

»» Common challenges for Europe and Asia as interdependence grows

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The European Union (EU) and developing and emerging countries in Asia (Developing Asia) are moving closer together. Not only have trade relationships become considerably stronger, the flow of finance and foreign direct investment has increased too. There is also a growing recognition that both regions will be faced with similar challenges in the future, such as increased climate protection, a need to rectify infrastructure deficits – a key obstacle to growth – and demographic change. Notwithstanding the current difficulties within the EU, economic and institutional integration has made greater progress in Europe than in Asia. Even so, new initiatives are emerging here too.

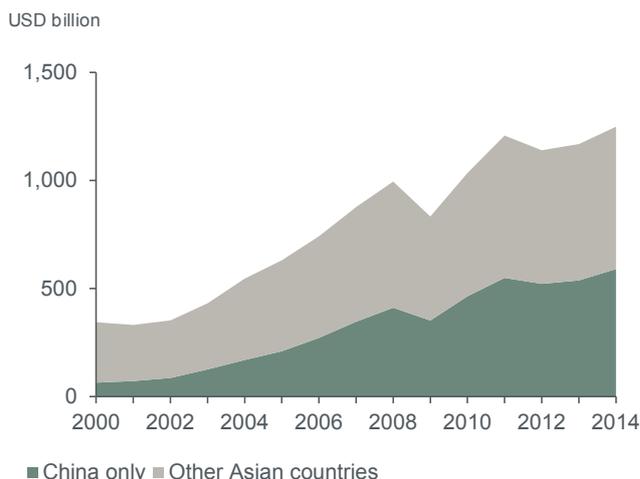
Sharp increase in trade

Against the backdrop of a prolonged economic upturn¹ in Asia's developing and emerging economies (Developing Asia)², trade in goods³ between these countries and the EU grew from USD 344 billion to around USD 1,250 billion in nominal terms between 2000 and 2014, i.e. by a factor of 3.6 (Figure 1). Aside from the slump in trade in 2009 during the global economic crisis and a temporary downturn in 2012, trade has constantly grown. This, in itself, is a striking development. However, it is also worth noting that trade between these two economic areas grew even more strongly than world trade. The EU's most important trading partner in Developing Asia is China. The proportion of overall trade in goods between the two regions that is attributable to China grew from 19 to 47% between 2000 and 2014.

However, in spite of China's growing dominance, it would be inappropriate to interpret trade relationships between the two regions as narrowly restricted to (or even predominantly with) China. Since 2000, trade excluding China has also grown considerably – by 136%.

An analysis of this trade by category of goods reveals a structure that shows the regions' relative competitiveness. Twenty-eight per cent of EU exports to Developing Asia are capital goods (machinery and vehicles; 54% for Germany alone)⁴. Exports from Asia to the EU are more diverse: although here, too, capital goods still account for 12%, electronics make up 19% and raw materials 6% (all data refers to 2014).

Figure 1: EU–Developing Asia trade in goods



Source: UNCTAD, own calculations

It is also worth noting that the bilateral trade between the EU and Developing Asia is not balanced. Over the entire period since 2000, exports from Developing Asia have exceeded those in the opposite direction and this trade surplus with the EU has tended to grow sharply over time; in 2014 it stood at around USD 200 billion. A finding such as this sometimes receives a very critical or concerned response, to the effect that ambitious emerging countries in Asia are clearly getting the better of the rich industrialised countries. Two issues argue against this, however. First, unbalanced bilateral trade does not imply a general external imbalance. In fact the EU does not suffer from such a problem. It has even had a positive current account balance (vis-à-vis the rest of the world) since 2010, with a surplus of between 1 and 2% of GDP. Second, the increase in EU exports to Developing Asia from USD 133 billion to 520 billion since 2000 and the aforementioned high proportion of capital goods show that the EU is perfectly able to hold its ground with competitive products on the Asian markets. High economic growth in Developing Asia has produced an effective industrial base in the region – one which is increasingly able to compete with industry in the EU. At the same time, however, Developing Asia is also a major consumer for the EU, with a great deal of purchasing power.

