade. South Asia requires greater economic integration among countries within the sub-region as well as closer ties with the rest of the developing Asian region. Finally, vulnerable economies will need support to develop the capacity to benefit from greater openness to international trade.

2. INTERNATIONAL TRADE AND INDUSTRIAL RESTRUCTURING

For East Asia and Southeast Asia, the key challenge is how the international production networks that are centered on the PRC will adjust to a prolonged period of reduced demand from traditional export markets. Recovery from the global financial crisis in the US and in Europe (as well as Japan) is slow and tentative.

Some recent policy discussions have thus prescribed that developing Asia in general—and East Asia and Southeast Asia in particular—should reorient its growth strategy and accord a larger role to domestic and regional demand. Not only would this provide additional engines of growth, it would also reduce the region’s vulnerability to shocks from the global economy.

For the East Asian economies in particular, the recommendation is to stimulate household consumption on the supply side, by providing governmental support to sectors and industries that cater to domestic markets, notably small- and medium-sized enterprises (SMEs).

Special attention has been devoted to the problem of the PRC-centered international production networks which will have to undergo structural adjustments in response to a different composition of demand. But a restructuring is inevitable for as long as exports to developed-country markets remain sluggish and if a gradual shift toward more domestic and regional demand is to be accommodated, for several reasons:

First, there is the issue of production specificity. PRC final-goods exports tend to be specific to foreign markets, and much of the PRC’s physical and human infrastructure is linked to a manufacturing sector that is geared for exports rather than for domestic consumption. For many of the PRC’s East Asian and Southeast Asian intermediate-goods suppliers, the problem may be worse, as the parts and components that they produce are not likely to have domestic uses, specific as these are to the regional production network. For the same reason, it is unlikely that these intermediate-goods exports can be easily diverted from the PRC to third markets.

Second, it is generally acknowledged that the production networks have excess plant capacity. If so, the excess capacity is likely to increase with the slowdown of exports to developed-country markets (and until domestic demand and intraregional trade increase), which in turn will increase the pressure for plant and firm closures.

Third, while domestic and regional consumption levels do not offset the shortfall in export demand, lower aggregate demand in East Asian and Southeast Asian economies is likely to lead to vertical consolidation in the production networks. Increased competition will drive out high-cost producers, reducing the number of parts and components suppliers. Similarly, import substitution (of intermediate goods) in the PRC may well reduce the scope for specialization in production and the number of segments in value chains. However, establishing final goods – producing firms in the intermediate goods–exporting countries may not be an option if the latter lack the endowments to produce the entire value chain.

Affording larger roles for domestic consumption and regional demand in East Asia and Southeast Asia in particular and in developing Asia in general, will thus require a gradual move away from vertical specialization and network trade to product-based horizontal specialization and intraregional trade in final goods.
For the PRC, the strategy implies that there will be increased pressure to phase out labor-intensive manufactures and allow them to move to less developed countries. Rather than retaining such industries by keeping wages behind productivity and holding the value of the currency down, the PRC must eventually become an importer of such goods.

A benefit of this restructuring is that, for countries at similar levels of industrial development and technological maturity as the PRC, a shift from vertical to horizontal specialization in the long term will promote the kind of intra-industry trade that underpinned the rapid expansion and integration of Western Europe when countries were producing and trading similar products, such as passenger cars, consumer electronics, and other household durables.

In the process of reorientation toward horizontal specialization, foreign direct investment (FDI) from more advanced economies in developing Asia will play a key role in relocating labor-intensive industries to the region’s less developed countries, thereby helping to deepen regional integration through both trade and investment. This was the course taken by Japan and subsequently the NIEs in the process of industrial upgrading and productivity growth.

Closing the gap between wages and productivity in the PRC will not only help to accelerate the growth of domestic consumption and demand for final goods, it will also encourage firms in certain labor-intensive industries to relocate gradually to poorer countries through FDI in Southeast Asia and South Asia. Recent data from the United Nations Commodity Trade Statistics Database (UNCTAD) show that intraregional FDI has been growing since the mid-2000s and now accounts for about half the region’s total inward FDI stock.

