Sri Lanka
State of the Economy Report 2014

Chapter 3
Rising Asia: Opportunities and Challenges for Sri Lanka

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3. Rising Asia: Opportunities and Challenges for Sri Lanka

3.1 Introduction

While predicting the future is fraught with risk, it is now generally accepted that the 21st Century will see Asia continue to emerge as the power house of the global economy, building on the remarkable socio-economic progress seen in the region over the last 50 years. It has overcome many hurdles, including the Asian financial crisis of 1997/98, the dot-com crash of 2001, and the more recent global financial crisis of 2008 and subsequent recession in many parts of the world. Although the countries in the region were affected differently, the fact remains that they weathered these crises, survived them and emerged more strongly to remain as a regional engine of growth.[1] Asia's rise is exemplified by its increasing contribution to the world economy which has grown from one-fifth in 2000 to about one-third of world GDP at present, and is expected to increase further to over 50 per cent by 2050.[2] Some have called this possibility the 'Asian Century'.

In addition, the Asian region is already the most populous in the world, and in the 21st Century it is expected to be home to the largest middle class in the world, providing much of the momentum for global GDP growth.[3] Asia will not only be the largest consumer of goods, but also the largest producer of goods and services. Indeed, it is also influencing global trends, be it through hard or soft power by way of increasing military prowess,[4] and popular culture. The latter include fashion (e.g., Uniqlo), music (e.g., J-pop, k-pop), and movies/TV/animations (e.g., Bollywood, Korean dramas, manga). However, Asia's continued rise is not given or 'pre-ordained'.[5] As their economies develop, Asia will find itself tackling more complex challenges such as increasing inequalities, and coming up against structural rigidities identified with the notion of a 'middle-income trap' etc., while regional frictions can also threaten to derail Asia's economic growth and achievements, if not satisfactorily contained.

These developments are likely to have profound implications for countries right across the world, including Sri Lanka. As the centre of global gravity shifts to Asia, Sri Lanka - strategically located in Asia next to the Indian Sub-continent, and in close proximity to Southeast Asia - will have sizable economic opportunities to explore in its own backyard. Sri Lanka has a long history of engagement with the region which needs to be deepened and broadened. China and India are

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1 Tellis, A. J. (2010), "Strategic Asia: Continuing Success with Continuing Risks", in Tellis, A. J., A. Marble and T. Tannner (eds.), *Asia's Rising Power and America's Continued Purpose*, National Bureau of Asian Research, Washington D.C.

2 ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.

3 Lee Kuan Yew (2014), "Congratulatory Remarks" at the 20th International Conference on the Future of Asia "Rising Asia - Messages for the Next 20 Years", 22-23 May 2014, Tokyo. Available at: http://future-of-asia.nikkei.jp/asia2014/eng/message.html.

4 The leading powers in the Asian region are building militaries to match their economic might. Even though its defence budget is less than a quarter the size of the US, China has been increasing its defence spending by about 12 per cent a year for the past decade, and the country is expected to become the world's largest military spender in 20 years [see *The Economist* (2012), "Asia's Balance of Power: China's Military Rise", April 7, 2012].

5 ADB (2011), *Asia 2050: Realizing the Asian Century,* Asian Development Bank, Manila.

Asia's rise is exemplified by its increasing contribution to the world economy which has grown from one-fifth in 2000 to about one-third of world GDP at present, and is expected to increase further to over 50 per cent by 2050.

already major economic partners, in terms of both development assistance and FDI. At the same time, Sri Lanka's trade and investment links with other emerging Asian economies, such as Malaysia and Singapore, are also gaining momentum. Nurturing strong relationships with Asian markets and improving the domestic capacity are key ingredients to utilizing opportunities from a growing Asia. It is imperative that Sri Lanka lowers barriers to trade and cost of doing business, and integrates further with regional markets. In this context, this Chapter will examine the broad shifts in global output, trade, FDI flows from the West to the East over the years, including the rising Asian middle class; the role of Asia in global economic governance; intra-regional trends within Asia, and some of the main risks and challenges facing the region; the opportunities for Sri Lanka in the context of rising Asian trade and financial flows, and the associated policy implications for the country.

3.2 A Rising Asia in the Global Economy

The belief in a future 'Asian Century' parallels the characterization of the 20th Century as the 'American Century', and the 19th Century as the 'British Century'. The phrase Asian Century arose in the mid to late 1980s, and is attributed to a 1988 meeting with the former leaders of China and India (Deng Xiaoping and Rajiv Gandhi, respectively) at which the Chinese leader commented that "[i]n recent years people have been saying that the next century will be the century of Asia and the Pacific, as if that were sure to be the case. I disagree with this view."[6] The reasoning was that "no genuine Asia-Pacific Century or Asian Century can come until China, India and other neighbouring countries are developed" - apparently an unlikely occurrence any time soon. Prior to this, the phrase made an appearance in a 1985 US Senate Committee on Foreign Relations hearing; leaders of the region began talking about a coming economic leap that would propel them into an "Asian Century".

A quarter of a century later, however, the Asian Century seems to have materialized with China emerging as the world's second largest economy and India as the third largest on a purchasing power parity (PPP) basis.[7] And on many dimensions, Asia is booming. Asia's performance has been the best in the 21st Century with the incomes of developing Asia at nearly US$ 5,000 (PPP) in 2010,[8] growing by 9.4 per cent between 2000 and 2010. Investment rates reached a high of 35 per cent of GDP over the last decade, while exports grew by 11.4 per cent. Net inflows of private capital averaged US$ 83 billion a year, while external debt fell to 14.5 per cent of GDP. Asia has accumulated huge foreign exchange reserves in excess of US$ 3.5 trillion. While these aggregate numbers are heavily weighted by China

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6 Pan, C. (2013), "The Asian/Chinese Century from the Chinese Perspective", *Griffith Asia Quarterly*, Vol. 1, No. 1, pp. 30-52.

7 *Ibid*.

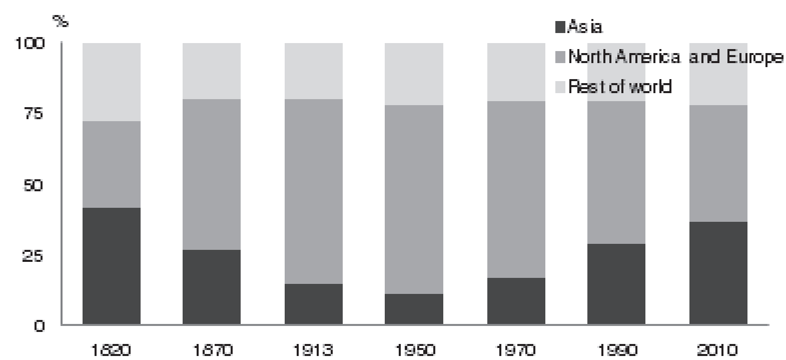
8 ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.

and India, the performance of Asia has been relatively broad based. Living standards for billions of people in Asia have improved at a rate not previously experienced in human history. The region's quick V-shaped recovery from the recession of 2008/09 is another testament of Asia's economic resilience and capacity to undertake reforms. The notion of an Asian Century has been subsequently reaffirmed by Asian political leaders, and is now a popularly used term in the media.[9]

While many call Asia's recent economic success the 'Rise of Asia', a more apt description would be the re-emergence of Asia.[10] In the middle of the 18th Century, Asia accounted for 58 per cent of the world's economy, led by China and India (Figure 3.1). However, the West saw much faster growth in the following two centuries after the Industrial Revolution, and Asia's share fell to 15 per cent around the 1960s. This trend was reversed with Asia re-emerging after 1950 led by Japan, and the rise of the newly industrialized economies (NIEs) such as Hong Kong, South Korea, Singapore and Taiwan. Starting from the 1980s, first Malaysia and Thailand, then China followed by India, Indonesia and Vietnam, boosted this growth further, raising Asia's share of global GDP beyond 20 per cent by 2010.

More recent developments offer greater optimism for Asia's pre-eminence in the world economy. The past three decades have been accompanied by a shift in the world production base to Asia from advanced economies; the overtaking of some of the world's advanced economies by a number of emerging economies, including China and India; and the emergence of Asia as the world's largest consumer market, with the prospects of becoming home to the largest middle class in the world, a major origin and destination of FDI, and a key trading partner in the world. The next section will look at these issues in turn.

Figure 3.1
Asian Economic Output (% of World Output), 1820-2010



Note: GDP is adjusted for purchasing power parity (1990)
Source: Commonwealth of Australia (2012), "Australia in the Asian Century - White Paper", available at http://www.murdoch.edu.au/ALTC-Fellowship/_document/Resources/australia-in-the-asian-century-white-paper.pdf.

Asia's growth is increasingly being driven by the large economies of China and India.

[9] Despite forecasts and prediction of the rising economic and political strength of Asia, the idea of an 'Asian Century' has faced criticism from a number of commentators who have argued it to be journalistic hype. They have pointed to the possibility of continuing high rates of growth leading to revolution, economic slumps, and environmental problems, especially in mainland China. Some believe that the 21st Century will be 'multipolar', or no one country or continent will have such a concentration of influence (i.e., 'nobody's Century').

[10] ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.

3.2.1 Unprecedented Growth and Shift in Global Production to Asia

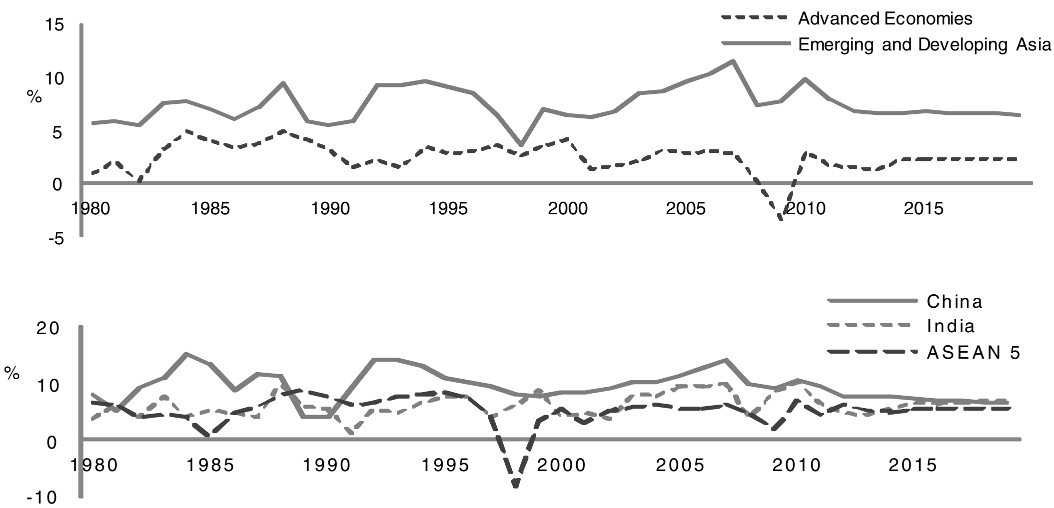
Since the Second World War, Asia has grown more than twice as fast as the rest of the world, despite poor performance under Maoist China and pre-reform India.[11] Seven of the 10 most rapidly growing economies in the world since 1955 are Asian countries.[12] Asian growth was spearheaded by Japan in the late 1950s, followed later by the NIEs, and then Southeast Asia. China's acceleration began in the late 1970s while India's take-off followed China by 15 years. Following several years of high growth, the Asian economies decelerated sharply following the Asian financial crisis (Figure 3.2). China, however, was barely affected with its closed capital account. Between the Asian financial crisis and the global financial crisis of 2008, Asia re-emerged as the world's most dynamic region.

Asia's growth is increasingly being driven by the large economies of China and India.

While crisis-affected economies settled into somewhat slower growth, the region's overall growth returned roughly to pre-crisis levels.

Asia's growth is increasingly being driven by the large economies of China and India. These two countries house over a half of world population, including some its poorest.[13] Asia's contribution to world output growth will largely be the result of

Figure 3.2
Comparative GDP Growth



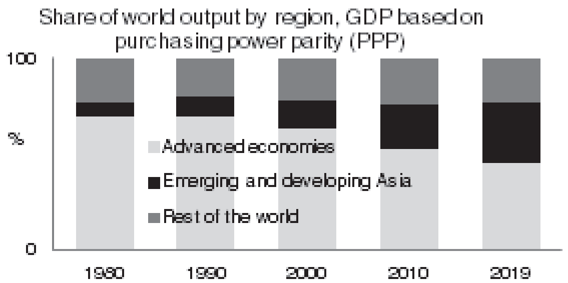
Source: Calculated based on IMF, "World Economic Outlook" database available at: http://www.imf.org /external/pubs/ft/weo/2014/01/weodata/index.aspx.

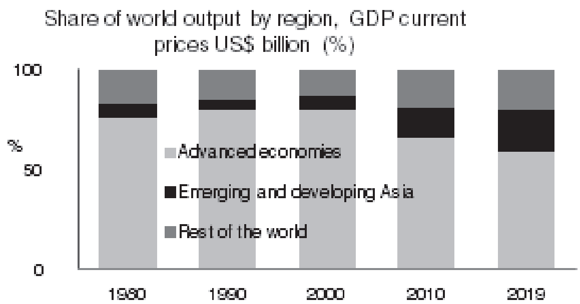
[11] Petri, P.A. (2010), "Asia and the World Economy in 2030: Growth, Integration, and Governance", in Tellis, A. J., A. Marble and T. Tannner (eds.), *Asia's Rising Power and America's Continued Purpose*, National Bureau of Asian Research, Washington D.C.

[12] ADB (2009), *Emerging Asian Regionalism*, Asian Development Bank, Manila.

[13] Tellis, A. J. (2010), "Strategic Asia: Continuing Success with Continuing Risks", in Tellis, A. J., A. Marble and T. Tannner (eds.), *Asia's Rising Power and America's Continued Purpose*, National Bureau of Asian Research, Washington D.C.

Figure 3.3
Shifts in World Production, 1980-2019





Source: Calculated based on IMF, "World Economic Outlook" database available at: http://www.imf.org /external/pubs/ft/weo/2014/01/weodata/index.aspx.

China and India are expected to grow rapidly, albeit at a slightly slower pace.

sustained growth by China and India. They are expected to grow rapidly, albeit at a slightly slower pace compared to the past decade.

Consequently, world output which was largely dominated by advanced economies is shifting to emerging and developing Asia, with the Asian region catching up in terms of both PPP and current US dollar terms, and accounting for an increasing share of world output (Figure 3.3).[14] It should be noted that Asia's share in global GDP is much larger in PPP terms than in market prices.

