M R Pridiyathorn Devakula: India and Asia - trade linkages and alliances

Remarks by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the Wharton Global Alumni Forum, Mumbai, 6 January 2006.

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Dean Harker,

Mr. Ambani,

Ladies and Gentlemen,

I am honored to be here today among friends and associates of the Wharton Global Alumni. Given that it is the first time that the School is organizing the Forum in India, it seems only fitting that we should be talking about the rise to prominence of India as an engine of growth, both in the region and globally. More importantly, I would like to highlight the potential for India's trade and investment linkages with East Asia, and how the two regions of South and East Asia can leverage on one another and become a global force to be reckoned with.

China and India, Asia's two largest economies, are often hailed as potential growth areas and the new engines of growth for the world. China's rising economic prominence has been particularly evident in the past decade and a half, with its gross domestic product (GDP) in purchasing power parity (PPP) terms, measured as a share of total world GDP, rising from 5.7% in 1990 to 13.6% in 2005.

India, although coming later into the scene, has quickly caught the attention of the world as a potential global economic powerhouse. India's economy is the 14th largest in the world measured in nominal US dollar terms, but in terms of purchasing power parity, India is the 4th largest economy in the world according to the iMF.

India's GDP in purchasing power terms has also risen substantially, with its share rising from 4.3% to 6.1% of world GDP over the past 15 years. India's unique characteristics that enhance this growth potential include its dynamic population and demographic structure, as well as its emergence as a global leader in service exports. This dynamism, growth, and positive sentiment has been clearly evident in India's stock market, which has rallied 40% in 2005, second only to Korea as best performing major market in Asia last year.

Sometimes overlooked however, is an informal group of Asian economies (excluding Japan) that account for the majority of trade and GDP in East Asia, known as Asia-9. The Asia-9 economies comprise China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand, and Taiwan.

The share of Asia-9's GDP in purchasing power parity terms has grown from 11.4% in 1990 to 20.6% in 2005. To put this in perspective, this exceeds the EU's PPP share of world GDP of 18.8%, Japan's share of 6.7%, and is very close to the United States 20.7% share of world GDP in 2005.

But I am not here today to overwhelm you with facts and figures! Today I would like to discuss one of the most important drivers of this phenomenal growth – and that is, international trade. I believe that Asia-9's experience of growth, or more specifically, intra-regional trade and production, can provide an interesting case study for our South Asian counterparts.

The emergence of the Asia-9 economies

To bring this perspective even closer to home to this audience, let us look at these developments from India's perspective. Traditionally, India's trading partners have been the G3 countries, with the US, the EU and Japan accounting for 52% of India's total trade with the world in 1990. At that time, India's trade with Asia-9 accounted for only 8.3% of India's total trade.

Fifteen years later, the structure has changed remarkably. The share of trade with the G3 countries, in terms of India's total trade, has fallen to 33.9%. During the same period of time, India's trade with Asia-9 has risen from 8.3% to 23.3% - an almost three-fold rise.

From the perspective of Asia-9 themselves, intra-regional trade among themselves has risen from 29.1% of their total trade in 1990 to 41.4% in 2005. More striking, the share of intra-regional trade among the Asia-9 economies has outgrown the share of their trade with the G3 countries over the same period, which has in fact fallen from 52.6% to 39.2%. In terms of growth, trade among Asia-9 economies has grown at an average 23% in the past 3 years, exceeding the average 17% growth in trade with G3 countries.

What message can we draw from these developments? I think that for the Asia-9 economies, increased trade-linkages and cross-border investment have resulted in a “symbiotic” relationship, with China as the driver of growth for the rest of Asia, AND vice-versa. Together, this relationship has helped raise the profile of Asia-9 as an important pillar for regional and international trade.

Factors underlying Asia-9’s growth in trade

What have been the driving forces behind this synergy in the evolution of trade among the Asia-9 economies? When one speaks of the remarkable growth in Asia, the general perception is that growth has been dominated by China. While it is true that growth has been driven by China, the traditionally strong trade and investment ties between the remaining Asia-8 have been just as important in allowing the high rates of growth to be sustained in the region. In terms of intra-regional trade among the Asia-9 economies in 2005, 13% of trade flows are with China, while 28.4% of trade goes on among the other 8 economies.

Why has this intra-regional trade grown so substantially? One explanation is that East Asia has adopted an outward oriented policy of internationalization of production process which has allowed the benefits to be derived from the linkages and alliances among the players in the region, both at firm level and at the level of the macro economy. With modern production processes broken down to components and parts that could be regrouped at the final assembly, East Asians have availed themselves of this phenomenon by capitalizing on the “benefits” from the international division of labour and production in the areas where they have the greatest comparative advantage. This has in turn brought about the lowest and most efficient production processes available on an international scale, while at the same time encouraging specialization and boosting productivity growth in individual economies.

This “internationalization” of the production process has now been replicated many times over. Countries move up the product ladder towards more sophisticated manufactured products, and parts of the production process are then relocated from traditional producers such as from Japan, Korea, and Taiwan to South East Asian countries with lower production costs. This has led not only to a rise in the value of trade in the region, but also in a shift of the structure of trade and inter-linkages in production in the region. Against this background, the success of any enterprise in the region, going forward, must involve production networks and supply chains based not only on one single national economy, but also across borders.