For the relatively more advanced economies in ASEAN—Indonesia, Malaysia, the Philippines, and Thailand—the key challenge will be how to reanimate private investment in high-productivity, skill-intensive sectors. Many of the sectors vacated by the NIEs have been captured by the PRC rather than by these higher-wage ASEAN economies. They have ample domestic resources to do so, but lack the entrepreneurial expertise and investment needed (despite the recent increase in intraregional FDI) for such a restructuring. Boosting private investment will thus serve the dual purpose of accelerating the growth of domestic demand as well as industrial restructuring in these countries. Indeed, new investment will mainly be needed to achieve the industrial restructuring necessary for a change in the product mix to match domestic and/or regional demand in East Asia and Southeast Asia.

However, the new incentive structure associated with the rebalancing of domestic and external demand, including changes in wage–productivity configurations and exchange rates, may not be sufficient to drive investment toward areas that need to expand in order to meet a faster growing domestic market. Therefore, government action toward higher domestic demand needs to be accompanied by industrial and investment strategies for dovetailing the structure of production to the pattern of domestic and regional demand.

Global and regional production sharing has become part of the economic landscape of developing Asia. Since the late 1990s, production and trade between countries in the region have been characterized increasingly by vertical specialization in networks, with intense intra-industry trade in parts of components, particularly in the information and communications technology and electrical machinery industries.

With the PRC as the network hub of regional assembly and the jump-off point of final goods exports predominantly to the United States and Europe, intraregional trade—mainly Japan, the newly industrialized economies and the more advanced Association of Southeast Asian Nations (ASEAN) economies as suppliers of intermediate goods—has grown even faster than the region’s trade with the rest of the world.

In 2008, the share of intraregional trade in parts and components accounted for more than 55% of total trade by East Asia and Southeast Asia combined. By contrast, the share of
intraregional trade in final goods was just about 43%. This reflects the region’s strong bias toward network trade in parts and components, rather than trade in final goods consumed in the region. Indeed, for Asia including Japan, trade in final goods is predominantly accounted for by demand outside the region—71%; 46% goes to the US and Europe.

The PRC has been sourcing a growing share of parts and components from other countries in the region, including Japan, while exporting the bulk of final goods to the rest of the world. As a share of PRC’s total manufacturing imports from East Asia, parts and components imports grew from 18% in 1994/95 to more than 46% in 2006/07. Vertical integration and network trade appear to have increased rather than reduced-Asia’s dependence on external demand.

3. GROWTH ECONOMIC POTENTIAL FROM TIGHTER REGIONAL INTEGRATION

South Asia is probably the most heterogeneous sub-region in Asia in terms of trade development. The giant Indian economy dominates the sub-region, with an emerging manufacturing sector (with strengths in labor-intensive manufactures, automotive, iron and steel, and pharmaceuticals) and a distinct competitive advantage in informatics and communications technology.

Compared to East Asia and Southeast Asia, however, South Asia trades less, receives less investment, and is less integrated with other countries inside and outside the region. Trade costs, including tariff and non-tariff protection, are well above the regional average. The intraregional trade share is but a fraction of East Asia’s. The extent of network trade is negligible.

Among the South Asian countries, only India stands out as a dynamic pole of economic growth that has been deepening its integration with the rest of Asia. The sheer size of its market means that India can be a haven for exports from other countries in the sub-region. In addition, its tighter integration with East Asia implies that India can serve as a sub-regional springboard for pan-Asian integration. India has already concluded several free trade agreements (FTAs), including with ASEAN and the Republic of Korea. Moreover, India has taken a leading role in promoting deeper economic integration in the sub-region through the SAARC Preferential Trading Arrangement and the South Asian Free Trade Area (SAFTA). These can be the bases for South Asia to integrate initially within the sub-region and later with East Asia and Southeast Asia.

A prerequisite for South Asia’s integration will be the reduction of trade costs. High tariff and non-tariff trade protection, poor physical connectivity, behind-the-border procedures have long been identified as major hurdles. A recent assessment by Asian Development Bank (ADB) and the Federation of Indian Chambers of Commerce and Industry (FICCI) points to the importance of targeted issues for improving the business environment in South Asia in the short and medium terms. Examples of priority actions for private sector-led integration are expanding the SAARC visa exemption scheme to business travelers, dealing with non-tariff barriers, improving customs stations on land, and promoting intraregional investment. South Asia’s integration with the rest of developing Asia, in turn, faces three problems.