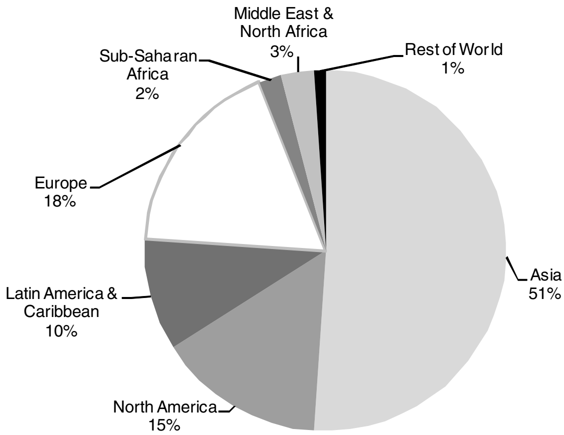
Asia's share of global output has increased from 7.5 per cent in 1980 to 23 per cent by 2010. The share is expected to reach around 30 per cent by 2019 according IMF projections. The ADB contends that if the region continues to grow on its present trajectory, Asia could account for more than a half of global GDP by 2050, increasing from US$ 17 trillion in 2010 to US$ 174 trillion by 2050 (Figure 3.4). It assumes the following: i) the seven high income developed economies,[15] will continue to be important markets as well as sources of research and innovations in the region; ii) the 11 fast-growing converging economies,[16] which have demonstrated

[14] GDP can be calculated based on market exchange rates and PPP exchange rates. The IMF defines PPP exchange rate as the rate at which the currency of one country would have to be converted into that of another country to buy the same amount of goods and services in each country, while GDP in current US dollar terms is measured based on market exchange rates prevailing in the foreign exchange market. See IMF (2007), "PPP Versus the Market: Which Weight Matters?", available at: https://www.imf.org/external/pubs/ft/fandd/2007/03/basics.htm.

[15] Brunei, Hong Kong, Japan, Korea, Macau, Singapore and Taipei.

[16] Armenia, Azerbaijan, Cambodia, China, Georgia, India, Indonesia, Kazakhstan, Malaysia, Thailand and Vietnam.

Figure 3.4
Asian Century Scenario, 2050

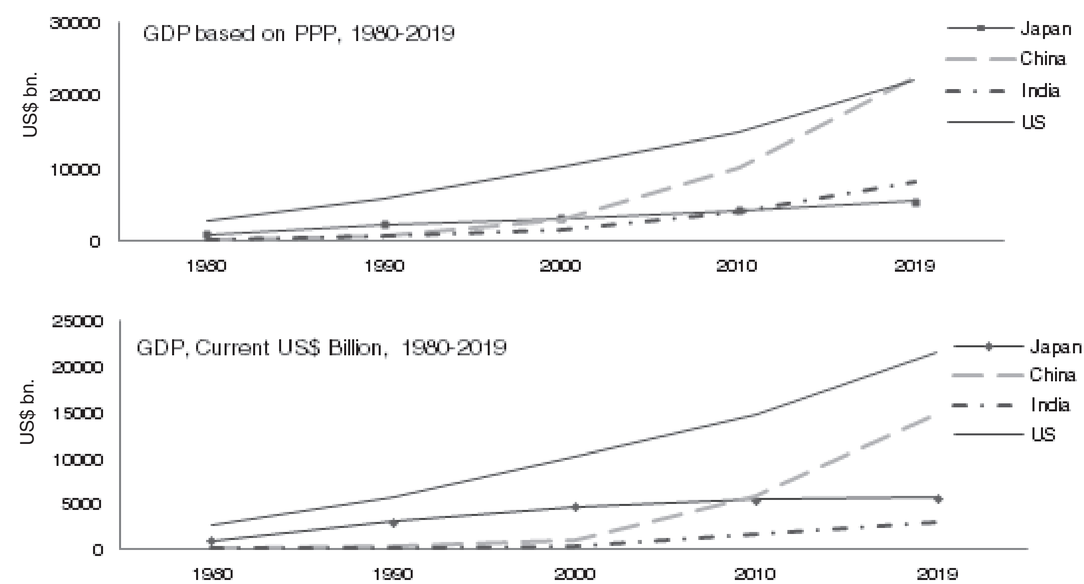


Source: ADB (2011), *Asia 2050: Realizing the Asian Century,* Asian Development Bank, Manila.

consistently high growth since 1990 would continue to do so for the next forty years; and iii) 31 slow/modest growing economies,[17] which have achieved modest or low long-term growth would succeed in joining the ranks of their fast-growing group by 2020, and raising their economic growth between 2020 and 2050. However, the study warned that continued growth is not guaranteed or 'preordained.'

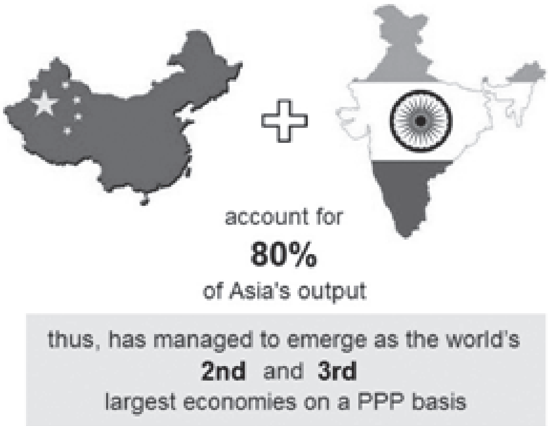
China and India which account for 80 per cent of Asia's output, have managed to emerge as the world's second and third largest economies on a PPP basis. Whilst China remains the second largest economy even in current US dollar terms, India's position ranks lower (Figure 3.5). Japan, one of the largest economies in the 1980s, was overtaken by China in 2002 on PPP basis, and later by India in 2011 on the back of a prolonged recession coupled with buoyant growth in China

Figure 3.5
Performance of China and India vis-à-vis Key Advanced Economies



Source: Calculated based on IMF, "World Economic Outlook" database available at http://www.imf.org/ external/pubs/ft/weo/2014/01/ weodata/index.aspx.

[17] Afghanistan, Bangladesh, Bhutan, Cook Islands, Fiji, Iran, Kiribati, Kyrgyzstan, Laos, Maldives, Marshall Islands, Micronesia, Mongolia, Myanmar, Nauru, Nepal, Pakistan, Palau, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Tajikistan, Timor-Leste; Tonga, Turkmenistan, Tuvalu, Uzbekistan, Vanuatu.



and India. Moreover, China seems to be catching up even with the US - the world's largest economy since 1872 - with IMF projections suggesting that it will overtake the US in PPP terms by 2019. Other projections estimate that China will overtake the US by 2017 in PPP terms, and in 2027 in market exchange terms.[18] These predictions have been advanced with the release of the latest World Bank (2014) International Comparison Programme report which shows that China is expected to overtake the US in 2014 to become the world's largest economy in PPP terms.[19] Nevertheless, China was behind the US based on GDP at market exchange rates - the US share of 22.1 per cent of global GDP was more than double that of China's 10.4 per cent. Although these emerging and developing Asian countries have been doing well in absolute terms, they rank lower in per capita terms (Table 3.1).

3.2.2 Asia as the Largest Global Market

In 2010, Asia was home to around 60 per cent of the world's population (Figure 3.6). Though projections show Asia's share of the world's population is set to slightly decline to around 54 per cent by 2050, Asia is still expected to remain the most populous region by 2050 accounting for around a half of the world's population.

Table 3.1
Twelve Largest Economies by Share of World GDP, 2011

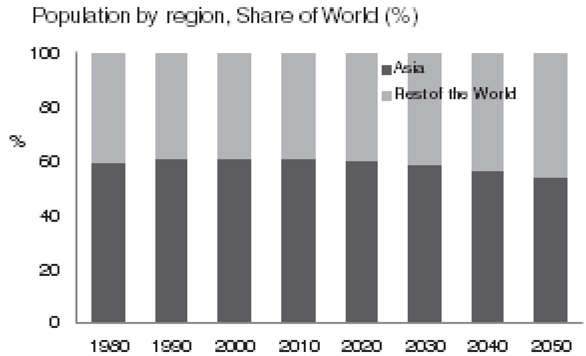
Ranking by GDP (PPP based)	Economy	Share of World GDP (PPP based, world=100)	Share of World GDP (exchange rate based, world = 100)	Ranking by GDP Per Capita (PPP based)
1	US	17.1	22.1	12
2	China	14.9	10.4	99
3	India	6.4	2.7	127
4	Japan	4.8	8.4	33
5	Germany	3.7	5.2	24
6	Russian Federation	3.5	2.7	55
7	Brazil	3.1	3.5	80
8	France	2.6	4.0	30
9	UK	2.4	3.5	32
10	Indonesia	2.3	1.2	107
11	Italy	2.3	3.1	34
12	Mexico	2.1	1.7	72

Source: World Bank (2014), "International Comparison Programme".

[18] Price Waterhouse Coopers (2013), "World in 2050, the BRICs and Beyond: Prospects, Challenges and Opportunities", available at: http://www.pwc.com/en_GX/gx/world-2050/assets/pwc-world-in-2050-report-january-2013.pdf; Kupchan. C.A. (2012), "The World in 2050: When the Five Largest Economies are the BRICs and US", available at: http://www.theatlantic.com/business/archive/ 2012/02/the-world-in-2050-when-the-5-largest-economies-are-the-brics-and-us/253160/.

[19] World Bank (2014), "Purchasing Power Parities and Real Expenditures of World Economies: Summary of Results and Findings of the 2011 International Comparison Programme", World Bank, Washington, D.C.

Figure 3.6
Population Share, 1980-2050



Source: UN, "The 2012 Revision of the World Population Prospects", available at http://esa.un.org/wpp/.

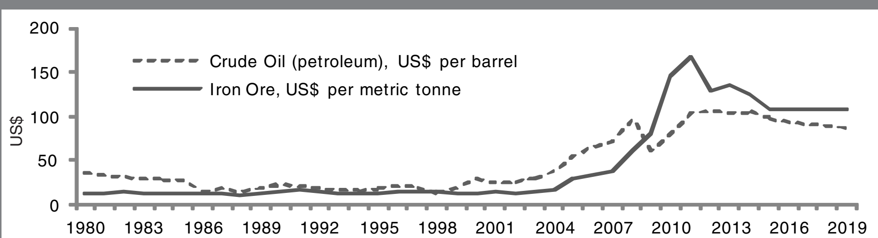
Per capita GDP in emerging and developing Asia has recorded high growth rates during the past three decades. It increased from US$ 411 to US$ 5,227 over the period 1980-2010 due to very rapid economic growth. According to IMF projections, it is expected to almost double to US$ 10,119 by 2019 (Figure 3.7), indicating an increasing purchasing power and market potential of the region. [20] The pace and scale of the transformation is staggering when considering the fact that it took the UK over 50 years to double its income per person during the industrial revolution.[21] Nevertheless, when considering GDP in per capita terms, emerging and developing countries' incomes would still be substantially less than that of advanced countries.

Box 3.1
Rising Demand from China and India for Crude Oil

Global oil prices have been largely driven by the demand from China and India both of which have been increasing their net oil imports. According to British Petroleum (2012), China and India are predicted to be the world's largest and third largest energy consumers, respectively, by 2030. Moreover, China and India are anticipated to account for 35 per cent of the global population and are likely to have 94 per cent of the net oil demand growth.

In fact, a study analyzing different scenarios for China's oil demand through 2020 finds that new demand from China's transport sector would raise world oil price by 1-3 per cent by 2020. However, according to IMF predictions, world oil prices as well as steel prices are likely to decline or remain the same from 2014 to 2019.

Prices of Crude Oil and Iron, 1980-2019



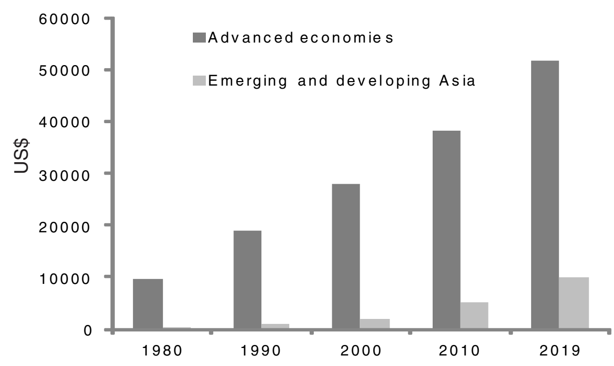
Source: IMF, "World Economic Outlook", various issues (includes projections for 2014-19).

Source: Niklaus, A. and J. Inchauspe (2013), *How Increased Crude Oil Demand by China and India Affect the International Market*, Curtin University, Perth; British Petroleum (2013), "Energy Outlook 2013"; IMF, "World Economic Outlook", various issues.

20 The growing affluence of the region, particularly by a select few is represented by ranking of a number of Asia's key cities like Hong Kong, Beijing, Seoul, and Mumbai in the Forbes "Top Ten Billionaire Cities" in 2013. See Geromel. R. (2013), "Forbes Top Ten Billionaire Cities – Moscow Beats New York Again", available at: http://www.forbes.com/sites/ricardogeromel/ 2013/03/14/forbes-top-10-billionaire-cities-moscow-beats-new-york-again/.

21 Commonwealth of Australia (2012), "Australia in the Asian Century - White Paper", available at: http://www.murdoch.edu.au/ALTC-Fellowship/ _document/Resources/australia-in-the-asian-century-white-paper.pdf.

Figure 3.7
Per Capita GDP (PPP) of Advanced Economies and Emerging and Developing Asia



Source: Calculated based on IMF, "World Economic Outlook" database available at: http://www.imf.org/external/pubs/ft/weo/2014/01/weodata/index.aspx.

Going forward, the ADB (2011) forecasts that Asia's per capita income could rise six-fold in PPP terms by 2050, allowing an additional 3 billion Asians to enjoy living standards similar to those in Europe today.

3.2.3 Asia's Growing Middle Class

With rising in incomes and people escaping poverty, Asia's low income earners have been gradually progressing to the middle income class over the past couple of decades. Typically, the middle class enjoys a higher standard of living, income and purchasing power, and is considered as major drivers of growth owing to more active participation in economic and political spheres.[22] In fact, the middle class can apply pressure for economic reforms and lay the foundation for a transition to a democracy as demonstrated in the cases of South Korea and Taiwan.

An ADB (2010) study on the middle class (defined as those consuming on average between US$ 2-20 per day), found that Asia's middle class accounted for 21 per cent of the region's population

Asia's per capita income could rise six-fold in PPP terms by 2050, allowing an additional 3 billion Asians to enjoy living standards similar to those in Europe today.

In 2008, 1.9 billion of the population in Asia belonged to the 'middle class' category

By 2030,
Asia's middle class is projected to expand to

of its population

[22] Chun. N. (2010), "Middle Class Size in the Past, Present, and Future: A Description of Trends in Asia", ADB Economics Working Paper Series No. 217, Asian Development Bank, Manila.

