



# ASIA-PACIFIC CENTER

## FOR SECURITY STUDIES

### AN ECONOMIC SURVEY OF THE ASIA-PACIFIC REGION AND ITS IMPORTANCE TO THE UNITED STATES

#### ABSTRACT

This report presents a high-level summary of the place of the Asia-Pacific region in the world economy and of the region's importance to the United States. It observes the magnitude of trade and investment in linking countries together. Having the world's largest economy, the United States remains an engine of growth that hauls the world's economy while reaping significant benefits in the process. The United States is part of a global, multipolar world of economic interactions promoting shared prosperity and, thereby, security.

This report helps fill a void by presenting a concise overview of trade and other macroeconomic relations. Its quantitative orientation points out to policy makers the importance of matching the priorities of international relations policy to economic proportions.

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Prepared by:  
**MARK G. HARSTAD**  
APCSS DEPARTMENT OF POLICY STUDIES  
harstadm@apcss.org



# CHAPTER 1

## THE GLOBAL ECONOMIC ROLE OF THE ASIA-PACIFIC REGION

In the aftermath of the Vietnam War, many countries of the Asia-Pacific region focused their attention on producing goods to satisfy the economic demand of the United States and Japan. This resourcefulness resulted in some of the fastest economic growth rates that the world has seen. Much of this prodigious growth was due to a reliance on market economics and a security umbrella maintained by the United States. This chapter looks back at Asia's historical dynamism in order to understand the region's current global economic role.

### Historic Asian Dynamism

**Comparisons.** In 1973, Asia accounted for just 15% of the world's economic output.<sup>1</sup> By 2003, the Asia-Pacific region's share was 23.9% of world output when measured on an exchange rate basis. (See Figure 1-A.) Using exchange rates, the world's second largest economy is Japan (14.7% of total), while China (3.4%) is sixth-largest.

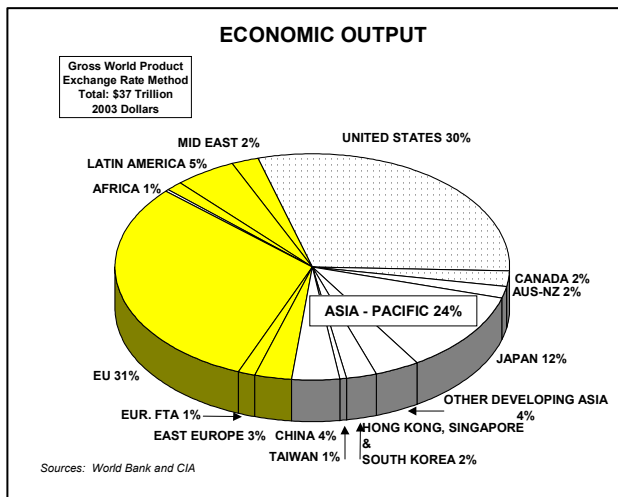


Figure 1-A

The exchange rate method measures an entire economy based only on international trade and finance sectors. An alternate method known as Purchasing Power Parity (PPP) makes technical adjustments to give weight to non-

international, non-industrial markets.<sup>2</sup> When using the PPP measure, the Asia-Pacific region far exceeds U.S. and EU totals, producing 35.1% of world output. (See Figure 1-B.) Further, by the PPP measure China is the world's second largest economy (12.4% of total), followed by Japan (6.9%).

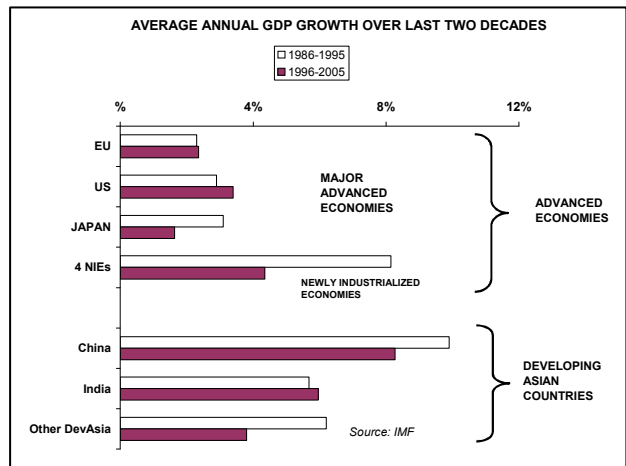
Figure 1-B  
Comparison of Regional Output (2003)

	PPP	Exchange rate
Asia-Pacific	\$17.9T (35.1%)	\$8.8T (23.9%)
United States	\$10.6T (20.8%)	\$11.0T (29.8%)
EU	\$10.9T (21.4%)	\$11.3T (30.5%)
World	\$51.1 T	\$37.0T

Sources: World Bank and CIA

**Growth.** Despite growth fluctuations, Developing Asia has had a higher average economic growth than the industrialized United States, Japan, and the EU over the last two decades.<sup>3</sup> (See Figure 1-C.) The status of the four Newly Industrialized Economies (NIEs) of South Korea, Taiwan, Hong Kong, and Singapore has transitioned from "developing" to "advanced," and they now see slower growth as their economies take on characteristics of industrialized economies. Among the developing economies, China has sustained the world's fastest growing economy over the last two decades, while India also has progressed at a respectable rate despite its high population and incidence of poverty.