Despite trade surpluses, Developing Asia remains a net capital importer – except for China

Overall, Developing Asia has a current account surplus with the rest of the world. By definition, this also means it has built up foreign financial assets. According to the aggregate financial account balance for countries in Developing Asia, this build-up of assets due from the rest of the world was around USD 65 billion in 2014. In 2008 it was as high as approximately USD 415 billion (Figure 2).

However, this does not mean that the region does not need capital inflows from the rest of the world. Overwhelmingly, the movement of capital in Asia’s developing and emerging countries is determined by China (in terms of volume), or to be more exact, by its currency reserves. This means the net savings in the Developing Asia region (at least those up to 2014) can be explained by China alone and by just one factor – the central bank’s currency reserves. If we exclude this, Developing Asia is not a net saver with respect to the rest of the world but is reliant on net capital inflows (net capital imports) from the rest of the world (Figure 2), although only to a relatively small extent.

For investors, there are some very attractive investment targets with great potential in Developing Asia, such as India, Indonesia and of course China. Taken together as a region, the Asian emerging countries therefore do not have, and have not in the past had, a major problem “attracting” capital inflows. These inflows may potentially also come from Europe, as Europe (EU 28) is a net saver with respect to the rest of the world.⁵ In 2014 alone, the EU built up financial assets due from the rest of the world amounting to USD 380 billion.

Figure 2: Net savings with respect to the rest of the world

Corresponds to financial account balances, in USD billion



Source: IMF, own calculations

Foreign direct investment has the potential to increase

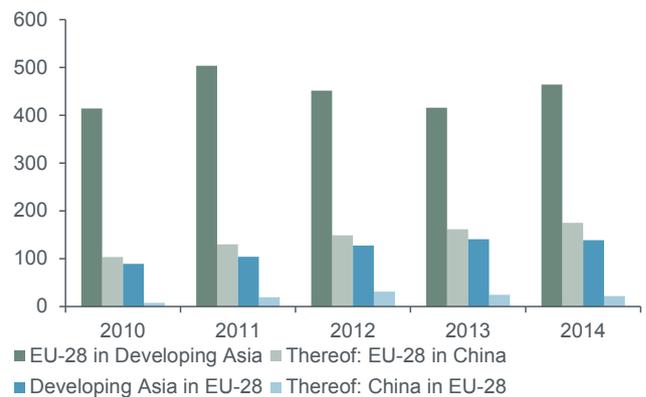
If we exclude China’s currency reserves, Developing Asia has a deficit, and the fundamental question is how this has been funded in the past and is funded today. One way to do this is to look at foreign direct investment (FDI).

Foreign direct investment is a particularly high-quality source

of financing. By its very nature, it tends to involve long-term commitments that are less subject to reallocation and rapid outflows of capital than portfolio investments. In line with the conclusion that Developing Asia needs capital inflows, considerably more foreign direct investment has flowed from the EU to Asia in the past than in the opposite direction. Accordingly, the two regions have different FDI stocks (Figure 3). Even so, Developing Asia’s FDI stocks in the EU are striking – they have increased over time and have now reached more than USD 100 billion.

Figure 3: Foreign direct investment in Europe and Asia

Stocks, USD billion



Source: IMF, own calculations

The dynamics of this development are not, however, entirely a cause for optimism. With average GDP growth of more than 7% p.a., Developing Asia was by far the most rapidly growing group of countries in the world over the last decade. This demonstrates that it also offered incentives for investors to increase the level of their investment in these countries. But foreign direct investment does not reflect the disproportionately high levels of growth in the Developing Asia region. Europe’s FDI stock in the rest of the world rose by an average of 7½% p.a. between 2011 and 2014 but the portion attributable to Asia increased by much less – just under 3%. If we exclude China, European stocks of FDI have actually been shrinking by around 1½% p.a. on average since 2011. In the opposite direction, the picture is very different. Over the same period, Asian foreign direct investment in the rest of the world as a whole rose by roughly 10% p.a., of which FDI in Europe increased by almost 12%. One reason for this could be the continuing high level of administrative complexity required for FDI in the Developing Asia countries – major bureaucratic obstacles, corruption or an opaque justice system are all factors that make foreign direct investment more difficult.