Table 3.2
Summary of Population, Class Size, and Total Expenditures by Region for 1990 and 2008

1990	% of Population Poor (<$2 per person per day)	Middle ($2-$20 per person per day)	High (>$20 per person per day
Developing Asia	79	21	0
Developing Europe	12	84	4
Latin America & the Caribbean	20	71	9
Middle East & North Africa	18	80	2
OECD	0	24	76
Sub-Saharan Africa	75	24	1
2008			
Developing Asia	43	56	1
Developing Europe	2	87	11
Latin America & the Caribbean	10	77	13
Middle East & North Africa	12	86	3
OECD	0	16	84
Sub-Saharan Africa	66	33	1
2030			
Developing Asia	20	59	21
Developing Europe	1	69	30
Latin America & the Caribbean	7	56	37
Middle East & North Africa	16	80	3
OECD	0	8	92
Sub-Saharan Africa	45	50	5

Source: Chun. N. (2010), "Middle Class Size in the Past, Present, and Future: A Description of Trends in Asia", ADB Economics Working Paper Series No 217, Asian Development Bank, Manila.

in 1990 (Table 3.2). Although the proportion is relatively small compared to other parts of the world, it has grown to 56 per cent by 2008. Consequently, Asia has emerged as a region with the largest segments of a middle class population in 2008 with 1.9 billion of emerging Asia's population in the middle class category. While there are large variations in the size and growth of the middle class across countries in the region, China and Vietnam have made great strides in increasing the share of their middle class population. Asia's middle class is projected to expand to 59 per cent of its population by 2030, while the region's higher income class (those spending more than US$ 20 a day) is projected to increase from 1 per cent in 2008 to 21 per cent by 2030.

Other studies find that Asia will account for a larger share of the global middle class, as high as 66 per cent of the global middle-class population (and 59 per cent of middle-class consumption by 2030).[23] Nevertheless, much of Asia's middle class still belongs to the lower middle class, consuming on average between US$ 2-4 per day and vulnerable to falling back into poverty.[24] For example, in China, India, Indonesia and the Philippines, the lower middle class is more than a half of the total middle class compared to Malaysia and Thailand with a bigger share of their population in the middle and upper middle classes.

[23] Pezzini, M. (2012), "An Emerging Middle Class", available at http://www.oecdobserver.org/news/fullstory.php/aid/3681/An_emerging_middle_class.html.

[24] ADB (2010), "Key Indicators for Asia and the Pacific 2010", Asian Development Bank, Manila.

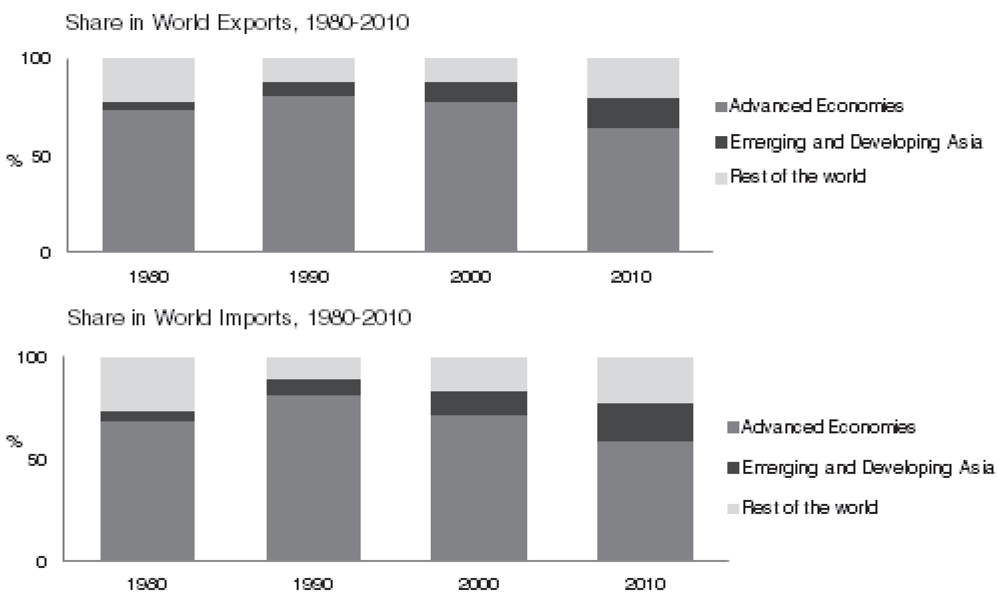
The rising middle class is expected to bring about higher expenditure and consumption patterns. In line with this trend, Asia is expected to become the foremost consumer in the world by 2030 accounting for 42 per cent of global expenditure - a two-fold increase from consumption levels in 2008.[25] The signs of Asia's growing middle class can be seen through the sales of consumer durables such as refrigerators, television sets, mobile phones and automobiles. China has now overtaken the US as the world's largest automobile market, while China and India are now the world's largest market for mobile phones. However, Asia's growing consumption can place pressure on natural resources and the environment. Moreover, emerging Asia is also experiencing a dramatic rise in middle class health problems, namely obesity, diabetes, cancer and heart diseases.

3.2.4 Shaping World Trade, FDI and Aid

Developing Asia's rapid economic growth has not only shifted the global economic centre of gravity away from the advanced countries, but has also raised the region's importance in world trade, boosting South-South trade.[26] Asia's share in world trade has been growing vigorously over the years; exports and imports from the region have grown at twice the rate of the rest of the world over the

Developing Asia's rapid economic growth has also raised the region's importance in world trade.

Figure 3.8
Share of World Trade Flows

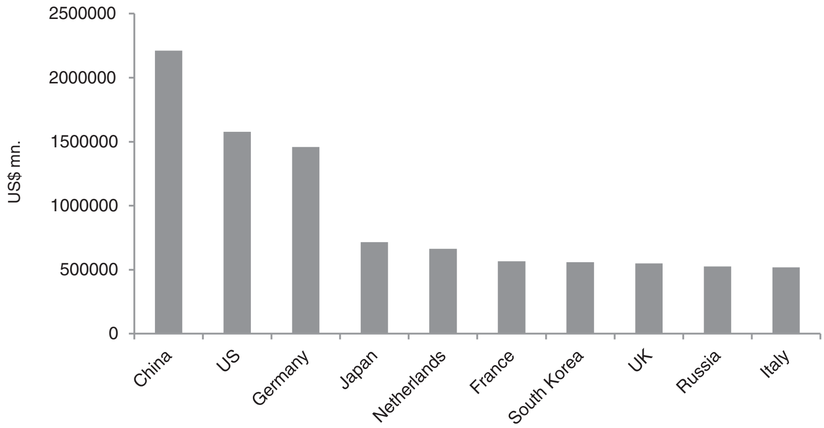


Source: Calculated based on IMF, "Direction of Trade Statistics", and "International Financial Statistics", various years.

[25] Chun. N. (2010), "Middle Class Size in the Past, Present, and Future: A Description of Trends in Asia", ADB Economics Working Paper Series No. 217, Asian Development Bank, Manila.

[26] Anderson. K., and S. Strutt (2011), "Asia's Changing Role in World Trade: Prospects for South-South Trade Growth to 2030", ADB Economics Working Paper Series. No. 264, Asian Development Bank, Manila.

Figure 3.9
Top 10 Exporting Countries, 2013 (US$ mn.)



Source: Compiled from International Trade Centre, "Trade Map" database, ITC, Geneva.

Developing Asia is also a growing source of investment as well as a destination of global FDI flows.

past three decades. Consequently, the share of emerging and developing Asia's exports has grown from 4.2 per cent in 1980 to 15 per cent in 2010, while the share of imports has increased from 4.6 per cent to 19 per cent during this period (Figure 3.8). An expansion in trade in Asia has been matched by a declining share of other regions including that of advanced countries. China is now the world's largest exporter (in value terms), followed by the US, Germany, Japan, the Netherlands, France, South Korea, UK, Russia and Italy (Figure 3.9). India is ranked as the 16th largest exporter. According to some estimates, developing Asia will continue to increase its share of global trade in the future, and come to account for as much as 40 per cent of world exports and 29 per cent of world imports by 2030.[27]

With regard to FDI, both inward and outward flows in advanced economies have slowed during the past three decades, while FDI flows to developing Asia have picked up. Advanced economies which accounted for around three-fourth of global FDI inflows during 1989-1994, accounted for only a half of FDI inflows by 2012, while its share in global FDI outflows have fallen to 75 per cent in 2012 compared to its share of 95 per cent during 1989-1994 (Figure 3.10). With the deepening recession and worsening economic conditions in advanced countries, coupled with stronger growth in emerging markets, FDI inflows to developing economies surpassed FDI inflows to developed economies in 2012 for the first time.[28] In fact, FDI inflows to the Asian region have been growing over the past three decades, and now account for 15 per cent of total global inflows, up from 11 per cent in 1980. Similarly, FDI outflows from Asia have grown but at a faster pace after 2005, and the region has increased its share to almost 10 per cent of outflows in 2012. While Asia's growing role as a source of investment as well as a destination is strengthening, advanced countries still account for a substantial share of global FDI flows despite the declining trends.

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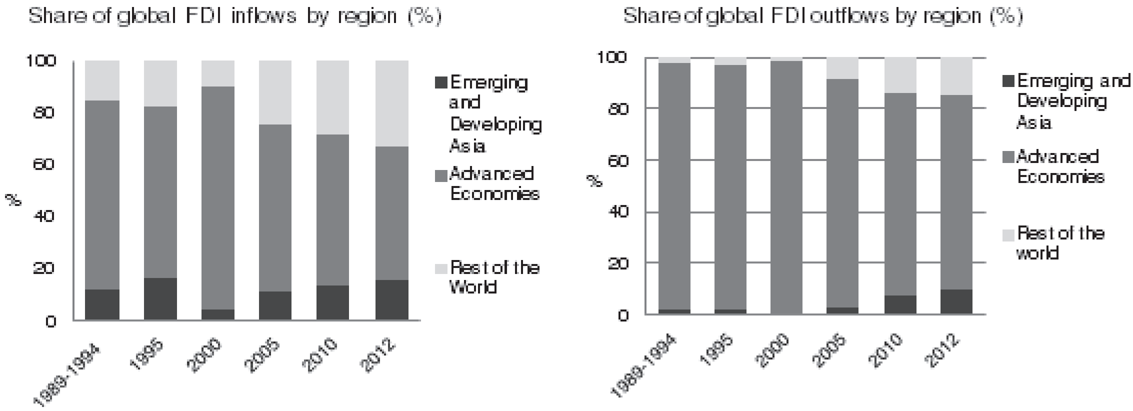
[27] *Ibid*.

[28] UNCTAD (2014), "Global Investment Trends Monitor" No.15, available at http://unctad.org/en/PublicationsLibrary /webdiaeia2014d1_en.pdf.

Figure 3.10
World FDI Flows, 1989-2012



Source: Calculated based on UNCTAD, "World Investment Report", various years.

Box 3.2
Emergence of Asian Brands

The rise of Asia has been accompanied by the emergence of several strong Asian brands which have managed to win over a large global presence in recent times. Japanese brands including Toyota, Honda, Cannon, Nissan, Sony and Panasonic and South Korean brands including Samsung, Hyundai and KIA are some of the leading brands in Asia which have been included in the world's top 100 brands as per the Global Inter-brand Ranking of 2013 (a leading global branding consultancy firm). Chinese brands including Lenovo, Huawei and Cherry, and Indian brands such as Tata, Reliance, Hero, Bajaj, Maruti Suzuki are also examples of Asian brands which have managed to conquer global markets with their value for money product propositions. Asian brands with their unique product offerings have set the stage for an era of affordability matched by superior quality.

Samsung is an example of an Asian brand which has emerged as a champion in the global market. Samsung, which had a net sales value of US$ 270 billion and total assets worth of US$ 470 billion in 2013, is currently ranked as the world's 8th best brand, and Asia's number one brand. It operates in a diverse set of sectors including consumer electronics, IT and mobile communications, health and medical equipment, etc. According to Strategy Analytics, a leading global market research firm, Samsung has even managed to overtake the two leading Western mobile brands – Apple and Nokia –as the most profitable phone firm. As per the Global Inter-brand report of 2013, Samsung with its innovative products such as Galaxy S4 and Galaxy Note II has grabbed a market share of 30 per cent in smartphone shipments surpassing Apple in smartphone sales.

Asian brands have also been making steady progress in acquiring global brands. Lenovo, the leading Chinese computer technology company, which acquired IBM'S PC business in 2005, also plans to acquire IBM's server business at a purchase price of approximately US$ 2.3 billion. Tata Motors in its efforts to diversify into the luxury car market has acquired Ford's Jaguar-Land Rover brands at a price of US$ 2.3 billion.

Aside from trade and FDI, emerging Asian countries have embarked upon an array of political and economic strategies. These are in part reflected by the role played by emerging Asian economies - such as South Korea, China and India - as sources of aid and development finance as countries compete for natural resources and regional and global influence. The economic motivation behind China's aid to Africa for example, is largely viewed as a means of procuring and securing Africa's natural resources. China's 'trinity-style' of cooperation aims to combine aid with market mechanisms such as trade and investment. However, the political intentions behind China's FDI and aid channeled to South and Southeast Asia have been more diplomatic and strategic. China's strategic interests in the Pacific and Indian Oceans have been referred to as the "String of Pearls", which is a chain of ports and maritime facilities in Southeast and South Asia developed by Chinese firms. Although China claims these initiatives to be a 'maritime silk road' that offer economic opportunities to Southeast and South Asian regions, these initiatives are often times perceived as a partial military strategy that would allow easy access to China's naval presence in the region.

By contrast to China, the bulk of India's development assistance and grants are confined largely to South Asia, although India has been active in training civil servants, public sector managers and engineers in some African countries to raise its political profile. By and large, however, India's overseas development assistance is mainly channelled to Afghanistan, Bhutan and Nepal. Similar to China, India's economic motivations behind provision of aid have both commercial and political undertones. For example, assistance to Nepal and Bhutan are to fulfil India's energy needs. India is expected to become a net exporter of aid as a result of collective factors, especially India's competition with China for energy resources and political influence, India's self-conscious role as an emerging power, and the belief that provision of assistance for economic and political purposes could be an effective way of improving international relations.

3.2.5 Asia's Global Economic Leadership

With the rise of Asia, the global economic architecture is already adjusting, as reflected by the emergence of the Group of Twenty (G20), expanding the existing Group of Eight (G8).[29] In the aftermath of the Asian financial crisis in 1997/98, due to the inadequacy of existing institutions, it was felt that crisis prevention and resolution efforts required the cooperation and involvement of significant emerging economies. Also, formal institutions such as the Bank for International Settlements and the IMF had decision-making bodies which were insufficiently representative, flexible, or independent from a very small group of powerful members.[30] As a result, the G20 was formed in 1999 with the inclusion of a number of emerging economies, expanding the 'club' of advanced economies that typically dealt with global economic and financial issues. The G20 which initially consisted of finance ministers and central bankers in the late 1990s was later elevated to a leaders' summit at the outbreak of the global financial crisis in 2008. It is now the 'premier forum for international economic cooperation', representing around 85 per cent of global GDP, over 75 per cent of global trade, and two-thirds of the world's population. The inclusion of emerging economies such as Brazil, India, China, Mexico and South Africa within the fold of G20 reflects the changing economic as well as political weight of emerging economies in the global economy. With

29 Petri, P.A. (2010), "Asia and the World Economy in 2030: Growth, Integration, and Governance", in Tellis, A. J., A. Marble and T. Tannner (eds.), *Asia's Rising Power and America's Continued Purpose*, National Bureau of Asian Research, Washington D.C.

30 Smith, G. S. (2011), "G7 to G8 to G20: Evolution in Global Governance", CIGI G20 Papers No. 6, Centre for International Governance Innovation, Canada.