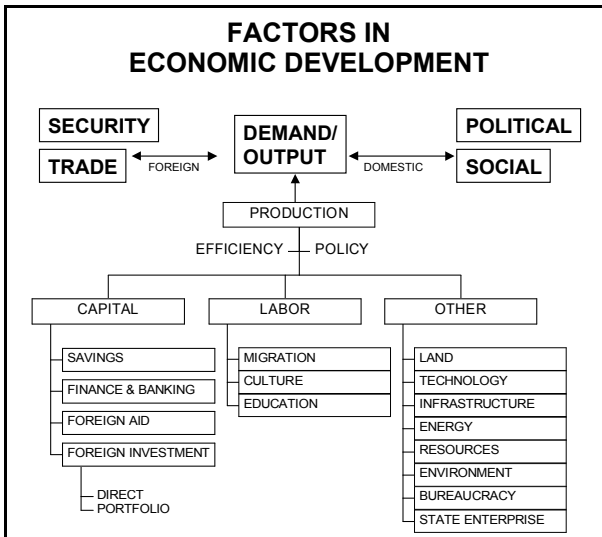
See Figure 1-C



## Fundamental Growth Factors

The region's growth reflects a harnessing of inputs towards internationally-oriented outputs. Long-term growth is sustained by prudent attention to economic policies. When growth falters, the mismanagement of these factors is clearly identifiable, such as when a bubble in property values is created.

Figure 1-D

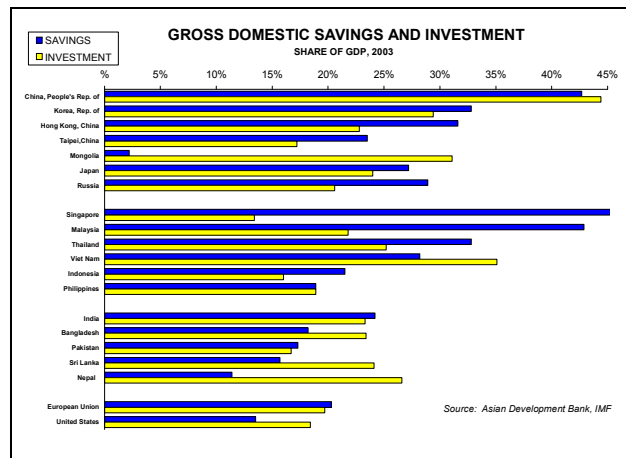


- Focus on international sectors. Relatively open economies are characterized by vigorous trade and investment ties with the United States, Japan, and Europe. Governments let the private sector meet international demand for consumer goods and technology.
- Harnessing of inputs. High inflows of capital and labor to modern sectors are sought. Societies encourage high rates of national saving and aggressive investment in physical and human capital. (See Figure 1-E.) Foreign capital is obtained in the form of direct investments in factories. Cultures value education and a strong work ethic. Energy is conserved. Productive infrastructure is encouraged. Land values are moderate.
- Prudent policies. The sound rule of law is maintained that encourages trade and investment through strong property rights. Macroeconomic stability is maintained through attention to trade deficits, current account balances, and sound financial

market infrastructures. Investment and commercial activity are promoted.

- Peaceful security umbrella. The forward presence of American forces helps dissuade the spillover of petty rivalries into larger regional conflicts and also allows countries to divert resources to economic growth rather than defense spending.

Figure 1-E



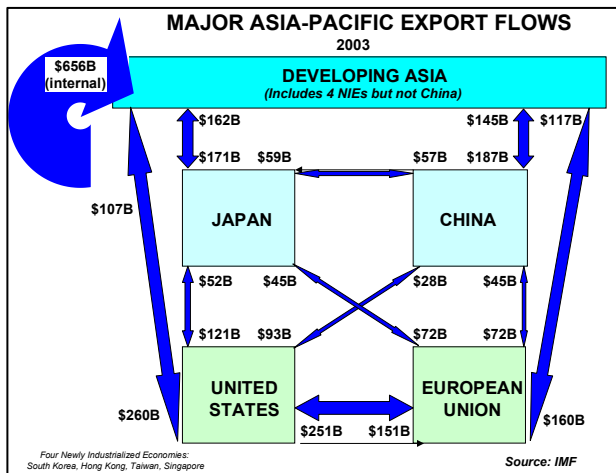
**Production plus Consumption.** Huge demand from industrialized countries has been a key engine of growth for Asian exports.

- Asia's historic economic policies have promoted domestic investment rather than consumption by harnessing domestic savings and investment, profits from exports, and foreign investment.
- Japan's past industrial policy followed this producer-oriented model, which promotes domestic, value-added industries sustained by cheap, intermediate inputs from other Asian producers.
- Over the decade, the countries of the Asia-Pacific have been emerging as lucrative consumer-oriented markets. This trend towards consumption is due to a growing middle-class base of well-paid workers.
- The dilemma of growth is that increased labor income from exports reduces labor's competitiveness with larger and poorer neighbors such as India and China. The dilemma's solution requires sustained growth spirals and prudent micro-, macro-, and institutional economic measures.