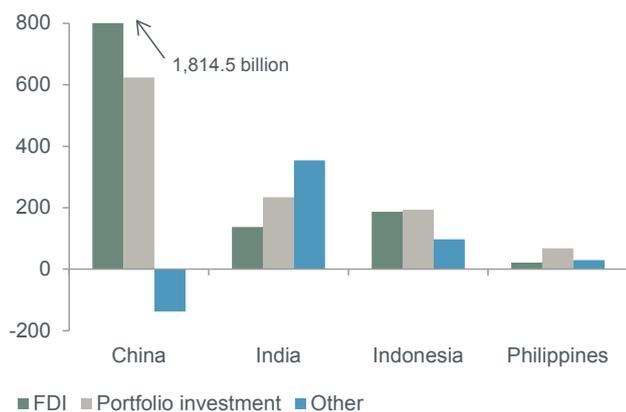
When considered separately, the particular importance of FDI in trade with China becomes clear. This is a result of the keen interest shown by multinational companies in investing in China. Such investment takes place in the form of joint ventures with state-owned Chinese companies. At the same time, levels of regulation for foreign investors on the Chinese capital market are relatively high. This makes other forms of investment, such as shares and bonds (portfolio investments)

or loans, more difficult for foreign investors to manage. Accordingly, FDI relationships with China have become more and more important; the EU-28 countries' stocks of FDI have grown by around 14% p.a. in recent years. Almost 40% of European FDI stock in the Developing Asia region now relates to China. In the opposite direction, however, a change is under way. Between 2011 and 2014, China's foreign direct investment position in Europe grew by more than 30% p.a. – a striking figure, though admittedly it had begun at a low level.

The huge importance of FDI inflows for China is also clear when compared with other countries in the Developing Asia region (Figure 4). For no other country in the region is FDI such a significant part of the external financing mix as it is for China. The Philippines, and also Indonesia, are examples of economies for which foreign portfolio investment makes up the largest share of financing, with foreign direct investment a close second in Indonesia. In India, 'other investment' is the dominant category, within which (traditional) borrowing is also regaining ground.

Figure 4: International investment position

Net liabilities as at Q2/2015, USD billion



Source: IMF, own calculations

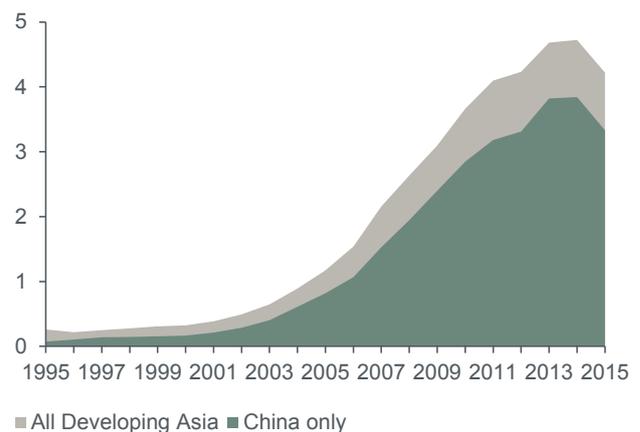
Debt – the other side of the coin

As set out above, foreign investors have built up net financial asset balances in the countries of Developing Asia. This goes hand in hand with increasing levels of indebtedness in Developing Asia vis-à-vis the rest of the world.⁶ If the funds flowing into the region from borrowing are put to good use, this drives growth and levels of debt remain under control. This is what has happened in Developing Asia, at least as far as external debt is concerned. While the region's external debt has risen hugely over the last decade – from around USD 900 billion (2005) to roughly USD 2,600 billion (2014) – its external debt-to-GDP ratio stabilised at around 16% from 2007 onwards, despite the fact that growth rates in the region have declined somewhat in recent years. If serious problems were to emerge with growth in Developing Asia, the issue of indebtedness could become more pronounced. The fundamental danger here is that the withdrawal of capital can lead to major problems with financing and, in extreme cases, to balance of payments crises, as was the case during the 1997/1998 Asian financial crisis. However, over roughly the

last ten years, Developing Asia countries have built up significant currency reserves that could help absorb shocks from balance of payments problems (Figure 5). Even so, the lion's share of these reserves belongs to China, which holds roughly four times as much in reserves as its external debt. In contrast, reserves held by the rest of the Developing Asia region are "only" enough to cover approximately 65% of external debt and unfortunately the trend is downwards – in 2008 the ratio was 100%.