The inclusion of emerging economies such as Brazil, India, China, Mexico and South Africa within the fold of G20 reflects the changing economic as well as political weight of emerging economies in the global economy.

Asia leading the global recovery in the wake of the financial crisis of 2008, the region is expected to have a bigger voice/role in the global stage, including the shaping of the G20 agenda.[31] In fact, these countries have become more active and outspoken in advocating for reforms in global architecture, through the G20 process as well as at UN and other global meetings. Given their limited formal voting power and the US and the European dominance of the World Bank and IMF, respectively, the emerging economies also prefer the G20 as the premier forum for deliberations on global policy.[32]

In 2009, G20 leaders agreed to reform the governance structures of the IMF and the World Bank to reflect better the increasing economic weight of dynamic emerging market economies in the world economy. They committed themselves to shift voting power from developed to developing countries in the IMF and the World Bank by at least 5 and 3 per cent, respectively.[33] Further to the reforms made, the quotas held by IMF members were doubled from their current level of US$ 340 billion and the quota expansion was used to shift the structure of quota holding in favour of some emerging market economies such as China and India.[34]

The global trade regime too has changed during the past two decades to encompass most developing countries, including China, which was outside the trading system in earlier rounds of trade talks. China's accession to WTO in 2001 has changed the balance of power within the organization, while countries like India which were less engaged in earlier rounds - reflecting the views of economies that were largely closed at one time - have become more vocal and active. In fact, these emerging Asian countries are playing an increasingly important role and are having a notable impact on the WTO's agenda. A recent development in the WTO, spearheaded and influenced by India, is the agreement to allow countries to provide a subsidy on staple food crops without any threat on punitive action. This agreement was passed in recognition of the right of developing nations for public stock-holding of food grains to ensure food security for their citizens. However, developed nations, particularly the US, are blaming India for failing to do more to cut global barriers to trade, like reducing red-tape from customs procedures, and delaying the Doha round of negotiations by trying to introduce a 'massive new loophole'. It is argued

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31 ADB and Peterson Institute for International Economics (2011), *Reshaping Global Economic Governance and the Role of Asia in the Group of Twenty (G20)*, Asian Development Bank, Manila.

32 Wade, R. H. (2011), "Emerging World Order? From Multipolarity to Multilateralism in the G20, the World Bank, and the IMF", *Politics and Society*, Vol. 39, No. 3, SAGE Publications, New Delhi.

33 Vestergaard, J and R.H. Wade (2014), "Out of the Woods: Gridlock in the IMF, and the World Bank Puts Multilateralism at Risk", DIIS Report 2014:06, Danish Institute of International Studies, Denmark.

34 Harding, R. (2014), "G20 Gives US Ultimatum over IMF Reform", *Financial Times*, available at http://www.ft.com/intl/ cms/s/0/eb06deb2-c1b7-11e3-83af-00144feabdc0.html#axzz34te6mBHF.

that such policies would create national surpluses of agriculture products that would eventually get dumped on world markets and hurt the interests of non-subsidized farmers elsewhere.

Emerging economies' representation at the UN Security Council has also shown some progress. While China is one of the five permanent members in the UN Security Council, in 2011, China officially expressed its support for an increased Indian role at the UN, without explicitly endorsing India's Security Council ambitions. However, recently China has expressed its support for Indian candidacy as a permanent member of the Security Council if India revoked its support for Japan's candidacy, thus making India the only candidate that has received support from all permanent members and most other nations as well. However, even as Asia makes an impact at global forums, intra-Asian tensions are also clearly visible in many instances.

3.3 Intra-Asian Developments: Towards Co-operation?

The 2008 global financial crisis led to a downturn in Asia's growth, with growth rates slowing down to 7.7 per cent in 2009 and exports falling by about 35 per cent from a peak to trough during July 2008 to February 2009.[35] Though the decline in growth in emerging Asia following the financial crisis was not as severe as that experienced during the 1997 Asian financial crisis, post-2008 growth is yet to reach pre-crisis levels. With the onset of the recession and slow down of the region, some have called into question the notion of an 'Asian Century', arguing that it is more of hype than a reality. However, Asia has shown a steady turnaround, recording positive growth levels. Though Asia was not at the epicentre of the crisis and this would have led to a quicker-than-expected turn around, it is still a sign of Asia's strong resilience to the stresses of the external environment.

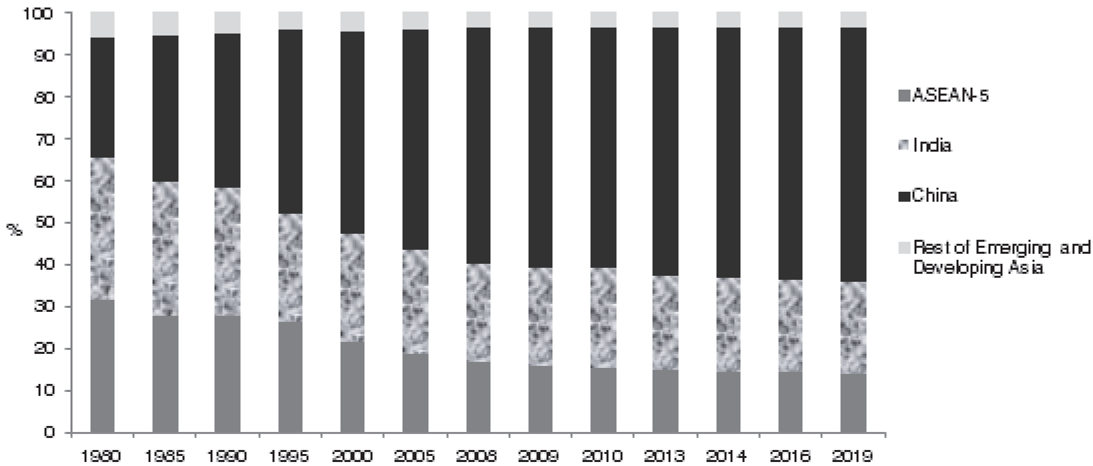
Asia's fortunes are overwhelmingly dependent on the continuing growth of its two major economies of China and India. Both countries dominate the landscape individually, whether in terms of their intra-regional share of GDP, consumer power, or in terms of their political influence on their Asian neighbours.

Despite growth slowing down across Asia in recent years, the prospects for Asia appear promising in the light of favourable developments taking place in the policy space of its two key economies, China and India. China's 12th Five-year Plan (2011-2015), endorsed by the National People's Congress, aims for an average annual growth of 7 per cent by moving the Chinese economy from export-and investment-driven growth to a more consumption-led growth. It also aims to undertake structural adjustment, improve social services, protect the environment, and promote transparency and governance.

Additionally, hopes of India's economic recovery have been rekindled, with the landslide electoral victory of the Bharatiya Janata Party (BJP) in May 2014. The new government, viewed as pro-business, is expected to nurture the manufacturing sector, attract foreign investment and build roads, bridges, ports, etc. It is also expected to trim spending on wasteful subsidies, reversing the previous government's retroactive tax claims, etc. The decisive election outcome suggests the new government will be able to implement reforms at a faster rate than previously expected, raising India's growth projections. India has been weighed down in recent years by high inflation, a weak currency

[35] Keat. H. S. (2009), "The Global Financial Crisis: Impact on Asia and Policy Challenges Ahead", paper presented at "Asia Economic Policy Conference: Asia and the Global Financial Crisis", Federal Reserve Bank of San Francisco, California, 19-20 October 2009.

Figure 3.11
Share of GDP (PPP) of Emerging and Developing Asia



Source: Calculated based on IMF, "World Economic Outlook" database, available at: http://www.imf.org/ external/pubs/ft/weo/2014/ 01/weodata/index.aspx

and a fall in foreign investment. The new government has pledged to boost growth, which has been below 5 per cent in recent years. A higher level of growth of at least 8 per cent is needed to provide enough jobs for India's growing labour force.

This section examines the trends within Asia and the prospects for intra-regional cooperation in the coming years.

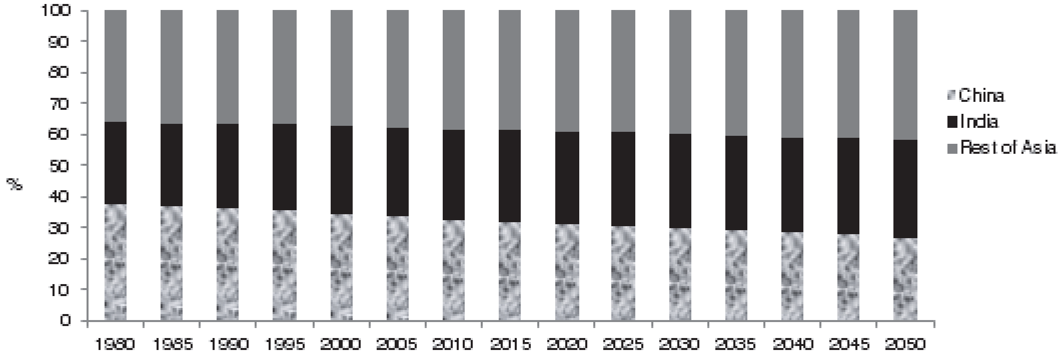
3.3.1 Intra-Asian Developments

Within emerging and developing Asia, China has become the biggest producer. Its contribution to GDP of emerging and developing Asia has been on a rapid upward drive since the 1980s, peaking at nearly 60 per cent in 2014. Near term projections reveal that China's contribution to Asia's GDP will remain at around 60 per cent as the country re-focuses on promoting growth that is more equitable and balanced, as a result of which China's growth rate is expected to moderate (Figure 3.11). India is the next largest economy in Asia, accounting for 22 per cent of emerging and Developing Asia's output in 2014, while its share in Asia's GDP is projected to hover around 20 per cent in the near term. India and China collectively accounts for over 82 per cent of output of emerging and developing Asia and are expected to be the catalysts of growth in the region.

ASEAN-5 (Indonesia, Malaysia, Philippines, Thailand, and Vietnam) are also an important group of countries in the region, contributing around 14 per cent to emerging and developing Asia's GDP. Their contribution to Asia's GDP suffered a major blow from the Asian financial crisis of 1997, has been on the decline since then and is projected to dip further by 2019.

In terms of population, China accounting for around 32 per cent of Asia's population is the most populous country in emerging and developing Asia, followed by India accounting for a share of around 28 per cent of Asia's population (Figure 3.12). Projections show that India's population is expected to expand in the coming years to a share of 30 per cent of emerging and developing Asia's total population, while projections for China show a contraction in its population, possibly owing to the adoption of the one-child-policy.

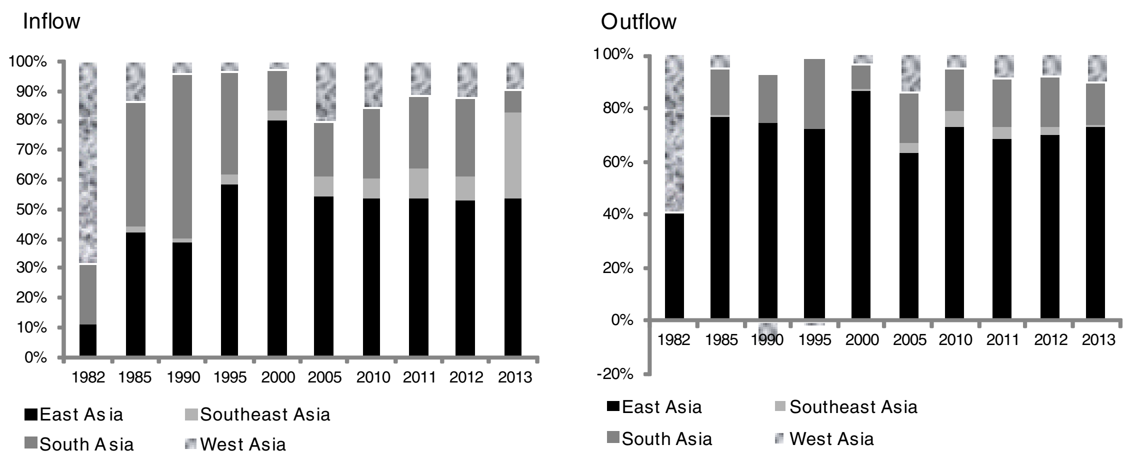
Figure 3.12
Population by Country, Share of Emerging and Developing Asia



Source: UN, "The 2012 Revision of the World Population Prospects", available at: http://esa.un.org/wpp.

Within the developing world, Asia recorded the highest level of FDI inflows. However, East Asia remained Asia's largest FDI destination as well as investor, accounting for 54 per cent of Asia's FDI inflows and 72 per cent of Asia's FDI outflows in 2013, respectively (Figures 3.13). China has the largest share in both FDI outflow and inflow among the East Asian countries accounting for over 56 per cent and 40 per cent, respectively.[36] Similarly, India dominates FDI inflows and outflows of South Asia, with about 90 per cent share of the total FDI inflows to the region and almost 98 per cent share of total FDI outflows from the region.[37]

Figure 3.13
Asia's Regional Share of FDI (1982-2012), in US$ million



Source: UN, UNCTAD database.

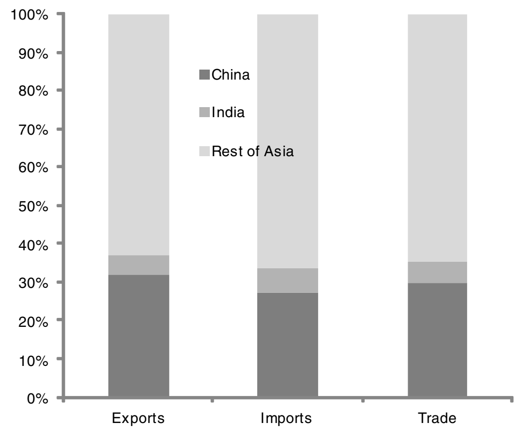
36 UNCTAD (2014), "Global Investment Trends Monitor No.16", available at: http://unctad.org/en/PublicationsLibrary /webdiaeia2014d5_en.pdf.

37 *Ibid*.

Since the 1990s, and especially after China's accession to the WTO, China has become one of the most-favoured destinations for FDI.[38] In 2012, China attracted inflows amounting to US$ 120 billion and ranked as the second largest host country in the world behind the US (US$ 168 billion).[39] China has also been catching up as a major global investor, climbing up from 32nd place in 2000 to become the third largest investor by 2012 (behind US and Japan).[40] China's outward FDI strategy has gone through stages from initial political opposition, to selective approval, and to enthusiastic encouragement.[41] Its outward FDI has been driven by a growing need to secure overseas energy and raw material resources, to remain competitive in the face of intensified domestic competition and over-capacity in a number of key sectors, continuingly rising foreign exchange reserves and associated currency appreciation, and increasing government support arising around the 'going abroad' strategy. China's rapid economic development, surging foreign exchange reserves, and strong interest in encouraging outward FDI, is expected to see Chinese corporations continue to invest abroad and emerge as a large source of FDI in the near future.