## Multipolar Trade System

Asia-Pacific trade is multipolar, with neither the United States nor Japan nor China being the single, dominant trade partner of Developing Asia.<sup>4</sup> (See Figure 1-F.) The United States produced 10% of the world's \$7.7T of exports in 2003, China 8%, Japan 7%, and the rest of Developing Asia represents a significant force in the global trading system.

Figure 1-F



In the early 1990s, exports to industrial countries steered the region's domestic economies at a healthy pace. This openness to foreign markets inspired foreign capital flows to the region in the form of direct investments and, in mid-decade, portfolio investments. However, the macroeconomic policies of many countries left overexposed current accounts and currency rates, while their microeconomic policies were unsupported by sound financial institutions. In 1997, global investors began to withdraw portfolio capital, leading to a chain-reaction of financial crisis across the region. Fortunately, foreign trade remained stable with industrial countries, and an unsteady recovery has ensued. Recent trends include:

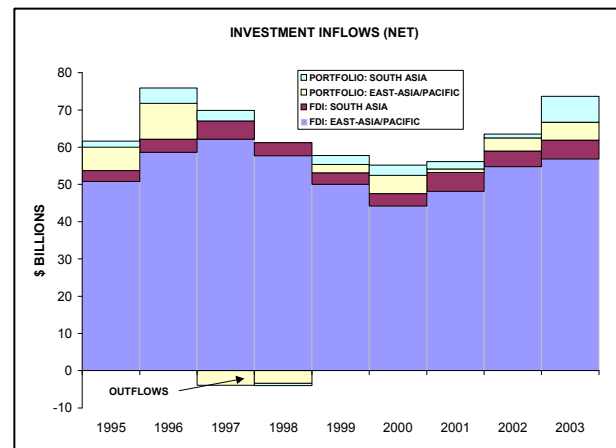
- Countries seek positive trade balances in order to accumulate foreign reserves that will buffer their currency markets.
- China's exports are outcompeting regional sectors such as textiles. Meanwhile, China's imports are stimulating region trade in resources.

## Foreign Capital Flows in Asia

Portfolio investments (i.e., foreign purchases of stocks and bonds) typically have a shorter term than foreign direct investment, which represent a foreign company's long-term commitment to an economy while providing direct control over the management of the investment. Throughout the Asian economic crisis, direct investors sustained a rather confident inflow to the region. U.S. companies in particular have an interest in a prosperous Asia, since U.S. direct investments typically have been used to multiply their access to Asian import markets.

**Foreign Direct Investment (FDI).** Developing Asia is the major destination of world FDI into developing countries.<sup>5</sup> (See Figure 1-G.) It received 45% (or \$62B) of all such flows in 2003 with the majority going to China (\$54B).

Figure 1-G



Japan's direct investment position in Developing Asia (including the 4 NIEs) was \$59B in 2003, while U.S. holdings were a significantly higher \$293B.<sup>6</sup>

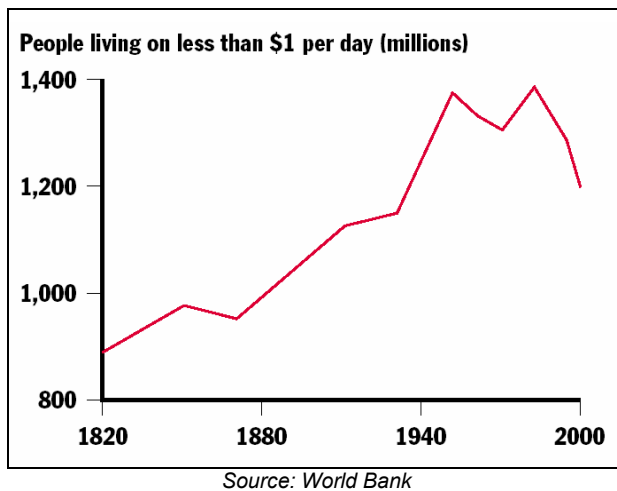
**Portfolio Investment.** In 1997 and 1998 there was a net portfolio outflow from the region. Investors now prefer the region, which, since 2000, annually receives over 60% of portfolio flows to developing countries.<sup>7</sup> However, net inflows to individual countries—especially China—vary each year according to investor sentiment.

## Globalization, Growth, and Poverty

Participation in a global system of trade and better business practices helps increase average income and reduce poverty among the poorest segments.<sup>8</sup>