First, broad-based support for new trade agreements may be hard to secure in South Asian countries and the vulnerable economies that are likely to be adversely affected by the erosion of preferential tariff rates and by altered discrimination patterns. Comprehensive strategies that address adjustment costs in this regard will thus be needed. An example is the Aid for Trade Initiative, particularly the parts with a regional focus, which will play an important role in supporting integration in South Asia.

Second, the benefits from region-wide integration are likely to be unevenly distributed across countries and sub-regions. The still-large differences in most-favored-nation (MFN) applied tariff levels, for instance, imply that some countries and sub-regions have lower trade costs and are more open to trade. In turn, these countries handle larger trade volumes. More specifically, at 11.9% in 2008, the average tariff
level of South Asia was considerably higher than those of East Asia and Southeast Asia, at 3.1% and 5.5%, respectively. Being more open, East Asia is thus preferred as a trading partner to South Asia and, potentially, will benefit more from region-wide integration.

Third, the substantial reduction of MFN tariffs in East Asia and Southeast Asia, and in India more recently, has diminished the trade enhancing potential of preferential tariff arrangements. This shifts the policy emphasis to reducing trade costs. Put differently, the benefits of pan-Asian integration will be greatest if regional tariff liberalization in trade of goods and services goes hand in hand with substantial improvements in trade-related infrastructure and trade facilitation. Trade infrastructure and facilitation initiatives, however, are either costly or administratively difficult to implement.

A recent study (Francois and Wignaraja 2009) explored the income effects of various regional integration scenarios. Based on a global computable general equilibrium model of 35 country groups and 36 sectors, benchmarked to the year 2017, and premised on zero tariffs in goods and services and substantial improvements in trade-related infrastructure and trade facilitation, the study compared the outcomes of an FTA between ASEAN, Japan, the PRC, and the Republic of Korea (ASEAN+3); an ASEAN+3 FTA that also includes India; and a pan-Asian integration scenario between ASEAN+3, India, and all the other countries of South Asia.

Among all the scenarios, the gains are largest for Asia including Japan (about US260 billion) and the losses are smallest for the rest of the world under the broad pan-Asian integration (ASEAN+3 and South Asia FTA) scenario. Reflecting relative size, East Asia (Japan in particular) stands to gain the most in absolute terms. In proportion to regional incomes, however, the gains for South Asia and East Asia are comparable, at 2.0%–2.3%.

Individual South Asian countries—and South Asia as a sub-region—stand to gain substantially from being part of broad pan-Asian integration. Similarly, the South Asia FTA benefits all its members, albeit India’s gains will be a fraction of those that it gets from integration with East Asia.

South Asia has the potential to become an economic power in the next 2 decades. For the region to live up to its potential, India may have to grant unilateral tariff concessions to its neighboring countries, thereby providing access to its huge market. In turn, South Asian countries will need to lower trade costs, which would enable them to exploit the economies of scale of a large production base made possible by an expanded (because integrated) market.

Free trade agreements (FTAs) are playing an increasingly prominent role in the process of gradual integration between South and East Asia. Examples of FTAs already in effect are the Asia-Pacific FTA, the Comprehensive Economic Partnership Agreements between India and ASEAN and India and the Republic of Korea.

Against the backdrop of stagnating global talks in relation to the World Trade Organization’s Doha Round, however, policy makers in developing Asia must ensure that the proliferation of FTAs between South and East Asian countries do not represent stumbling blocks that undermine the prospects of establishing a more comprehensive regional arrangement and of making further progress in world trade liberalization.

Rather, policy makers should pursue „open regionalism“ with its emphasis on inclusiveness and on the compatibility of regional integration with multilateralism. This requires that developing Asia strive for the most far-reaching and comprehensive agreement, including all countries in all sub-regions, thereby boosting regional trade and incomes, while limiting the adverse effects on the countries excluded.

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