China and India have also emerged as significant trading nations not only within Asia but also globally. Together they account for roughly 36 per cent of Asia's total trade, with China holding a larger share (Figure 3.14). Internationally, China is ranked as the largest exporter and second largest importer in the world in 2013, while India held the 16th and 12th positions, respectively. In fact, 2013 marked another milestone for China - it is very likely that China overtook the US as the largest trader - a title the US has held for decades though concerns have been flagged about the accuracy of China's export data.[42]

Figure 3.14
Exports, Imports and Total Trade, by Country, 2013



Source: Compiled from ITC Trade Map, International Trade Centre, Geneva.

3.3.2 Asian Integration

Asia's economies are increasingly vital not only to the world but to each other. As Asia's economies have grown larger, they also have become more integrated - through trade, financial flows and direct investment. However, increasing integration in the region is mostly confined to East Asia. Intra-regional integration in trade as a share of East Asia's total trade increased from 45.5 per cent in 1990 to 61.5 per cent, which is slightly lower than EU (64.9 per cent) but higher than for North America (40 per cent) and other developing regions (Table 3.3). Interdependence within the region has increased significantly after the 1997/98 Asian financial crisis.[43] Regional integration in East Asia is more developed

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38 Chen, C. (2011), "Asian Foreign Direct Investment and the 'China Effect" in Ross, G. *et al*. (eds.), *China: The Next Twenty Years of Reform and Development*, ANU Press, Canberra.

39 Other Asian countries among the top 20 host economies of FDI flows in 2012 included Hong Kong (ranked 3), Singapore (8), India (15) and Indonesia (17). See UNCTAD, "World Investment Report 2013".

40 *Ibid*.

41 Cheng, S. and R. R. Stough (2007), "The Pattern and Magnitude of China's Outward FDI in Asia", Regional Research Institute, West Virginia University, US.

42 BBC, "China Overtakes US as World's Largest Good's Trader", available at http://www.bbc.com/news/business-25678415.

43 ADB (2009), *Emerging Asian Regionalism: A Partnerships for Shared Prosperity*, Asian Development Bank, Manila.

because of manufacturing supply chains which are linked to global markets, namely in the West.[44] Integration efforts in the region have made more headway in terms of trade and FDI than in finance and monetary policy, which remains very much a national policy preserve.

With the slow progress of the WTO's Doha round, many Asian economies have turned to negotiating bilateral and plurilateral free trade agreements. Consequently, there has been an upsurge in the number of trade agreements in the region despite being a relative late comer to using FTAs. [45] Most of the agreements in the region are bilateral FTAs (190 recorded in 2013) rather than plurilateral agreements (71), probably because bilateral agreements are easier to negotiate.[46] The majority are with partners outside the region. The major Asian players - China (a total of 27 agreements as of 2013), India (34), Japan (26) and South Korea (32) are all heavily involved. Of the ASEAN countries, Singapore has the highest number of FTAs at 38. In South Asia, aside from India, Pakistan is also a partner to 27 agreements. However, these agreements are considered to be 'weak-to-very-weak', in terms of being partial, somewhat dirty and mostly 'trade light'.[47] That is, they have been largely limited to tariff cuts; they have hardly dealt with non-tariff barriers in goods, services and investment and suffer from complex rules of origin.

Much of the past integration efforts have centred in Southeast Asia. The ASEAN Free Trade Area (AFTA), adopted in 1992, was the first major regional free trade agreement in Asia. AFTA aimed to promote the free flow of goods within ASEAN. It has since been upgraded to an Asian Economic Community (AEC) to be established by 2015 to create a single market for goods, services, capital and movement of persons. While ASEAN has had success in bringing down intra-regional tariffs under AFTA, it has seen little progress on AFTA-plus issues such as services, investment, non-tariff barriers and mutual recognition and harmonization of standards.[48] In order to improve existing ties with other major partners in the region, namely China, Japan, and South Korea, ASEAN+3 as a forum was created in 1997. This was followed by the even larger East Asia Summit (EAS), which included these countries as well as India, Australia, and New Zealand - forming the ASEAN+6.

ASEAN which has concluded free trade agreements with China, Korea, Japan, Australia, New Zealand, and India is now in the process of establishing a Regional Comprehensive Economic Partnership (RCEP) by building on the East Asia Free Trade Agreement (EAFTA) and the Comprehensive Economic Partnership in East Asia (CEPEA) initiatives of ASEAN+3 and ASEAN+6, respectively. The bloc will contain three of the largest economies in the world (China, India and Japan), representing 49 per cent of the world's population and 30 per cent of world GDP. The RCEP, formed in 2012, aims to deepen cooperation by focusing on opening more trade in goods and services, eliminating trade barriers, and gradually liberalizing services and FDI. The RCEP is also expected to help further entrench ASEANs centrality to economic cooperation within Southeast and East Asia. Working groups on goods, services and investment have been already established, and negotiations amongst the 16 parties which began in early 2012 are expected to be completed by 2015. However, harmonizing/

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44 Sally, R. (2010), "Regional Economic Integration in Asia: The Track Record and Prospects", ECIPE Occasional Paper No. 2/2010, Brussels.

45 Kawai, M. and G. Wignaraja (2009), *Asian FTAs: Trends and Challenges*, Asian Development Bank Institute, Tokyo.

46 Compiled using the ADB Asian Integration Centre Database, available at http://aric.adb.org/fta.

47 Sally, R. (2010), "Regional Economic Integration in Asia: The Track Record and Prospects", ECIPE Occasional Paper No. 2/2010, European Centre for International Political Economy, Brussels.

48 *Ibid*.

consolidating various disparate agreements into RCEP is likely to be a challenge.[49]

Another mega-regional agreement that has emerged recently in the region is the Trans-Pacific Partnership (TPP), which does not include all ASEAN member countries. To manage trade, promote growth and regionally integrate the economies of the Asia-Pacific region, the TPP was proposed in 2008 as an expansion of an earlier agreement between Brunei, Chile, New Zealand and Singapore signed in 2005. The US, Canada, Australia, Peru, Vietnam, Mexico and Malaysia subsequently joined. TPP countries account for about 40 per cent of the world economy. The entry of the US into the TPP is seen as a means of keeping the US engaged in Asia as well as controlling China's increasing economic and strategic interests and influence in the East Asian region. Thus far, 19 rounds of negotiations have been held with the objective of developing an agreement which goes beyond existing 'traditional' trade agreements.[50] TPP has been called a 'state-of-the-art' trade agreement covering trade in goods and services, investment, intellectual property rights, environmental protection, labour, financial services, technical barriers, etc. In fact, TPP calls for deeper integration than RCEP, which will be a partial WTO-plus agreement. Moreover, it is less flexible than RCEP; the latter considers each country's needs and enable special and differential treatment of ASEAN member countries. Thus, certain provisions under TPP will be difficult for developing countries to meet. Nevertheless, TPP is pushing for an ambitious conclusion as early as possible.

Some observers argue that competition between the two regional trade agreements to be Asia's predominant economic arrangements has the potential to create divisions within ASEAN.[51] Singapore, Malaysia and Vietnam may focus on promoting TPP to other Southeast and East Asian countries while the rest of the ASEAN countries are likely to aim to further develop RCEP.

In comparison to East and Southeast Asia, South Asia's regional integration initiatives have been weak and the region remains the least integrated. This is reflected in a very low level of intra-regional trade at below 5 per cent of the region's total trade, lagging well behind other regions in the world (Table

Table 3.3
Intra-regional Trade Share (%)

	1990	1995	2000	2005	2010
EU	65.7	65.4	64.1	64.9	64.9
Asia	45.2	52.5	53.2	55.1	55.6
East Asia	28.6	35.4	36.8	36.9	36.8
South Asia	1.9	4.1	3.9	4.3	3.1
South East Asia	16.9	21.0	22.7	24.9	24.6
Africa	7.8	9.4	8.3	9.3	10.4
North America	37.2	41.9	46.8	43.0	40.0
Latin America	14.8	18.6	15.4	18.0	19.3

Source: Compiled from ADB, Asian Regional Integration Centre Database available at: http://aric.adb.org/integrationindicators.

49 Armstrong, S., (2013), "Will Asian Trade Strategies Unite or Divide?", East Asia Forum, available at http://www.eastasiaforum.org/2013 / 09/15/will-asian-trade-strategies-unite-or-divide/

50 Cheong, I., (2013), "Negotiations for the Trans-Pacific Partnership Agreement: Evaluation and Implications for East Asian Regionalism", ADBI Working Paper Series, Asian Development Bank Institute, Tokyo.

51 Pakpahan, B., (2012), "Will RCEP Compete with the TPP?", East Asia Forum, available at http://www.eastasiaforum.org/2012/11/28/ will-rcep-compete-with-the-tpp/.

3.3). The South Asian Association of Regional Cooperation (SAARC) was formed in 1985, and a South Asian Preferential Trade Area (SAPTA) became operational in 1995. The latter had limited product coverage. For this reason, the preferential trading area was upgraded to a free trade area through the formation of the South Asian Free Trade Area (SAFTA), which came into effect in 2006. It is supposed to be a full-fledged FTA by 2015 but intra-regional trade remains very low; tariff lines in members' 'sensitive lists' exclude just over a half of intra-regional trade. Also, countries maintain relatively high tariffs with respect to each other and third countries, in addition to high non-tariff barriers (NTBs) and FDI restrictions. Compared to developments in ASEAN and its FTAs with other Asia-Pacific countries, South Asia has been reserved about the inclusion of services, investments, trade facilitation and infrastructure development.

In an important step to strengthen the SAFTA process and deepen integration in the region, the SAARC Agreement on Trade in Services (SATIS) was signed in April 2010 and the agreement entered into force in November 2012. However, the agreement is yet to become functional as all countries have not submitted their schedules for liberalization. Negotiations for the Agreement on Promotion and Protection of Investment are still on. This is likely to create an enabling environment for cooperation beyond mere trade to include investment and finance flows.

Unlike ASEAN, SAARC has not had much luck in forging trading agreements as a regional grouping with other countries/regions in the world; India and Pakistan and some of the smaller South Asian economies have pursued trade agreements with countries/regions outside South Asia on their own. However, studies suggest that tackling key impediments in cross-border infrastructure, barriers to trade in goods and services, and business regulations can foster South Asian integration with the rest of Asia, especially with East Asia.[52] Moreover, India is seen to have an incentive to include its South Asian neighbours in an FTA with East Asia rather than going it alone. Thus, the rest of South Asia can stand to gain by deepening South Asian integration and fostering ties with East Asia. The key to such a regional strategy include investments in infrastructure, improvements of logistics, and greater openness to trade and investment.

3.4 Major Challenges Confronting Emerging and Developing Asia

As Asia continues to grow and converge with average global living standards, there will be risks and challenges for the region to overcome to sustain its growth momentum to realize the Asian Century. Indeed, the challenges over the next 20 years have been identified by key policy makers in the region. The next section will discuss some of these risks including the middle-income trap, income disparities, environmental degradation and climate change, rapid urbanization, political tensions, and demographic changes.

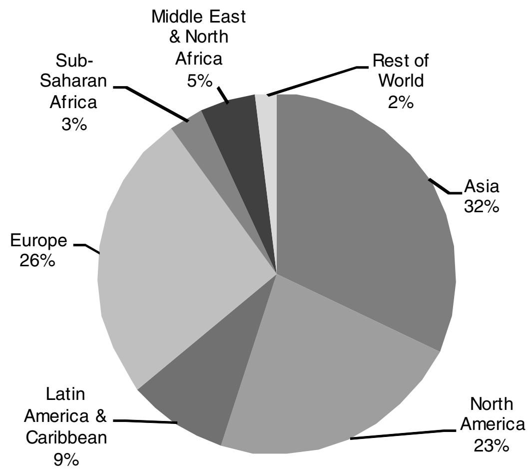
3.4.1 Middle Income Trap

As already discussed, it has been suggested that if Asia continues to grow on its present trajectory, it could account for more than a half of global GDP by 2050. The notion of the Asian Century assumes that Asian economies can maintain their present growth momentum for another 40 years, whilst adapting to changes in global economic and technological environment, and recreate comparative advantages on a continuous basis. Alternative scenario to the Asian Century is the

52 Wignaraja, G., (2014), "Assessing the Experience of South Asia-East Asia Integration and India's Role", ADBI Working Paper Series No. 465, Asian Development Bank Institute, Tokyo.

As Asia continues to grow and converge with average global living standards, there will be risks and challenges that Asia will have to overcome to sustain its growth momentum.

Figure 3.15
Middle Income Trap Scenario



Source: ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.

'Middle Income Trap' scenario, a pessimistic scenario whereby the 11 fast growing countries stagnate and not grow to advanced country levels, while the other 31 slow-modest growth economies do not improve upon their past record. Under this scenario, these countries will fail to shift from investing in physical capital to investing more in human capital, create a better environment for entrepreneurship and innovation, and improve their environment performance. Consequently, they cannot make a timely transition from resource-driven growth with low cost labour and capital to productivity-driven growth. In other words, Asia would follow the pattern of Latin America over the past 30 years. Under this scenario, Asia would fall far short of the Asian Century and the costs would be staggering; total GDP in 2050 would reach only US$ 61 trillion and not US$ 148 trillion, and GDP per capita (PPP) would be only US$ 20,300, as opposed to US$ 38,600. Consequently, Asia would only be able to increase its share of the world GDP to about 32 per cent (Figure 3.15) as opposed to 51 per cent under the Asian Century scenario (see Figure 3.4).

3.4.2 Asia's Rising Inequality

High growth and development is accompanied by risks and challenges in different forms. The forces that drive Asia's rapid growth, namely advanced technology, globalization, and market-oriented reforms, prompt an inevitable escalation in inequality.[53] While Asia's rapid growth in recent decades has lifted hundreds of millions out of extreme poverty, the region still remains home to two-thirds of the world's poor, with more than 800 million Asians still living on less than US$ 1.25 a day and 1.7 billion surviving on less than US$ 2 a day.[54]

53 ADB (2012), *Asian Development Outlook 2012: Confronting Rising Inequality in Asia,* Asian Development Bank, Manila.

54 Kuroda, H. (2013), "Asia's Challenges", OECD Forum, available at http://www.oecd.org/forum/asia-challenges.htm.

Asia's progress in poverty reduction has accelerated in recent years. The number of poor in East and South Asia was reduced by 425 million during 2005-2010.[55] South Asia alone is expected to see a poverty reduction of 430 million over 2005-2015, representing a fall in its poverty rate from 40 per cent to under 9 per cent.[56] Nevertheless, the gap between Asia's rich and poor has widened alarmingly in the past two decades. In many countries, the richest 1 per cent of households account for close to 10 per cent of total consumption, and the top 5 per cent account for more than 20 per cent.[57] The Gini coefficient, a common measure of inequality, has increased in much of the region. Taking developing Asia as a single unit, it has increased from 39 to 46. Inequality widened in 11 of the 28 countries in the region including in the three most populous countries of the region - China, India and Indonesia.[58]

The gap between different economic levels is not only in income. Inequality of opportunity is prevalent and is a crucial factor in widening income inequality. For example, school-age children from households in the poorest income quintile are up to five times more likely to be out of primary and secondary schools than their peers in the richest quintile; infant mortality rates among the poorest households were 10 times higher than those among the affluent households; in South Asia, women's labour force participation is only 40 per cent of that of men's; and in Central and West Asia, girls' primary and secondary school enrolment levels are 20 per cent lower than those of boys.[59] For developing Asia as a whole, 1.7 billion people (45 per cent of the population) lack access to sanitation, and 680 million are without access to electricity.