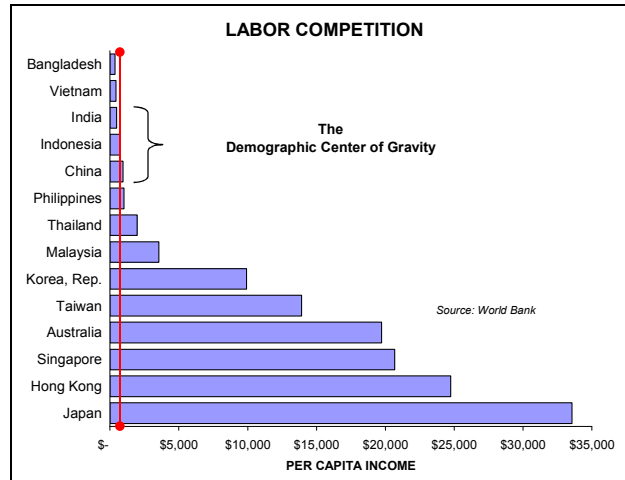
- Global poverty has declined in the last two decades despite increased populations. The number of people living on less than \$1 a day has declined from 1.4B to 1.2B. (See Figure 1-H.)
- The income of the world's poor has risen dramatically, and the level of absolute poverty has dropped sharply, from 75% of the population in 1988 to 37% in 1998. Poverty was cut in half in only 10 years.<sup>9</sup>
- The per capita incomes of populous Asia-Pacific countries like China, India, and Bangladesh are much higher than two decades ago. These countries experienced initial growth through privatization, followed by attention towards foreign markets.
- Those who do not employ globalization practices, such as North Korea and Burma, do not see sustained economic growth.
- Research indicates that growth is positively correlated to institutional governance; however, governance is not necessarily correlated to growth, especially in cases of crony capitalism and "state capture" of profitable assets.<sup>10</sup>

Figure 1-H  
WORLD POVERTY



**Competing Labor Markets.** Populous economies like China, India, and Indonesia are more open and now represent a demographic center-of-gravity that attracts sectors using cheap, unskilled labor. (See Figure 1-I.)

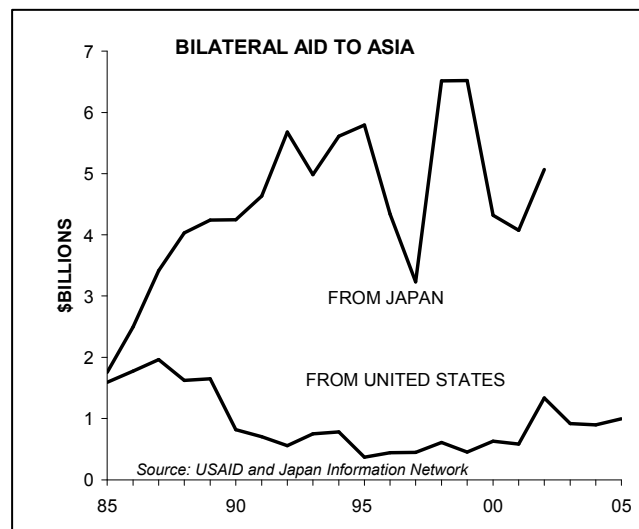
Figure 1-I



**Foreign Aid and Other Official Flows.** Many official projects are developed when private flows are risky and not immediately profitable, or where social benefits are key.

- The leading Asian recipients were Viet Nam (\$1.8B), Indonesia (\$1.7B), Bangladesh (\$1.4B), China (\$1.3B), Pakistan (\$1.1B), India (\$0.9B), Philippines (\$0.7B), and Sri Lanka (\$0.7B).<sup>11</sup>
- While 55% of Japan's aid goes to the region, only 4% of direct U.S. aid does so.

Figure 1-J



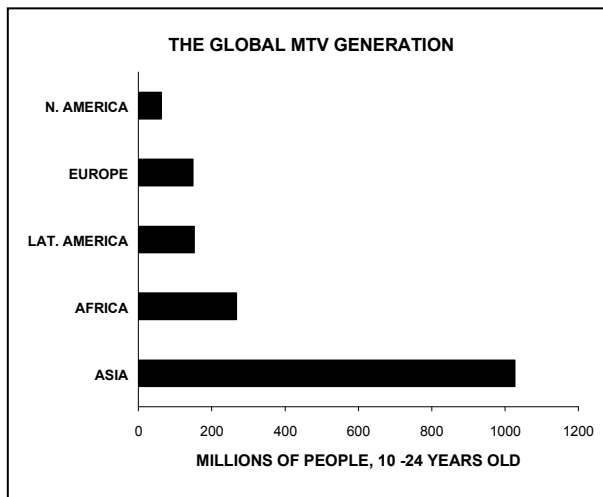
## Key Factors for Asia's Future

**Energy, Infrastructure, and Environment.** As Asia's economies grow, so do their requirements for a better infrastructure that balances demand in energy, population, and environmental factors. The American experience in achieving this tradeoff gives its businesses a competitive edge in contributing to the modernization of Asia's infrastructure.

**Urbanization.** Urban issues have taken on increasing importance as populations move to the cities, placing stress on physical and social infrastructures. At present, 33% of Developing Asia's population reside in urban areas.

**Asia's Demographic Potential.** The magnitude and youth of Asia's population present a huge market for trade and investment in Asia. The Asia-Pacific region's 3.4B people comprise 56% of the world's population. About 1B of Asia's people are between 10 and 24 years old. This "MTV Generation" has been characterized as urban, educated and consumption-oriented—with a reluctance to save. (See Figure 1-K.)

Figure 1-K



Source: World Resources Institute

**International Cooperation.** Multilateral trade groups not only promote tariff reduction, but seek a free, fair, and rule-based environment, where healthy competition improves security.