This can be witnessed today in the case of manufactured goods, such as automobile production, electronics or textile and garments. In each case, raw materials are being sourced in one country, whilst assembly production or designs of that same product could be made in another country - all based on the location where they best have comparative advantage.

The second factor contributing to rising intra-regional trade is the reform efforts and liberalization policies undertaken by the Asia-9 economies. These reforms which came out of the collective efforts of government and the private sector, include significant trade reforms and progressive liberalization and opening up of markets to greater trade and foreign investment. The outward oriented policy has allowed East Asian firms to be well integrated with the global trading system and ready to participate actively in intra regional trade when the opportunities arise. As important are the structural reforms that encompass the legal, regulatory, and institutional reforms to provide a conducive environment for foreign investors. We have also strengthened the banking and financial sectors so that they are in a position to provide efficient financial services in support of intra regional trade. International standards and best practices are also being adapted in many disciplines such as in the areas of governance, accounting, and taxation to ensure credibility and transparency to our foreign counterparts. These constitute important ingredients of East Asia’s success stories. But most important is the willingness of the governments to open up their economies and the understanding of the business sector on the need to cooperate with their foreign counterparts.

Against this background it is interesting to note that growing intra-regional trade has not been the result of the rise in exports to final destination markets in the G3 countries alone, but also the result of stronger domestic demand growth in the region itself. The rise of the educated middle class in Asia-9 has grown considerably. This affluent middle class has an appetite for consumption that can help sustain growth in the region well into the next decade. MasterCard International recently did a study which tracks consumer trends in Asia and defines the middle class as those earning more than five thousand US Dollars per year. According to this study, when a person's income reaches this level, consumption moves very quickly from basic to discretionary spending – that is to fuel holidays abroad, eating out, and visiting shopping malls – which is a powerful driver of domestic demand within the region. This same study estimates that this middle class will almost double by 2010, signaling the arrival of the Asian consumer as a key driver of growth in the region.

Third, an important reason for these successful relationships has to no small extent been driven by the cultural and ethnic ties within East Asia. These ties, which came about because of historical, geographical and cultural proximity, may vary greatly from country to country, but have no doubt played a part in lubricating the wheels of trade and investment in the East Asian region.

Going forward, domestic demand in the region will continue to grow and further support growth in intra-regional trade. The lowering of tariffs in most Asia-9 economies and bilateral free-trade agreements have supported the development of the "pan-Asia" supply chain. It has been estimated that once an FTA between ASEAN-China is signed, a collective 1.7 billion consumers with a combined GDP of almost US$ 2 trillion will be a powerful force supporting sustainable growth, especially as per capita incomes continue to rise and trade barriers continue to fall in the region.

Finally, a move of regional exchange rates towards greater flexibility will continue to support this increase in trade, with more market-oriented exchange rates sustaining further growth in intra-regional trade. In the past, despite the various exchange rate regimes adopted in Asia-9 economies – which have included both fixed and flexible exchange rate regimes – intra-regional trade has nonetheless grown at a substantial rate. The recent move by the Chinese and Malaysian authorities in the middle of last year to introduce greater flexibility to their exchange rates will help to further support this increased trade. The managed float exchange rate system will allow the exchange rate among Asia-9 to move in close alignment with one another which will make it conducive to trade within the region.

You may be wondering why I have focused on developments in China and Asia-9 and how that is relevant to this audience today. I think this is extremely relevant. Allow me to elaborate further.

As one coming from East Asia to this esteemed gathering, I would like to invite our hosts to "Look East", in the same way that the East Asian region has embraced the policy to "Look West". A number of initiatives have already started, such as the current negotiations over an ASEAN-India Free Trade Agreement, which will further help to cement this relationship. The private and public sectors of both sub-regions could benefit from this synergy and ride on the momentum of growth towards what many have termed "the Asian Century". There is an immense potential to realize from the individual comparative advantages of all the countries in South and East Asia. While China's trade share with India as a fraction of India's total trade stands at 7.7%, another 15.6% of India's trade is with the other 8 Asian economies.

India has the potential to lead trade and economic growth and specialization in the South Asian region. I note with great interest the developments under the landmark agreement to create a South Asian Free Trade Area (or SAFTA), which includes Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka. As I understand it, the SAFTA, scheduled to come into effect on 1 January 2006, will more than double the size of the market in the region. Implementation of the SAFTA along with the needed reforms to facilitate intra regional trade could spearhead growth and investments within the region. These in turn could raise the profile of the South Asian region as another pillar of growth of the global economy.

We recognize all too well that the process of reform, deregulation, and trade liberalization takes time and a strong political will, as well as business sector understanding and acceptance of change. But the reform process in East Asia has proven to be worth the efforts, as you can see from the fast growing intra-regional trade. Many of these reforms remain to be completed, and we need to continue to press on with the reform agenda. But the changes from now on should not be as difficult, as public sentiment is supportive of the benefits of these reforms, in terms of the increased efficiency, predictability, and transparency to businessmen and entrepreneurs, both domestic and foreign. One just needs to cross that threshold.

Thank you for your attention.