Hence, the opportunities generated by rapid economic growth have not been equally shared by all. Large and increasing inequality could threaten social cohesion and political stability within countries. Countries are responding to rising inequality, with more and more countries placing emphasis on inclusive growth. For example, China is a strong supporter and follower of inclusive growth, a concept that is consistent with its pursuit of development and social harmony. While speeding up the transformation of economic growth patterns and maintaining stable and relatively fast economic growth, China is increasingly refocussing on integrating economic development with improvement of people's lives.[60]

3.4.3 Environment

Another most visible side-effect of Asia's rapid growth has been issues related to environmental degradation and climate change. Over-exploitation of natural resources, such as water, land, energy, forestry, and fisheries, has resulted in degrading air quality and eco-systems, reducing the supply of clean water, and creating significant health hazards. Asia has become the world's largest source of greenhouse gas emissions (GHGs), which are

55 ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.
56 *Ibid*.
57 Kuroda, H. (2013), "Asia's Challenges", OECD Forum, available at http://www.oecd.org/forum/asia-challenges.htm.
58 ADB (2012), *Asian Development Outlook 2012: Confronting Rising Inequality in Asia*, Asian Development Bank, Manila.
59 Kuroda, H. (2013), "Asia's Challenges", OECD Forum, available at http://www.oecd.org/forum/asia-challenges.htm.
60 *Ibid*.

linked to global warming and climate change. Its cities are amongst the most polluted and the most vulnerable to extreme weather incidents. Recent climate-related disasters in China, the Philippines and Thailand are a reminder that Asian policy makers must act now to protect their citizens and mitigate and reverse the signs of climate change to secure sustainable growth for the future.

For example, one of the growing concerns in China is the 8 per cent increase in wastewater each year and the main cause of this number is the absence of wastewater treatment facilities in more than 278 cities.[61] To counteract this environmental degradation, China has decided to deploy a comprehensive tariff reform for water and wastewater treatment. Further, the government has decided to issue corporate bonds to help fund the development of water treatment facilities throughout China. Moreover, China is currently the second largest emitter of energy-related carbon dioxide emissions mainly because it is the world's largest coal consumer. [62] China has intentions to make better use of their coal resources, primarily expending it on generating electricity. The country also stipulated that all power plants using coal install desulphurization equipment by 2010 to utilize their sulfur while reducing the amount of pollution produced. Nonetheless, much remains to be done in Asia to mitigate and address significant environment degradation and pollution that has accompanied rapid economic growth across the region.

3.4.4 Urbanization

Urbanization is the result of industrialization and economic growth across Asia as there has been a shift from agrarian to industry and service driven economies. Asia is going through a historic demographic transformation from a rural society to an urban society. Approximately 44 million people are being added to Asia's urban population every year. By 2025, the majority of Asia's population is expected to be urban, and by 2050, Asia is predicted to have 3.2 billion urban inhabitants led by internal migrants.[63] This represents an approximate doubling of the current urban population of 1.6 billion people. By 2050, even small, poor Asian countries are also expected to experience major changes. Cambodia's urban population will grow from 20 per cent to 44 per cent, an increase of 7.5 million people, in Lao PDR it will grow from 33 per cent to 68 per cent, adding 5.2 million people to its urban population.[64]

This rapid growth poses both enormous management challenges and opportunities for city leaders. While rates and percentages of urbanization vary across Asia, urbanization is expected to be approximately 53 per cent across Asia.[65] In the Asian context, the benefits of urbanization include better wages and increased productivity. Some countries have already achieved levels of urbanization that the rest of Asia will achieve by 2050. The economic prosperity and high living standards of Japan (67 per cent urban), South Korea (83 per cent urban) and Malaysia (72 per cent urban), along with the economies of Hong Kong, China and Singapore, demonstrate the potential benefits of Asia's future urbanization.[66] Therefore, the successful management of a national economy is closely linked to the successful management of urbanization since about 84 per cent of GDP is generated by cities.

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[61] Yang, Hong, Zhuoying Zhang and Minjun Shi (2013), "Quenching China's Thirst for Economic Growth", East Asia Forum, available at http://www.eastasiaforum.org/2013/01/23/quenching-chinas-thirst-for-economic-growth.

[62] Gardner, D., (2014), "Can China Win the War on Air Pollution?, East Asia Forum, available at http://www.eastasiaforum.org/ 2014/04/09/can-china-win-the-war-on-air-pollution.

[63] UN (2011), *World Urbanization Prospects 2011*, Economic and Social Affairs Division.

[64] ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.

[65] ADB (2008), *Managing Asian Cities: Sustainable and Inclusive Urban Solutions*, Asian Development Bank, Manila.

[66] ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.

The detriments of urbanization can include pollution, congestions, waste management, housing issues and over-burdened infrastructure. Some of the risks of urbanization are growing inequality in cities, unmet expectations of the rapidly emerging middle-class, and high carbon environments and consequences of climate change. City and town planning, professional urban management and self-financing will be important elements to manage the impending rapid urbanization.

3.4.5 Political Tensions

China's rapid economic rise both in terms of its size and power is challenging old and established regional orders. In addition, as China's influence grows over Asia, it is inevitable that it will confront US interests in the region, with relations becoming fraught with tensions at times. History has shown that the rise of new powers often leads to conflict with incumbent powers. Moreover, territorial and maritime disputes in the East and South China Seas can continue to fester while tensions in Asia between other countries due to unresolved historical issues, territorial disputes and nationalist populism are potential set-backs to the notion of greater Asian cooperation and integration efforts.

Maritime and territorial disputes in the South China Sea are arguably among the most pressing security issues facing the Asia-Pacific region, which involve both island and maritime claims among seven sovereign states in Asia, namely Brunei, China, Indonesia, Malaysia, the Philippines, Taiwan and Vietnam.[67] The disputes include the maritime boundary in the Gulf of Tonkin as well as maritime boundaries off the coasts of Vietnam, Malaysia, Brunei and the Philippines. The South China Sea area is potentially rich in natural gas and oil deposits and abundant in fishing opportunities where it is believed to have around 8 per cent of the world's fishing catches and the area is one of the busiest shipping routes in the world.[68] Hence, the disputes are spurred by different interests of nations, which include acquiring fishing areas around the two archipelagos, the potential exploitation of suspected crude oil and natural gas under the waters of various parts of the South China Sea, and the strategic control of important shipping lanes.[69]

Further complicating the South China Sea tensions, in 2011, China objected to India's naval presence and oil exploration initiatives in the South China Sea region. However, India had stood its ground and continued to maintain its presence. India has a stake in oil blocks in Vietnam and a growing strategic and defence partnership with Hanoi and other countries in the region.[70] China has been objecting to Indian exploration projects in the region, claiming that the territory comes under its sovereignty. Whereas India continues to maintain that its exploration projects in the region are purely commercial, China has viewed such activities as an issue of sovereign rights.[71] Like other major powers, India is concerned about China's challenge to free access to the South China Sea. The South China Sea passage is too vital for trade and international security to be controlled by a single country. Concerns have been rising about China's claim to ownership of much of the South China Sea and the Chinese Navy's assertive behaviour in the region.

Prolonged border tensions between countries are another problem that hinders Asian regional

67 Yuyuico, E., "The Real Story Behind the South China Sea Dispute", available at: http://www.lse.ac.uk/ideas/programmes/southeastasiaprogramme/pdfs/sa_southchinaseadispute.pdf.

68 Odgaard, L. (2003), "The South China Sea: ASEAN's Security Concerns about China", *Security Dialogue*, Vol. 34, No. 1.

69 Hookway, J. (2011), "Tensions Flare Over Disputed Asian Sea", *The Wall Street Journal*, available at http://online.wsj.com/news/ articles/SB10001424052702304259304576375203724909870.

70 Chaudhury, D. R. (2014), "China-ASEAN Pact on South China Sea Region Can Bring Some Relief to India, *The Economic Times*, available at: http://articles.economictimes.indiatimes.com/2014-04-25/news/49406042_1_south-china-sea-territorial-claims-asean-and-china.

71 Pant, H. V, (2013), "The South China Sea: A New Area in Chinese-Indian Rivalry", *The Nation*, available at: http://www. nationmultimedia.com/opinion/The-South-China-Sea-A-new-area-in-Chinese-Indian-r-30208644.html.

development. A Sino-India border dispute exists on sovereignty over two large and various smaller separated pieces of territory, under contest between China and India. The western most, Aksai Chin, is claimed by India as part of the state of Jammu and Kashmir and region of Ladakh but is controlled and administered as part of the Chinese autonomous region of Xinjiang.[72]

3.5 Implications of Emerging Asia for Sri Lanka

As a small open economy, the external environment plays an important role in determining Sri Lanka's growth prospects, albeit to a lesser extent in recent years as the country has seen its share of exports to GDP decline sharply to under 16 per cent. Nonetheless, developments across the world have a strong bearing on the country's future growth prospects.

The US and the EU remain important export destinations for Sri Lanka's exports. With the repercussions of the recession receding and global economic activity picking up pace, recent developments have offered better prospects for advanced economies. With US in the lead, growth in advanced economies (excluding Japan) is projected to be on the upside.[73] US growth is projected to increase from 1.9 per cent in 2013 to 3 per cent by 2015 due to upward pressure exerted by moderate fiscal consolidation, increase in inventory demand, a recovery in the real estate sector, declining level of unemployment, higher household wealth, and the easing of bank lending. Europe, where growth has been crippled in the aftermath of the Euro Crisis, has shown slight signs of recovery in 2013 with growth rates improving from -0.7 per cent recorded in 2012 to -0.5 per cent in 2013, while projections for 2014-15 also show signs of continued economic recovery. Emerging and developing Asia, despite recording a marginal slowdown in growth in 2013 compared to 2012 is projected to grow modestly in 2014-15. Though growth in emerging and developing Asia has been slowing down, Asia still by and large out-performs advanced economies in its growth prospects and remains the world's engine of growth.

Sri Lanka should seize new and expanding opportunities that will come with the rise of Asia – opportunities in trading goods and services that would benefit Sri Lankan businesses and consumers alike.

The transformation of the Asian region into a global powerhouse is gathering pace. Asia will not only be the largest consumer but also the largest producer of goods and services. In this context, Sri Lanka should seize new and expanding opportunities that will come with the rise of Asia - opportunities in trading goods and services that would benefit Sri Lankan businesses and consumers alike. Moreover, it will provide an opportunity for Sri Lanka to diversity its dependence away from industrial economies, reducing its susceptibility to developments and imperatives in these markets, as demonstrated by a dip in exports experienced in 2009 due to faltering economic activities in the major markets and the loss of GSP-plus concessions in 2010.

[72] Liu, Xuecheng Liu (2011), "Look Beyond the Sino-Indian Border Dispute", China Institute of International Studies, Beijing.
[73] IMF (2014), "World Economic Outlook", International Monetary Fund, Washington, D.C., April 2014.

Sri Lanka is well positioned to capitalize on these opportunities given its geographical position in Asia and its long history of engagement with countries in Asia. In this context, Sri Lanka should deepen and broaden its engagement with Asia in the years to come, namely with fast-growing converging economies as well as high-income developed economies in the region. Sri Lanka should engage with the region not only economically, but also politically, culturally and socially. Improving people-to-people contacts could unlock large economic gains.

3.5.1 FDI in Sri Lanka from Asia

While Asia has been rapidly integrating with the world, this has been accompanied by closer intra-regional integration of not only trade but also investments. Investments in the region by Japanese multinationals are not something new. This was followed by intra-regional investments by companies from high income economies such as Hong Kong, Korea, Singapore and Taiwan. Since early 2000, however, there has been the rise of investments by Chinese and Indian companies around the world and in particular, in the developing world and the rest of Asia.

In 2013, Sri Lanka received FDI amounting to US$ 916 million, with infrastructure and manufacturing sectors absorbing the highest amounts, with infrastructure alone receiving 57 per cent of the FDI flows. Major infrastructure investments included telephone and telecommunication networks, housing and property development and ports and container terminals. The manufacturing sector secured 25 per cent of FDI while the service sector attracted 17 per cent of the FDI, with the expansion of the tourism industry.

Sources of FDI to Sri Lanka are dominated by Asia with India, China, Malaysia, Hong Kong and Singapore being the largest investors in Sri Lanka (Table 3.4). Malaysia has been a significant investor in the country, with major investments including Dialog Axiata, the cellular mobile telephone network, and Merbok MDF Lanka which manufactures MDF boards. Since 2012, there has been a significant rise in investments from China to Sri Lanka mainly targeting infrastructure development according to the Board of Investment of Sri Lanka (BOI).

India is also an important FDI source, emerging as the second largest investor during 2010/11. While the profile of Indian investment in Sri Lanka is highly diversified, much of the initial flows were in manufacturing. Since the late 1990s, the composition has shifted in favour of services such as hospitals, restaurants, retail trade and oil distribution, helped by the removal of restrictions on outward FDI by India, opening up of a number

Table 3.4
Main Source of Investors in Sri Lanka

Rank	2008	2009	2010	2011	2012
1	Malaysia	Malaysia	India	Mauritius	Hong Kong
2	India	UK	Malaysia	India	UAE
3	Netherlands	India	U.A.E	Hong Kong	China
4	UK	Netherlands	UK	Malaysia	India
5	Luxembourg	Hong Kong	Singapore	British Virgin Island	Singapore
6	Hong Kong	Luxembourg	Hong Kong	Singapore	Mauritius
7	US	Singapore	Netherland	UAE	Netherland
8	Sweden	US	Mauritius	UK	Malaysia
9	China	Sweden	US	Netherlands	UK
10	Singapore	China	Japan	Japan	Luxembourg

Source: Board of Investment of Sri Lanka.

of services to foreign ownership in Sri Lanka, and the overall improvement in the investment climate with the end of the conflict. Indian Oil Corporation, Tata, Bharat Airtel, Aditya Birla Group, Ambuja, CEAT, Ashok Leyland and Hero are some of the most visible Indian investments in Sri Lanka.

FDI flows from China and India to Sri Lanka have gained momentum with the expansion of trade relations with Sri Lanka. As major drivers of growth in Asia, Sri Lanka can gain from expanding ties with China and India, beyond trade in goods, in the areas of services and investments. If Sri Lanka's existing FTA with India and the proposed FTA with China can accommodate services and investments, the benefits of trade will be more widespread.