- The World Trade Organization (WTO). WTO membership entails the restructuring of protected sectors. Transitory labor problems ensue, but in the long run there is a decline in producer costs and consumer prices. WTO's dispute mechanisms help to systematize trade dialog. China and Taiwan became members in November 2001.
- Asia-Pacific Economic Cooperation (APEC). APEC is an organization of 21 economies on both sides of the Pacific whose key goal is sustaining growth through economic openness. APEC maintains high visibility through annual Ministers Meetings and concomitant APEC Leaders Meetings.
- Emergent Organizations. Both the Association of Southeast Asian Nations (ASEAN) and the South Asian Association for Regional Cooperation (SAARC) are planning to reduce tariffs through Free Trading Agreements (FTAs).

## CHAPTER 2

### THE U.S. ECONOMIC STAKE IN ASIA

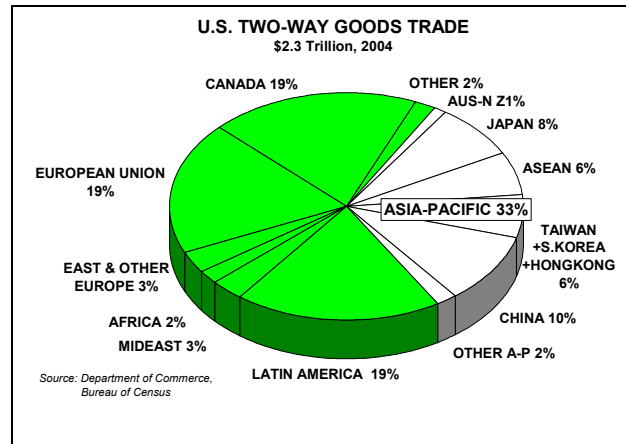
America benefits not only from order and stability in the Asia-Pacific region, but also from our deepening economic interdependence. The mutual gain from competition and cooperation has grown to become a vital American security interest. Managing this interdependence, with its attendant benefits and problems, requires enhanced economic cooperation and increased attention to diplomatic and military security relations. As a result of Asia's demographic potential, U.S. producers will increasingly turn to Asia's markets and will capitalize on U.S. strengths in technology, agriculture, consumer goods, and media—critical to improving U.S. trade balances—and also on services such as telecommunications, banking, environmental cleanup, and tourism. Beyond trade, U.S. investors are discovering Asia's markets can be profitable, given sound market institutions.

#### Trade and the U.S. Economy

International trade has become an increasingly important component of the American economy, as reflected in the rising share of exports and imports in the U.S. economy.<sup>1</sup> U.S. consumption of foreign imports rose from 8% of GDP in 1975 to 13% in 2004. However, U.S. production of exports weakened from 8% to 7% over the same period. The small size of these trade ratios compared to those of other countries reflects the sheer size of the U.S. economy. It also explains the low priority that American institutions—such as its schools and language programs—often give to improving their international foundations.

Developing Asia and Japan are key sources of U.S. imports and major markets for U.S. exports. Although most public attention focuses on America's persistent trade deficits with the region, trans-Pacific trade ties remain, on balance, mutually beneficial. The Asia-Pacific region accounted for an estimated \$767B—or 33.5%—of total U.S. merchandise exports and imports in 2004.<sup>2</sup> (See Figure 2-A.)

Figure 2-A



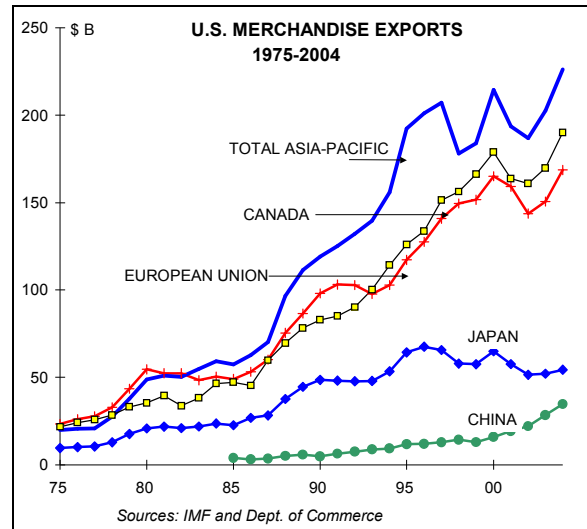
American companies and their workers both benefit from ties to the global economy. According to Commerce Department calculations, \$1B of exports correlate to between 14K to 19K jobs,<sup>3</sup> indicating that more than three million jobs are generated by U.S. exports to Asia. Wages in export industries are about 16% higher than those firms concentrating on domestic sales.<sup>4</sup>

These linkages dictate a major stake in preserving an open trading system on both sides of the Pacific. With interdependencies due to trade and investment, international security frictions increasingly will be greased by economic lubricants. Trade sectors will promote peaceful methods within their own countries, and will challenge their governments to avoid heavy-handed shows of force that threaten profits. U.S. exports and imports are part of a broader security strategy that promotes the peaceful exchange of goods for the profit of all participants. That is, trade is a win-win strategy.

American business has yet to reach its full potential in the region. The attainment of mutual prosperity is impeded not only by foreign official tariffs, but also by other foreign barriers in the form of non-transparent or incomplete legal and regulatory frameworks, insufficient protection of intellectual property rights, bungled industry standards, and official corruption.