Figure 5: Currency reserves

USD trillion



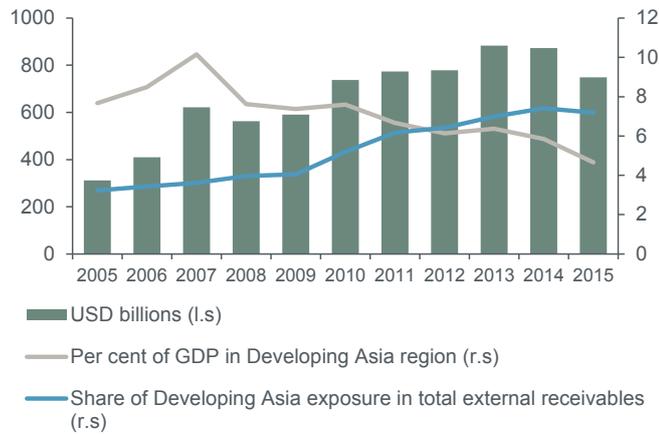
Source: IMF, own calculations

From a European point of view, European banks' exposure to Developing Asia increased up until 2013 but has since been declining (Figure 6). This is a consequence of the specific problems experienced by the European banking sector in the wake of the financial and economic crisis. One way to address the problem is to implement a significant deleveraging process. However, European banks' business in Asia is not excessively affected by this. The percentage of all international assets made up by assets due from Developing Asia has increased continually for some years, more recently stabilising at around 7%.

To summarise, we have seen that trade relationships between the EU and Developing Asia have evolved rapidly. This has also involved increasingly close financial relationships between the two regions. Naturally, China plays a particularly important role because of its size. Particular attention should continue to be paid to the issue of foreign direct investment in future. Europe is already heavily involved in Developing Asia in this respect but its foreign direct investment position has essentially remained static in recent years. In the opposite direction there is still considerable potential for emerging countries in Asia to make up lost ground in terms of FDI.

Figure 6: European banking sector* exposure to Developing Asia

*Eurozone, UK and Sweden



Source: BIS, own calculations

Hand in hand with strengthening economic relationships between the EU and Developing Asia comes a growing recognition that both regions face similar challenges when it comes to major issues such as climate change, levels of infrastructure and demographics. This is examined below. Lastly, we will discuss the prospects for deeper economic and political integration in Asia, potentially following the model of the EU, as well as further liberalisation of trade between Europe and Asia.

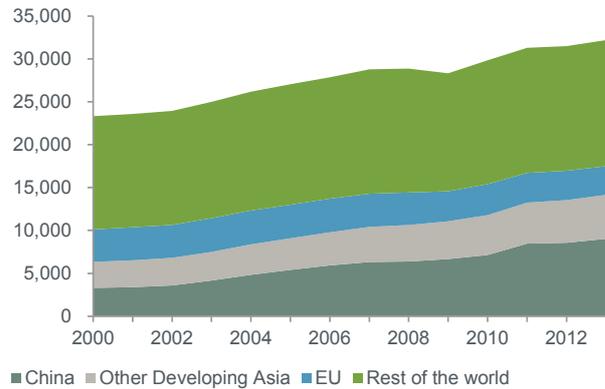
Climate protection must be given higher priority

In order to reduce the growing risks and consequences of global climate change, there is basic agreement that CO₂ emissions must be substantially reduced. The Paris climate change agreement adopted in December 2015 lays the groundwork for this but needs to be further developed. Europe and Asia bear a great responsibility when it comes to meeting global climate change goals. Cumulative CO₂ emissions from the EU and Developing Asia have risen sharply and accounted for more than 54 % of global emissions in 2013 (Figure 7). These trends are not uniform, however. During the period from 2000 to 2013 the EU's emissions initially rose somewhat but since 2007 have tended to fall and in 2013 were 12 % lower than in 2000. In contrast, Developing Asia has seen a continuous rise in CO₂ emissions since 2000, amounting to a total of 123 %. The increase in China has been particularly sharp – China is now responsible for 28 % of global emissions, making it the world's largest emitter of greenhouse gases.