3.5.2 Development Assistance to Sri Lanka from Asia

With the rise of Asian countries and other emerging economies like China, India, Brazil and South Africa, the global aid landscape is fast changing, especially over the last decade. Aid from traditional donors to Asia is declining, with total global aid falling by 6 per cent since its high point in 2010.[74] Meanwhile, the volume of development cooperation from non-OECD Development Assistance Committee (DAC) members is increasing, with non-DAC contributions expected to increase to at least US$ 50 billion by 2025. These rising development actors are changing the nature of international cooperation relationships, typically referring to themselves as South-South cooperation partners or providers, rather than as 'donors'. China is by far the dominant Southern provider. If a broader definition of aid is used - a definition that includes grants, no interest loans and concessionary loans - China is already the second largest bilateral donor in the world, behind only the US.[75]

Countries like China and India are the most visible within the Asian region in the case of Sri Lanka (Figure 3.16). The major bilateral partners include China, India, Japan, Middle East and multilateral partners including the World Bank and the ADB. Since 2007, China has emerged as the biggest donor to the country and Chinese assistance in the form of loans and grants have mainly gone into infrastructure development projects - such as roads and transportation, power and energy, and ports, largely financed through concessional loans. India too has emerged as an important development partner of Sri Lanka recently. Indian assistance has primarily gone into infrastructure (railway development) and livelihood development, especially in the Northern and Eastern Provinces of the country. The changing aid landscape has provided Sri Lanka with more choices in funding sources and instruments at a time when Sri Lanka's access to concessional finance from multilateral donors has declined due to being classified as a lower middle-income country, while the country's traditional donors, namely the US and EU countries reduced support as the conflict escalated during 2006-09 amidst charges of human rights violations. In this context, Asian donors have proved attractive given that they deliver with speed, impose few conditions and do not interfere with government policy, focusing on infrastructure development. An increase in funding sources has diminished traditional donors' ability to leverage aid as an incentive for 'good' behaviour.

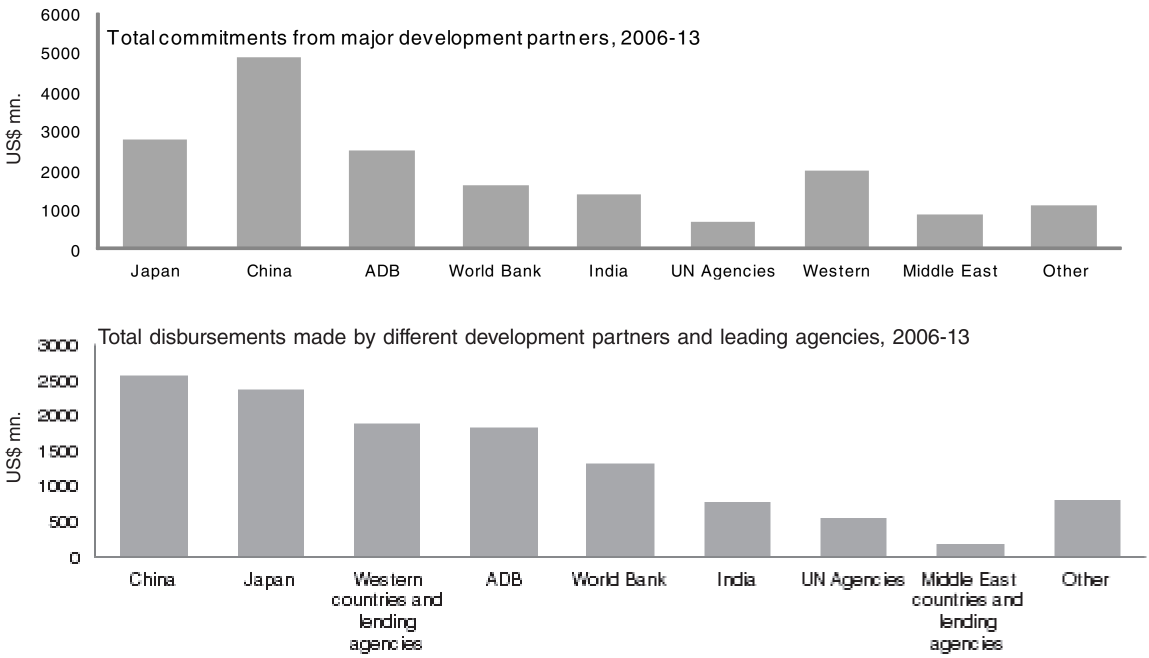
3.5.3 Sri Lanka's Trade in Goods and Services with Asia

Industrialized countries continued to be the major destinations for Sri Lanka exports over the last three decades while developing Asia accounted for a major share of imports (Figure 3.17). Industrialized

[74] Mulakala, A. (2014), "The Rise of Asia's Southern Providers in East Asia", available at: http://asiafoundation.org/in-asia/2014/02/12/the-rise-of-asias-southern-providers-in-east-asia/.

[75] Chin, G. and F. Quadir (2013), "Development Aid and the Rise of New Donors", Asia Research Brief Number 1, York Centre for Asian Research, Canada.

Figure 3.16
Total Commitments and Disbursements by Major Development Partners, 2006-13



Source: External Resource Department (2013), "Global Partnership Towards Development", Ministry of Finance and Planning, Colombo.

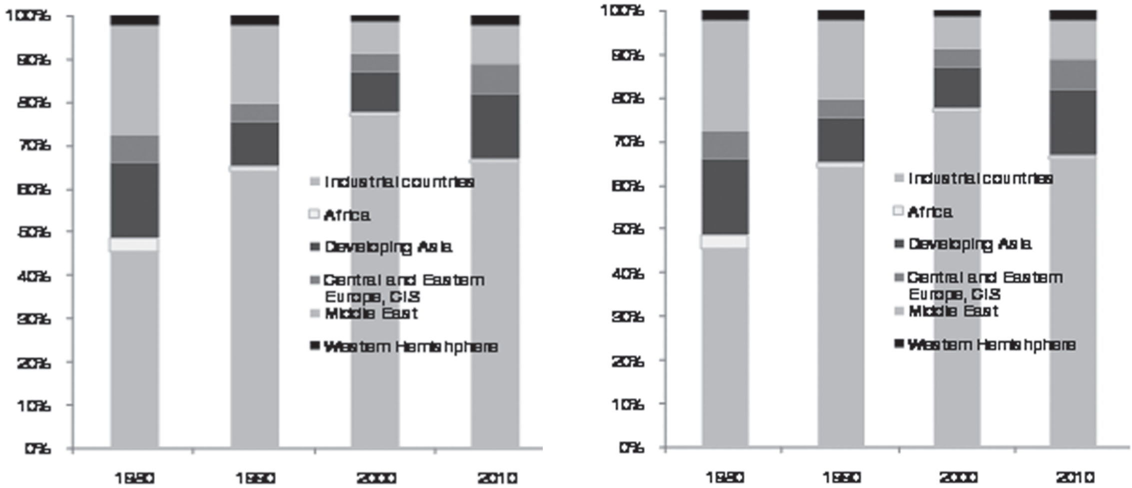
countries account for over 60 per cent of exports, with the US remaining the largest export destination. In 2013, the US accounted for about 24 per cent of Sri Lanka's total exports, followed by the UK (10.4 per cent) and India (5.2 per cent). The EU as a region accounted for 32 per cent of Sri Lanka's total exports.[76]

Sri Lanka's efforts at export diversification have been limited, and exports remain concentrated in industrialized countries and few products, namely the US and the EU and garments, respectively. Asia has managed to increase its share of Sri Lanka's total exports, especially in the last decade, indicating strengthening of trade links between Sri Lanka and the rest of the Asian region. In fact, exports from Sri Lanka to most Asian countries and the region as a whole grew at a higher rate than Sri Lanka's exports to the rest of the world. For example, Sri Lanka's exports to Asia grew by 32 per cent during 2008-2012, which was higher than its export growth to the world (6 per cent) while exports to 27 of the 38 countries in the region exceeded the world average.[77] Nonetheless, much of the increasing growth and share of exports to Asia was driven by market penetration into India which gained momentum in early 2000 with the signing and implementation of the India-Sri Lanka Free Trade Agreement (ISFTA).

Similarly, imports from Asia to Sri Lanka have grown substantially. Imports from the Asian region have on average grown by 33 per cent compared to imports from the rest of the world (14 per cent) over the last five years, while 19 out of the 29 countries from the region reported growth rates above the

[76] CBSL (2013), *Annual Report 2013*, Central Bank of Sri Lanka, Colombo.
[77] Compiled using ITC Trade Map Database.

Figure 3.17
Sri Lanka's Exports and Imports, by Region, 1980-2010



Source: IMF, "Direction of Trade", various years.

world average.[78] Currently, Sri Lanka sources as much as 60 per cent of its requirements from the region. Since 2000, India has become the largest source of imports and held this position in 2013, followed by China and Singapore. In 2013, India accounted for almost 18 per cent of Sri Lanka's total imports while China and Singapore accounted for 16 per cent and 9 per cent of total imports, respectively.

While Sri Lanka traded with almost all of the countries in the Asian region, Sri Lanka's trading partners appear to be concentrated amongst a few countries. The top ten trade partners in Asia, account for as much as 84 per cent of Sri Lanka's exports to Asia and 96 per cent of imports from Asia (Table 3.5). India is the most important Asian market for Sri Lanka accounting for a share of 30 per cent of Sri Lanka's exports to and imports from Asia. Notably, India has emerged as the largest trading partner of Sri Lanka, not only in Asia but with the rest of the world with bilateral trade exceeding US$ 3.7 billion in 2013. China is the next most significant trading partner in the Asia market, but mostly as a source of imports; China accounted for 22 per cent of imports from Asia. Increasingly Sri Lanka's trade flows within Asia are concentrated between India and China; in 2012, India and China collectively accounted for 53 per cent of Sri Lanka's imports from Asia and 36 per cent of Sri Lanka's exports to Asia. While the concentration in Chinese and Indian markets offer favourable prospects for Sri Lanka due to stronger growth prospects in the two countries, the reliance on two markets alone comes with considerable risk. Hence, it remains imperative that greater support is rendered for Sri Lankan traders to look for markets elsewhere in Asia, reaching beyond Indian and Chinese markets.

In terms of composition of exports to the Asian region as seen in Figure 3.18, Sri Lanka's export basket consists predominantly of vegetable products (29 per cent), textiles and clothing (16 per cent), plastics and rubber products (10 per cent) and transport, machinery and electrical and food products (7 per cent each) for which Asia's demand is expected to rise in the future in line with its rising income levels and a booming middle class. For example, the real value of world agrifood demand in 2050 (in 2007 US dollars) is projected to be 77

[78] *Ibid.*

Table 3.5
Sri Lanka's Top Ten Traders in Asia, 2012

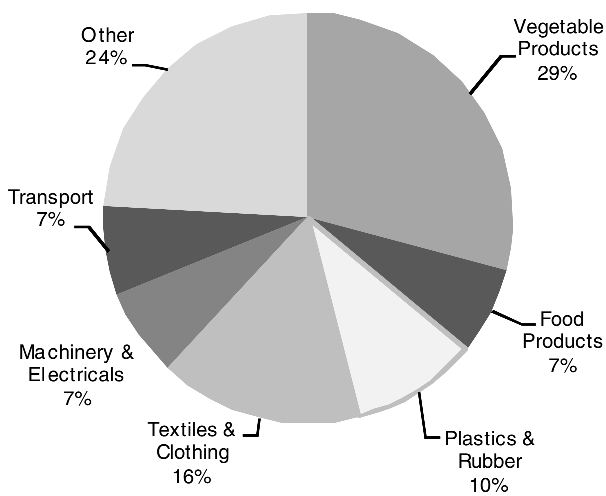
Country	Exports		Imports	
	Share of Asia	Share of World	Share of Asia	Share of World
India	30	6	31	20
China	6	1	22	14
Singapore	5	1	11	7
Iran	10	2	6	4
Japan	11	2	5	3
Hong Kong	6	1	5	3
Indonesia	6	1	4	2
Pakistan	4	1	3	2
Thailand	3	1	4	3
Malaysia	3	1	5	3

Source: Calculated based on International Trade Centre, "Trade Map", ITC, Geneva.

per cent higher than in 2007, and most of the projected rise is expected to come from Asia, accounting for 71 per cent of the projected increase between 2007 and 2050.[79] This increase will be led by China and India, accounting for 43 per cent and 13 per cent of the projected increase in demand, respectively.

Moreover, as evident from Figure 3.19, a simple analysis of Sri Lanka's indicative potential to trade with Asia shows that Sri Lanka has the potential capacity to expand trade with the region in these product categories,[80] namely textiles and clothing, followed by vegetable products and plastics and rubber for which Sri Lanka's exports to Asia have also been growing vigorously at an average annual rate of 14 per cent, 17 per cent and 20 per cent, respectively, during 2003-2012.[81] In this light, Sri Lanka stands to benefit from strengthening trade relations

Figure 3.18
Composition of Exports to Asia, 2012



Source: Calculated based on World Bank, WITS Trade Database.

[79] Linehan, V. *et al*. (2012), "Food Demand to 2050: Opportunities for Australian Agriculture", Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES), Canberra.

[80] Indicative potential is defined as the lower of the value a selected country exports to the world or the value the partner country imports from the world minus the current trade between the two countries under review.

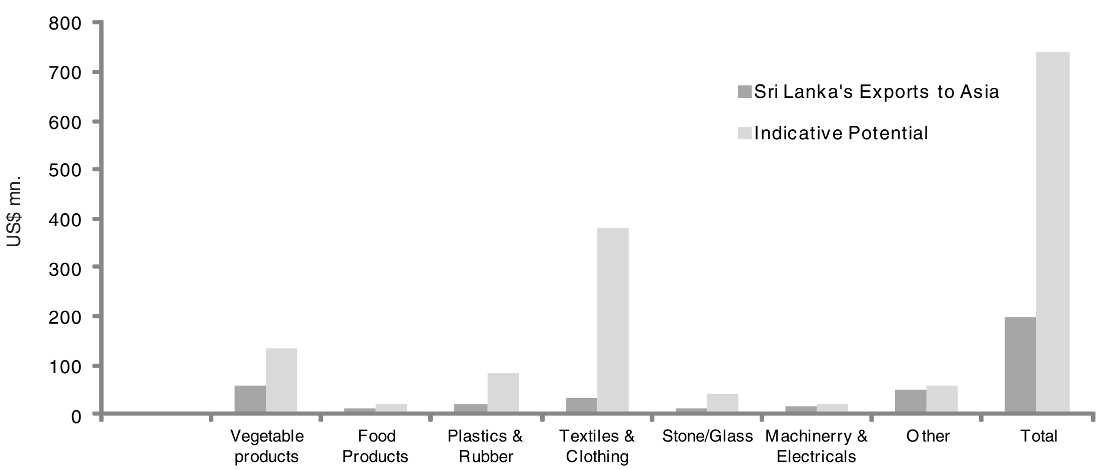
[81] Calculated based on World Bank, WITS Trade Database.

with Asia considering the demand prospects for its major exports to the region, combined with its geographic proximity. Sri Lanka has been strengthening its trade ties with the major economies in the region - it already has a FTA with India which has been in place since 2000 - and is now negotiating a trade deal with China with which it has established a very close relationship over a considerable period of time (Box 3.3).