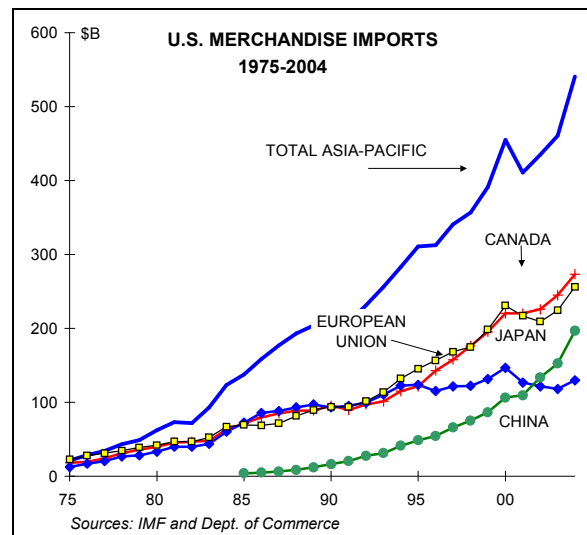
**U.S. Exports.** The Asia-Pacific region purchased 28% or \$226B of U.S. merchandise exports during 2004 (see Figure 2-B).<sup>5</sup> Japan is America's third-largest export market (\$54B), after Canada (\$190B) and Mexico (\$111B). Developing Asia bought \$156B in U.S. exports, a sizeable 15% increase over 2003. Major American merchandise exports include agricultural products, power industry equipment, computers and electronics, and aircraft and parts. Trade in services—which includes such industries as finance, engineering, and transportation—is not reflected in the merchandise trade data, and represents another opportunity for American firms. Some \$99B in 2003 or 32% of total services exports are with the Asia Pacific region.<sup>6</sup>

Figure 2-B



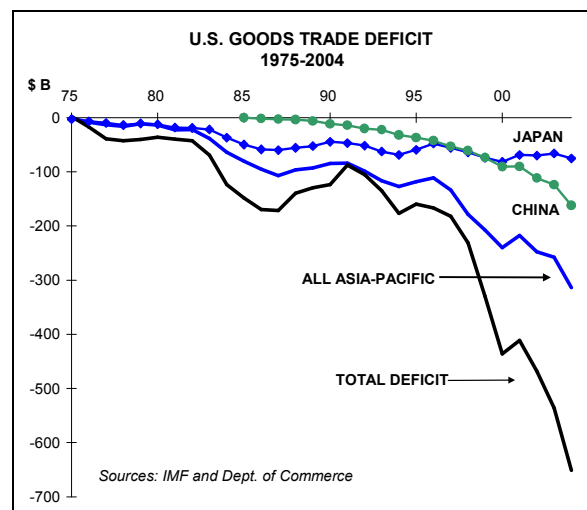
**U.S. Imports.** In 2004, American consumers bought \$540B worth of goods from the Asia-Pacific market, a full 37% of total U.S. merchandise imports. (See Figure 2-C.) The leading source of U.S imports is Canada (\$256B), followed by China (\$197B), Mexico (\$156B) and Japan (\$130B). Developing Asia (less China) as a whole sold \$204B. While a significant share of U.S. imports represent low-end, labor-intensive production (such as toys and textiles), imports from Developing Asia now include electronics and machinery. The diversity of low-end and high-tech products sold by the region reflects its progress up the development ladder.

Figure 2-C



**The U.S. Trade Deficit.** The region alone accounted for 48% of the \$652B U.S. merchandise trade deficit in 2004. (See Figure 2-D.) China now comprises 25% of the deficit and Japan 12%. Trade deficits are influenced more by macroeconomic policy than disputes over trade barriers. Such policy seeks to balance savings and investment, taxes and government spending, and foreign transactions of goods, services, and finance.<sup>7</sup> Balances reflect not only government policies and market conditions but also domestic politics, management practices, and cultural dispositions toward savings and consumption.

Figure 2-D



## U.S. Investment Abroad

### **U.S. Direct Investment Abroad (DIA).\***

Typically U.S. companies use their direct investments in Asia to augment the market for U.S. export sales. U.S. holdings in the Asia-Pacific region increased substantially from \$46B in 1987 to \$293B in 2003<sup>8</sup> and occurs primarily in the industrialized Asian economies of Japan, Australia, the Four NIEs, and China. (See Figure 2-E.) American companies in Asia have yet to realize their full potential, since 33% of U.S. merchandise trade is with Asia, but only 16% of its DIA is in the region. This trade-investment mismatch is partly due to misgivings of U.S. investors in Asia-Pacific economic institutions, with investors concerned over internal stability more than traders.

**U.S. Investment in Foreign Securities.\*\*** In the mid-1990s, an overconfident inflow of portfolio investments to the region induced a withdrawal reaction among investors who belatedly learned, for example, that investments in Asia were directed to unproductive and inflated property markets. Not only were financial institutions weak in the region, but also basic business laws concerning bankruptcy were not instituted. Today, U.S. purchases of foreign securities is cautiously returning. (See Figure 2-F.)