The Paris Conference showed once again that it is not politically viable to implement an emission reduction roadmap that is binding for all countries. The main reason for this is that developing and emerging countries fear it would hold back their economic development in relation to industrialised countries. Nonetheless, there is a range of ways in which decarbonisation can be combined with higher levels of prosperity. The distribution of sources of CO₂ emissions by sector in the EU and Developing Asia (Figure 8) reveals some starting points for ways in which a win-win situation like

Figure 7: CO₂ emissions

Millions of tonnes

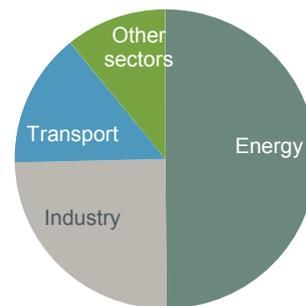


Source: International Energy Agency, own calculations

this can be achieved. On average, half of emissions relate to the energy sector in both regions⁷, while a quarter come from industry and around 15 % from the transport sector. There is great potential to increase the use of renewable energy. In industry, there is still significant scope to introduce more energy-efficient processes. There is also major potential in the transport sector if the strong focus on private transport that has so far prevailed were to be changed and fuel price subsidies that stimulate consumption were eliminated. Finally, additional insulation in buildings can also play an important part.

Figure 8: Source of CO₂ in Developing Asia and the EU

Weighted average, 2013



Source: International Energy Agency, own calculations

The EU and Developing Asia are both well aware of these facts and many steps have already been taken in the right direction. However, both regions need to show a greater degree of commitment and determination to the path towards a more climate-friendly economy.

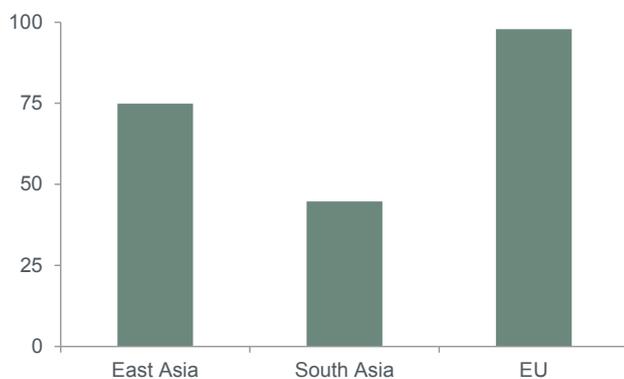
Infrastructure deficits, increasing urbanisation

In Developing Asia, population growth is mainly focused on cities at present and will continue to be in the future. In East Asia in particular, urbanisation has proceeded at a very rapid pace. Of the world's 70 largest cities, 37 are in Developing Asia. Even so, the degree of urbanisation in Asia (48 %) is

still lower than it is in the EU (75%) but, according to a UN estimate, it will continue to rise strongly, reaching 64% by 2050. According to this source, urban growth is also increasing in Europe, albeit at a comparatively slow rate, and is set to reach around 80%⁸ by 2050. Asian cities are already suffering from gridlock, significant shortfalls in the areas of water supply, disposal of waste water and refuse, and severe pollution (air, waterways, soil). For example, only 75% of the population in East Asia has access to a proper waste water disposal system. In South Asia this figure falls to as low as 45% (EU 98%, Figure 9). That means that 1.5 billion people in East and South Asia have no access to acceptable systems for the disposal of waste. There are also major infrastructure deficits in rural areas.