**Multinationals and Labor Outsourcing.** Statistical surveys<sup>9</sup> indicate that the typical U.S. activity of outsourcing to foreign affiliates promotes sales and employment on both sides of the production chain. Outsourcing is a microeconomic activity that serves to adjust the absolute and comparative advantages of production for both parent and affiliate.<sup>10</sup>

**Foreign Aid as Investment.** Foreign aid is an order of magnitude smaller than private flows; however, it provides policy makers an opportunity to directly shape development. Such aid can be effective for large infrastructure projects, where market forces are difficult to mobilize. Top U.S. aid recipients are Egypt (\$535M in 2005), Afghanistan

\* Direct investment occurs when an investor owns more than 10% of the targeted business.

\*\* Securities investments include those in corporate stocks and bonds, government agency bonds, and treasury bonds and notes.

Figure 2-E

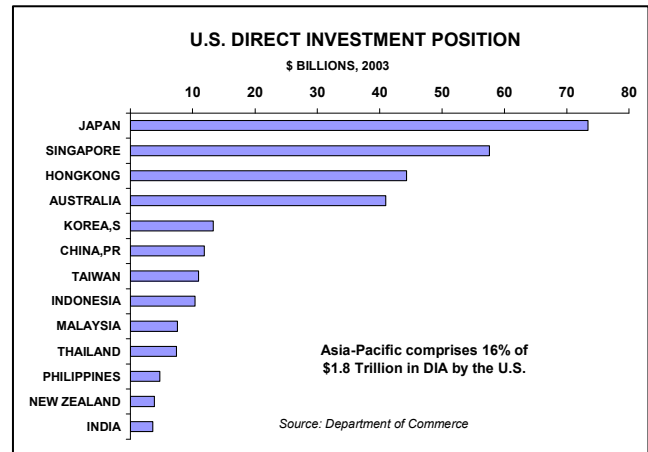


Figure 2-F

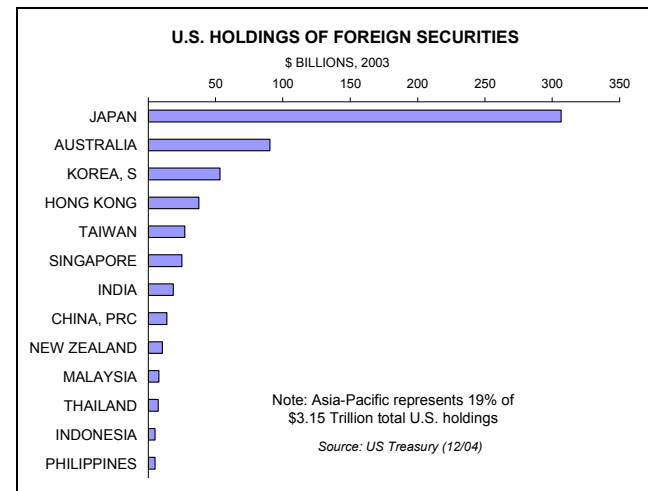
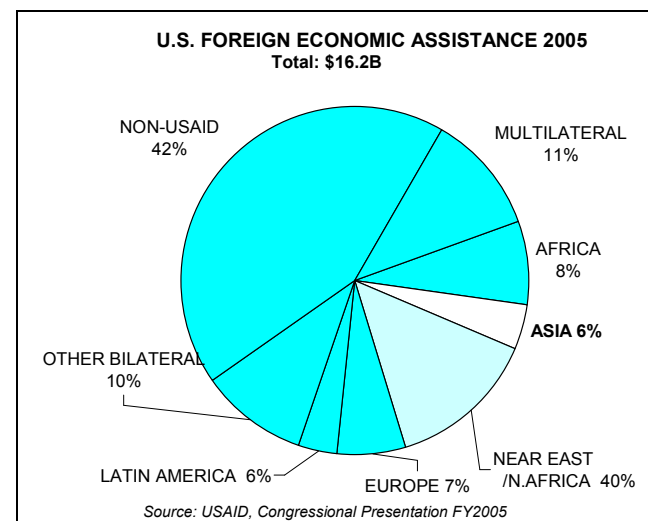


Figure 2-G



(\$397M), Israel (\$360M), Pakistan (\$350M) and Jordan (\$250M). The Asia-Pacific region directly received \$646M, or 6% of U.S. economic assistance in 2005.<sup>11</sup> (See Figure 2-G.) American military assistance to the region is modest, going towards International Military Education and Training (IMET, \$9.5M) and Foreign Military Finance (FMF, \$32M) grants.

### Foreign Capital Investment in the United States

**Foreign Direct Investment (FDI).** Japan's sizeable FDI in the United States (\$159B in 2003) is driven at the macro-economic level by the availability of dollars caused by the imbalance of bilateral trade and at the micro-economic level by the desire of Japanese companies to reduce risks by establishing in-country manufacturing ties with U.S. markets. Emerging markets in Asia use FDI in U.S. markets to promote access and distribution networks. Nevertheless, the primary source of U.S. FDI remains Europe, due to the greater integration of multinational corporations across the Atlantic.

**Foreign Investment in U.S. Securities.** A striking trend of several Asian countries is to defend their currencies, their current account surpluses, and their trade flows by investing in U.S. securities. Following the lead established by Japan in the late 1980s, the Four NIEs, China, and Australia are increasing their claims on U.S. financial assets. (See Figures 2-I and 2-J.) Securities represent to these countries a reserve of stable U.S. assets that can also be used as a tool to defend their currencies against market raids. In general, the inflow of foreign securities investment lowers U.S. interest rates and provides alternate sources of capital to U.S. firms.

Figure 2-H

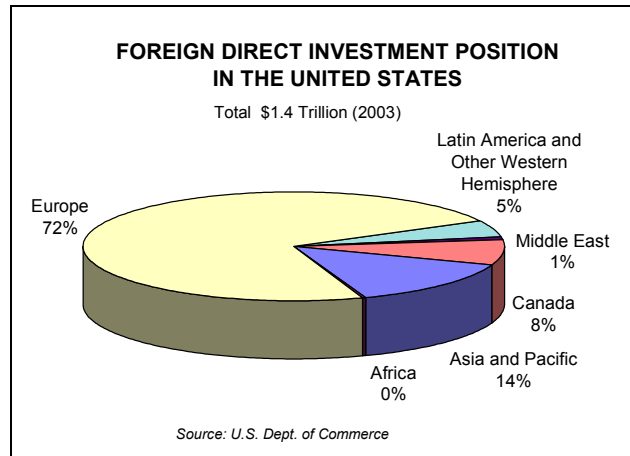


Figure 2-I

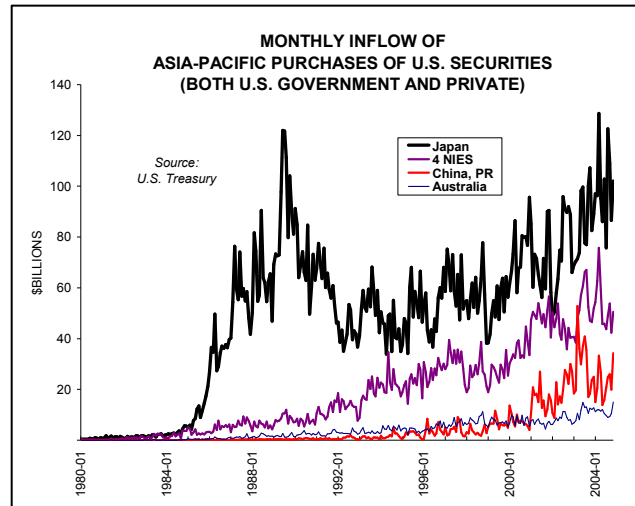
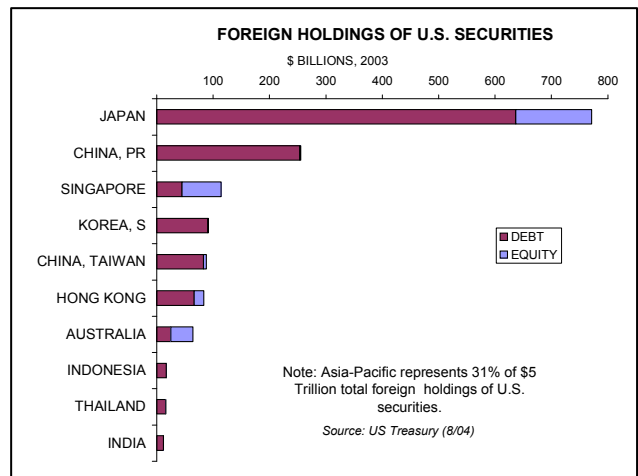


Figure 2-J



## Endnotes

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### Chapter One

- 1 Maddison, Angus, *The World Economy in the Twentieth Century*, 1989 and *Monitoring the World Economy 1820- 1992*, 1995.
- 2 World Bank, *World Development Report* and *World Development Indicators* ([www.worldbank.org](http://www.worldbank.org)); and CIA, *The World Factbook*. The exchange rate method converts foreign currency to U.S. dollars using market exchange rates. It is fairly straightforward to calculate; however, it does not account for the buying power of a country's currency for those goods and services that are not transacted in the international trading system, but only trade in domestic markets. The PPP method of estimation is more cumbersome, but accounts for domestic purchasing vitality.
- 3 International Monetary Fund (IMF), *World Economic Outlook* ([www.imf.org/](http://www.imf.org/)). In 1997 the Newly Industrialized Economies were given "Advanced Economy" status. See also ADB, *Asian Development Outlook* ([www.adb.org](http://www.adb.org)).
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- 10 Economic Report of the President together with the Annual Report of the Council of Economic Advisors, February 2005 ([www.gpoaccess.gov/eop/index.html](http://www.gpoaccess.gov/eop/index.html)).
- 11 Agency for International Development (USAID), Congressional Presentation, Summary Tables, FY 2005. [http://www.usaid.gov/policy/budget/cbj2005/pdf/fy2005summtabs4\\_alloc.pdf](http://www.usaid.gov/policy/budget/cbj2005/pdf/fy2005summtabs4_alloc.pdf) Note: In contrast to OECD foreign aid figures, U.S. government statistics also include military and other forms of assistance.

### Chapter Two

- 1 Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts* ([www.bea.doc.gov/bea/dn/nipaweb/](http://www.bea.doc.gov/bea/dn/nipaweb/)). Includes goods and services trade, and is based on a recent revision of the National Income and Product Accounts.
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