Figure 9: Proportion of the population with access to proper wastewater disposal

Percentages, 2015



Source: World Bank

In Developing Asia, these problems result to a large extent from the rapid, often uncontrolled or unplanned growth of cities. However, the public sector's lack of financial strength and the weakness of the institutions who wield it (badly paid, poorly qualified staff and insufficient numbers, lack of regulation, corruption etc.) are also important factors. Increasing public revenue (tax rates, strengthening tax administration) or abandoning questionable subsidies would be important contributors to improving the situation. There are an immense number of issues to be tackled – not only must existing infrastructure deficits be eliminated, the challenges of the future must also be managed.

The basic level of infrastructure in the EU may be better than in Developing Asia but Europe also has similar problems, in particular a shortage of funding. In many cases the funds available do not even cover depreciation, so existing facilities are run until they wear out. As mentioned above, there is a real shortage of funds to finance the change of course that is needed, for example in transport policy (reducing the level of private transport) or energy policy (promoting renewable energy and energy efficiency – green cities). EU budgets need to be prioritised more effectively and there needs to be more high-level focus on infrastructure policy that concentrates on sustainability.

It is equally true of Developing Asia and the EU that urban

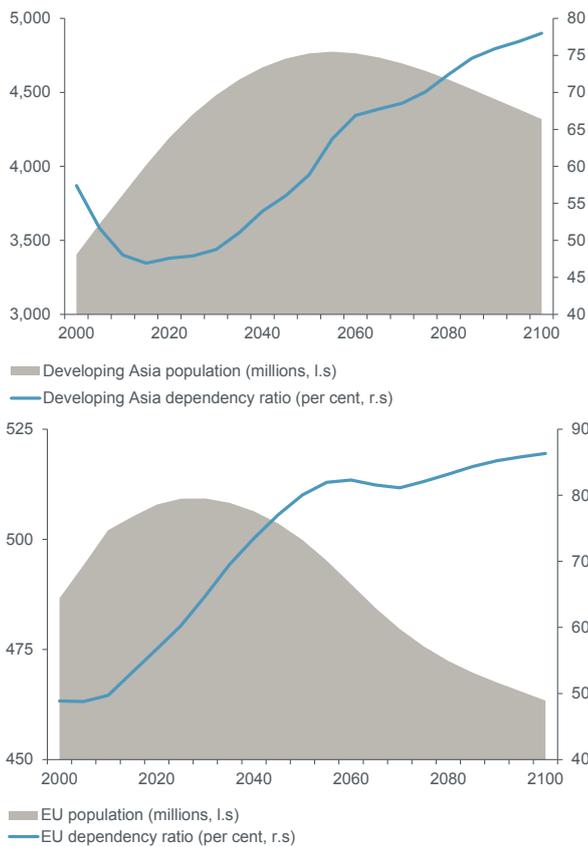
agglomerations do not just generate problems – they also provide opportunities. Cities can sow the seeds for progress elsewhere. In a relatively small space, it is possible to reach a large number of people, easier to guarantee access to information and political participation and the division of labour and innovation flourish in cities. Implementing the right infrastructure policies makes it possible to find win-win situations and overcome the tension between the goals of environmental quality and material growth.

Demographic trends call for an immediate change of course

Particular attention must be paid to population growth in both regions. Thanks to its higher birth rates⁹, Developing Asia has experienced an enormous rise in population in recent decades. According to the UN's current forecast, this growth will peak in 2055 at a population of 4.8 billion (Figure 10). In order to keep population levels stable, a birth rate of 2.1 children per woman is required. The EU has fallen below this level since the end of the 1970s (it is currently 1.6) but the considerable rise in life expectancy compensates for this. According to the UN's forecast, the EU population will peak in 2025 and then fall rapidly until the end of the century (Figure 10, excluding immigration).

Changes in population are a key determining factor in socio-economic development. The coming decline in population in Europe and Asia will create problems. The change in the age structure is also particularly serious. From an economic point of view, the size of the labour force as a proportion of the total population is crucial. People in work produce goods and services to meet current needs and their savings enable investments to be made for the benefit of future generations. The relationship between the number of people who are not of working age (young people under 15 and senior citizens aged 65 and above) and the working population (aged 15–64) is known as the dependency ratio¹⁰. In Developing Asia this has now reached its lowest level and is set to rise sharply from now on, reaching almost 80% by the end of the century (Figure 9). In its recent publication, Asian Development Outlook 2016, the Asian Development Bank estimates that this demographic factor will curb potential growth in Asia by 0.4 percentage points by as early as 2020. A very similar trend in the dependency ratio is expected in the EU, with a final value even in excess of 85% (Figure 10).

Figure 10: Demographics in Europe and Asia



Source: United Nations, own calculations

Both regions must overcome the challenges of an ageing society. In Developing Asia, this is already a significant problem for China but is an issue that also increasingly presents a danger in other countries too. What is needed is a pension scheme that guarantees a decent level of income for all in old age, along with a healthcare system that takes account of the particular needs of senior citizens and which they can afford. In addition, it is important that the labour market provides incentives/opportunities to increase employment among women and offers attractive conditions for older workers so that people continue working as long as possible. In addition to these factors within individual countries, however, greater liberalisation of labour markets for immigrants should also be an option. All of these questions arise both in Developing Asia and the EU – the only difference is the actual situation locally. The right social, labour market and fiscal policies can lay the groundwork for society to develop in a sustainable, positive way.

Regional integration and differences in trade agreements in Europe and Asia

Economic and political integration in the EU is watched with interest in Developing Asia. However, there is little appetite in Developing Asia for a far-reaching transfer of national sovereignty to regional institutions. The greatest progress in this respect has been made in the liberalisation of trade between the ten members of the Association of Southeast Asian Nations (ASEAN)¹¹. ASEAN is an economic alliance with some political components. Following the extensive abolition of tariffs that has already taken place, the ASEAN

Economic Cooperation (AEC) came into force at the start of 2016. This provides for complete liberalisation of trade and the free movement of labour. Even so, this process is only likely to be put into practice in small stages (“AEC Blueprint 2025”) – more extensive political integration should not be expected in the near future. There is wide variation among ASEAN members in terms of their economic power, political systems and religions. In some cases there are also border conflicts between members (Thailand and Cambodia). The EU’s current, acute institutional problems (refugee policy, Brexit, efforts to overcome the euro area debt crisis) are certainly not likely to encourage ASEAN to increase its efforts towards integration. The principles of non-intervention in the internal affairs of other member states and decision-making by consensus remain dominant among ASEAN members.

There is a great deal going on in terms of the liberalisation of trade. This should actually be negotiated in the form of global/multilateral agreements under the umbrella of the World Trade Organisation (WTO) but no progress is being made with WTO efforts to achieve this. The so-called Doha Round that began in 2001 has reached a dead end; it seems doubtful that it will ever reach a successful conclusion. The WTO’s 162 member states have very different interests and the principle of unanimity is now proving to be a major obstacle. A large number of bilateral or regional initiatives have emerged as an alternative to multilateral WTO solutions. According to the WTO, the number of agreements of this type has risen hugely in recent years and now stands at 276. The EU, and also the countries of Developing Asia in particular, are very active in this area. Within Developing Asia there are 25 trade agreements (e.g. China – Singapore) and as many as 72 agreements have been concluded with countries outside the region (e.g. ASEAN with Australia and New Zealand). There are two treaties between the EU and Developing Asia (with South Korea and Papua New Guinea/Fiji). Under WTO law, the establishment of a free-trade zone without a customs union is in fact allowed as it is viewed as a step towards global free trade. However, the conflict with the WTO’s central principle of “most-favoured nation” treatment (advantages gained by parties to a treaty must be granted to everyone else) is clear and consequently effects arise that distort or divert trade.

The large number of bilateral agreements leads to the conclusion that the countries concerned have little faith left in multilateral WTO solutions. However, to a certain degree there is now also a race to lay down specifications in the field of technical trade rules (standards, testing and approval procedures for imported goods) that then de facto become relevant to third countries. Against this backdrop, negotiations are currently under way between the EU and the USA to reach agreement on the Transatlantic Trade and Investment Partnership (TTIP), for example. While it remains uncertain whether the TTIP will actually be achieved, twelve neighbouring countries in the Pacific signed a Trans-Pacific Partnership (TPP) in October 2015. From Developing Asia these include Vietnam, Singapore, Malaysia and Brunei. Although the TPP does not actually come into force until it

has been ratified by all twelve countries, for the non-TPP countries in Developing Asia, and for the EU, this agreement is already an important parameter within their own trade policy strategy.

Conclusion

Developing Asia is a rapidly-growing region with a great deal of potential. Some of this potential has already been realised – in particular, bilateral trade with the EU is robust. In addition, Developing Asia is not just an attractive region for European exporters but also appeals to investors seeking to place their portfolio investment or foreign direct investment there.

However, there is also a flipside to the rapid pace of growth in Asia's emerging countries, in particular with regard to the environment. The region also suffers from inefficient and poorly developed state apparatus. This entails enormous problems with implementation. Developing Asia and Europe face similar challenges in terms of transport infrastructure, albeit at different levels, and demographic change. All of these are issues for which solutions can be found through closer cooperation between the two regions, as long as they are prepared to transfer technology and priority is given to supranational and global needs over national interests.

However, the global proliferation of bilateral trade agreements gives little cause for hope in this respect. ■

Economic indicators

	EU	Developing Asia
Average real-terms GDP growth (% p.a.)		
2000–2007	2.6	7.7
2008–2009	-1.8	6.2
2010–2015	1.0	6.8
GDP per head 2015 (USD at PPP)	37,802	15,328
Population (millions)	505	4,009
Sovereign debt as a proportion of GDP (2015, per centage)	88	46
Foreign debt as a proportion of GDP (2014, per centage)	Not available	23.6
Current account balance as a proportion of GDP (2015, per centage)	+2.2	+2.0

Source: IMF, World Bank, own calculations

¹ The table at the end of this document shows basic data on economic developments in the EU and developing and emerging countries in Asia.

² Developing and emerging countries in southern, eastern and central Asia, i.e. excluding the industrialised nations of Japan, Australia and New Zealand.

³ The data on trade in goods presented below comprises goods exported from the EU to developing and emerging countries in Asia and exports from those countries to the EU. Data source: UNCTAD.

⁴ Flows of goods within trade statistics are broken down using the Standard International Trade Classification (SITC). This system does not include a category for capital goods. In this paper, the term 'capital goods' refers to the mechanical engineering products and vehicles covered by part 7 of the SITC.

⁵ It is not possible to separate out the flows of capital between Europe and Asia precisely, as the underlying data necessary to do this is not available. The relevant information is only available for foreign direct investment.

⁶ Strictly speaking there is no inevitable connection between (prolonged) periods of net capital imports and indebtedness. If net capital imports (or more generally, global balance of payments imbalances) were to take place solely using equity instruments such as sales or purchases of shares, then these imbalances could exist even without external debt arising. But this is unrealistic because capital imports always take place using a range of instruments, which of course also include liabilities in the sense of genuine debt.

⁷ The share accounted for by the energy industry in the two regions roughly corresponds to the average level found in both regions. In contrast, the value for the industry sector in Developing Asia is higher than it is for the EU (28 versus 12%), while the opposite is true for the transport sector (Developing Asia 12, EU 26%).

⁸ The UN forecast referred to above (World Urbanization Prospects 2014) only includes figures for Europe as a whole, rather than separate values for the EU.

⁹ The fertility rate (births per woman) in South Asia was still as high as 5 or 6 in the 1970s, subsequently falling slowly to the current level of 2.6. In East Asia, the fertility rate started out at a similarly high rate but then declined more rapidly, primarily as a result of the one-child policy in China.

¹⁰ From an economic point of view the number of dependants as a proportion of the working population (known as the economic dependency ratio) is crucial, while the number of dependants as a proportion of the working-age population (the demographic dependency ratio) is less important. However, reliable labour market figures for developing countries are in short supply and producing long-term forecasts of the economic dependency ratio is problematic, both for industrialised and developing countries.

¹¹ The members of ASEAN are Indonesia, Thailand, Malaysia, the Philippines, Singapore, Brunei, Vietnam, Laos, Myanmar and Cambodia.