Sri Lanka not only has a potential to expand trade in goods with the rest of the Asian region, but also in services. Intra-regional trade in services in Asia is expected to grow significantly from 2010 to 2020 mainly in the financial, computer and information, communication, travel and transportation sectors. Sri Lanka has a comparative advantage in producing and exporting travel, transportation, computer and information, communication, and insurance services. Among these, travel and transport services exports have expanded since 2009 securing a share of about 70 per cent of Sri Lanka's total services exports to the world in 2012 (Figure 3.20). With the growing affluence in Asia, the demand for travel and tourism services are expected to rise within Asia. Outbound tourist numbers from the region have already grown substantially. For example, China's figure increased from 4.5 million to 57 million between 1995 and 2010, and India's from 3 million to 11 million over the same period.[82]

In 2013, Sri Lanka saw 1.3 million tourist arrivals, as a result of which earnings from tourism rose to US$ 1,715 million. In terms of visitor arrivals, Western Europe accounts for over 30 per cent of tourist arrivals, while Asia secured 40 per cent of the total tourist arrivals (Figure 3.21). India remains the largest source of tourists to the country, followed by the UK, Germany and the Maldives. China is also emerging as a tourist market for Sri Lanka; growth in tourist arrivals from China has significantly increased over time, with a 96 per cent increase in 2013 alone.[83]

Figure 3.19
Sri Lanka's Existing and Indicative Potential to Trade with Asia (US$ mn)



Source: Calculated based on World Bank, WITS Trade Database.

82 UNWTO (2011), "Tourism towards 2030", World Tourism Organization.

83 SLTDA (2013), "Tourism Statistics 2013", Sri Lanka Tourism Development Authority, Colombo.

Box 3.3
Sri Lanka-China FTA

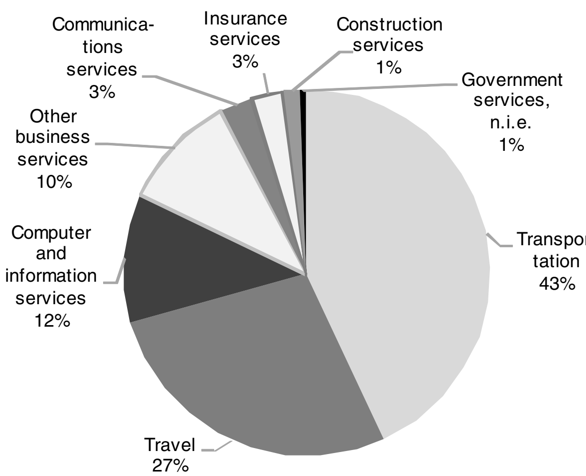
While historical and cultural relations between Sri Lanka and China date back to many centuries, modern day economic and political ties were established with the signing of the historic Sino-Lanka Rubber-Rice Pact in 1952 and establishment of formal diplomatic relations in 1957. Over the past 55 years, very cordial relations have prevailed between the two countries and bilateral economic cooperation has strengthened. During the last few years, relations between the two countries have been elevated to a higher level, cemented by several visits by Sri Lanka's President to China.

Trade flows between Sri Lanka and China have improved notably in recent times. Total trade has more than doubled between 2009 and 2013 from US$ 1.2 billion to US$ 3.1 billion, with China becoming the second largest trading partner of Sri Lanka, after India. However, while China is now the second largest source of imports to Sri Lanka, it is a much less prominent export destination. Nevertheless, it is encouraging that exports have been growing vigorously, recording an annual growth of 25 per cent during 2009-2013. While Sri Lanka's exports to China have grown over the last 5 years, imports from China have grown at a faster rate (32 per cent) than exports, resulting in an expanding trade deficit of US$ 2.8 billion in China's favour by 2013.

The strong political relations between the two countries provide a robust foundation for stronger economic ties. Both countries have agreed to embark on a free trade agreement (FTA) and commenced a joint feasibility study in August 2013. The study which was finalized in March 2014 reported that an FTA would bring substantial economic and trade benefits to both countries. In this context, negotiations are likely to commence at an early date. Indeed, the impending visit of China's President to Sri Lanka in 2014 - the first Chinese Head of State to visit Sri Lanka in three decades - is likely to accelerate the process.

In negotiating a trade agreement with China, a few concerns should be borne in mind taking into account Sri Lanka's experience with FTAs to date with India, Pakistan and SAFTA. Tariff concessions alone may not be sufficient in expanding trade between the two countries. The actual capacity of Sri Lankan exporters to cater to the large Chinese market, as well as non-tariff measures (NTMs), may constrain traders from fully utilizing a potential agreement. China has already signed 11 FTAs with other countries and regional groupings, with these partners producing similar goods as Sri Lanka and already having preferential or duty free access to the Chinese market. In this context, it is imperative that trade negotiations not only cover products in which Sri Lanka has a comparative advantage, but also that concessions awarded by China are greater or at least equivalent to tariff reductions granted to other countries/regions. Moreover, a well-conceived negative list as well as a longer tariff liberalization programme which provides special and differential treatment to Sri Lanka and its local industries would be vital to allay fears of a 'China threat' that afflicts businesses around the world, including those in Sri Lanka.

Figure 3.20
Composition of Sri Lanka's Exports of Services in 2012

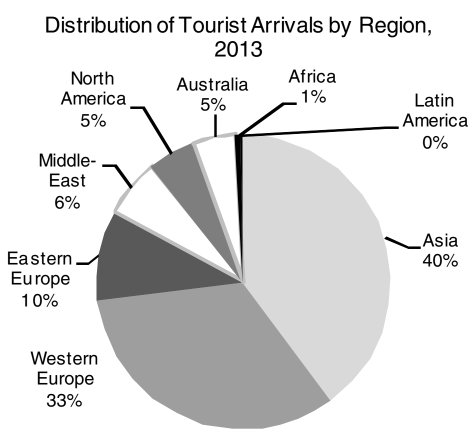


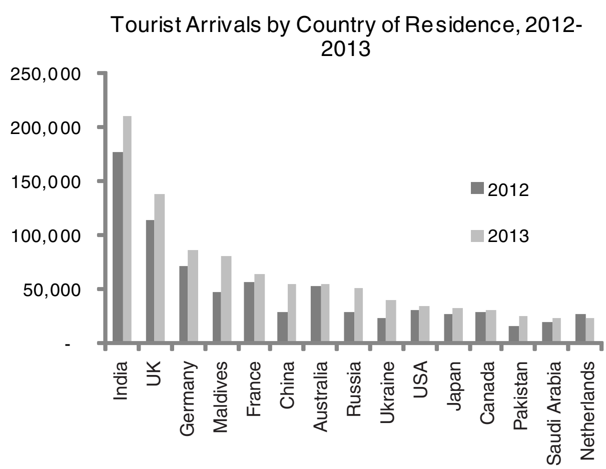
Source: Calculated using data from ITC Trade Map database available for 2012.

While the emergence of Asia provide opportunities, a number of countries in East and Southeast Asia have developed into hubs in competing areas of interest to Sri Lanka.

Despite the increasing tourist arrivals to Sri Lanka and several international chain-affiliated hotels (Shangri-la, Marriott, Hyatt, Mövenpick and Sheraton, etc.) in the process of setting up operations to meet future demand, the industry is faced with issues related to inconsistent service standards, lack of trained staff, lack of rooms and inadequate marketing efforts.[84] Hence, Sri Lanka needs to overcome these challenges and position the industry correctly in terms of both the capacity and service standards in order to better utilize the demand for travel by the expanding middle class in Asia.

Figure 3.21
Distribution of Tourist Arrivals





Source: Sri Lanka Tourism Development Authority, *Tourism Statistics* 2013.

[84] *Ibid.*

While the emergence of Asia provide opportunities in terms of trade in goods and services and financial flows to the country, a number of countries in East and Southeast Asia (Hong Kong, China, Singapore, South Korea, and Malaysia) have developed into hubs in competing areas of interest to Sri Lanka. This is a cause of concern as the government has a vision to develop Sri Lanka into a 'dynamic hub' in the areas of shipping, aviation, commerce, energy and knowledge. Comparative statistics of Sri Lanka vis-a-vis other countries in the region indicate that Sri Lanka is far behind in terms of shipping, aviation, commerce, energy and knowledge.[85] Across the five hubs, Sri Lanka performs relatively well in shipping but poorly in energy and knowledge. For example, the three busiest ports in the world are located in Asia (Singapore, Shanghai and Hong Kong). While Colombo port's performance is relatively modest, with an annual container throughput of 3.6 million twenty foot equivalent units (TEUs) in 2011 and ranks at 29th place amongst the 125 ports in the world, there are many Asian ports (19) handling larger volumes.[86] To better capitalize on Sri Lanka's geographic position and become a shipping hub, it is imperative that ports in the country are developed and regulatory reforms are undertaken. Some recent initiatives in this regard have been Hambantota port development, the Colombo South Port Expansion Project and development of a port city in Colombo.

In terms of carrier departures (take-offs of air carriers) Sri Lanka does far worse in terms of world ranking - coming at 68th place out of 150 airports worldwide in 2012,[87] despite infrastructural development (establishment of Mattala International Airport, modernization of Bandaranaike International Airport and domestic airports, etc.). There are many countries ahead of Sri Lanka, including China, Japan, India, Indonesia, Malaysia, South Korea, Thailand, Singapore, etc., and much remains to be done to establish Sri Lanka as an aviation hub like Dubai or Singapore. Sri Lanka also faces stiff competition from countries in the region from becoming a hub for commercial services, international banking and international investment; Hong Kong is the world's most popular city for international businesses, reflecting a shift in economic power to Asia in recent years. [88] Other top cities for business in Asia include Singapore, Beijing, Shanghai, Tokyo, and Mumbai, which are challenging cities such as New York, Frankfurt and London that have traditionally been the world's top business centres.

Developing Sri Lanka as a knowledge hub in Asia is also a key development strategy of the government and it is commendable that a number of initiatives have been taken in this regard over the years (i.e., establishment of new faculties and higher education institutes, introduction of new degree courses, invitation to foreign universities to set up campuses, etc.). However, Sri Lanka has to catch up as developments in tertiary education have not only been stagnant, but also fallen behind its neighbouring countries. While the US, UK and Australia have been traditional destinations of higher education and attract considerable numbers of international students, countries within Asia including Singapore, Malaysia, China, Hong Kong, and, India have embarked on reforms to create global educational hubs. Singapore stands out as an example; it has recruited prestigious foreign universities to establish local campuses, with the goal of expanding access for the local student population as well as serving as a higher education 'hub' for the region.[89] Thus, Sri Lanka not only has to raise the international standards of its education,

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[85] Abeyratne, S. (2014), "Employment Implications of the Five-Hubs Strategy of Sri Lanka", International Labour Organization, Colombo.

[86] American Association of Port Authorities (2011), "World Port Rankings", available at http://www.aapa-ports.org/ Industry/ content. cfm?ItemNumber=900#Statistics.

[87] World Bank, "World Development Indicators", available at http://data.worldbank.org/indicator/IS.AIR.DPRT/countries/ LK? display=default.

[88] CNBC, "World's Most Popular Business Cities", available at http://www.cnbc.com/id/44084372.

[89] Altbach, P.G., *et al*. (2009), "Trends in Global Higher Education: Tracking an Academic Revolution", UNESCO, Paris.

but also has to face stiff competition from its neighbouring countries which are already far ahead.

3.6 Policy Implications of Rising Asia for Sri Lanka

While Sri Lankan businesses should take the lead in reaping the opportunities of emerging Asia, the government should support such efforts by reducing the cost of doing business, removing unnecessary barriers to trade, attracting foreign investment, and better integrating the country with regional markets.

While Sri Lankan businesses should take the lead in reaping the opportunities of emerging Asia, the government should support such efforts.

- Sri Lankan businesses need to develop competitive products and services which will be in demand in Asia. In this regard, the government needs to work with businesses to build capabilities, identify opportunities given that the Asian region as a whole will be highly competitive, as businesses from other countries in the world will also be seeking to secure similar opportunities.

- Sri Lanka needs to raise awareness of the opportunities available to firms in Asia of doing business in Sri Lanka. In this regard, it is imperative that the cost of doing business in Sri Lanka is reduced. Sri Lanka's overall rank in 'Ease of Doing Business' has dropped from 83 in 2013 to 85 in 2014 out of 189 countries.[90] Sri Lanka's rank has improved in indicators such as dealing with construction permits, getting electricity, paying taxes, and trading across borders. However, Sri Lanka still has much to do to build an investor-friendly environment in the country. For instance, although Sri Lanka has made it easier to get construction permits, it still takes 186 days and 17 procedures compared to Hong Kong where it takes only 71 days and 6 procedures. Further, Sri Lanka's rank has deteriorated in the following indicators: starting business, registering property, getting credit, protecting investors, enforcing contracts, and resolving insolvency - all of which indicate that more needs to be done vis-à-vis East and Southeast Asia in attracting investments to the country. Apart from the regulatory reforms, macroeconomic stability is essential to create a conducive environment to attract investments and enterprises. For this reason, Sri Lanka needs to maintain macroeconomic stability whilst undertaking regulatory reforms.

- Building a successful business partnership in Asia requires an ability to establish relationships with partners and customers; strong relationships are particularly important in the Asian markets. In this regard, bilateral business councils, industry and professional associations can support Sri Lankan businesses to network and make connections in the region.

- In order to capitalize on opportunities stemming from emerging Asian economies, there should be greater efforts made towards eliminating unnecessary trade related bottlenecks in the

[90] World Bank (2014), *Doing Business Report,* World Bank, Washington, D.C.

country. As reflected by the scores in the 2014 Global Enabling Trade Index[91] of the World Economic Forum, Sri Lanka is ranked at 84 out of 138 countries and fares well when compared to a number of countries in Asia (Bangladesh, India, Nepal, Pakistan, Laos), while it still lags behind when compared to most fast-growing Asian countries (China, Malaysia, Thailand, Vietnam) and the high-income developed countries in the region (Hong Kong, Japan, Singapore and South Korea). Sri Lanka has undertaken favourable improvements in most trade facilitation indicators over recent years. The number of documents needed to export and import has declined from 21 in 2007 to 12 in 2013, while the number of days required to export/ import has dropped from 52 in 2007 to 39 in 2013. The automation of customs procedures which began with the introduction of the Automated Systems for Customs Data (ASYCUDA) system in 1992 has contributed towards improving trade facilitation in Sri Lanka. Nonetheless, more needs to be done including implementing a fully automated customs system in the country along with the implementation of a Single Window concept under which all agencies and institutions involved in the customs process are linked through a single entry point. These will ensure the Sri Lanka will not only fall in line with the Trade Facilitation Agreement arrived at the Bali Ministerial Conference in December 2013, but they will be vital to fully benefit from growing trade prospects in Asia and elsewhere in the world. In addition, infrastructural development - roads, airports, ports and communications systems - is an essential component to facilitate cross-border trade and travel, and thereby link Sri Lanka to the region.

- Establishing strong trade links with countries in Asia through bilateral and regional paths are essential to accessing the growing regional markets. While being committed to a multilateral process, Sri Lanka has been a proponent of bilateral and regional preferential trade initiatives and currently has preferential/duty free access to a number of countries in the Asian region under the FTAs with India and Pakistan, SAFTA, and the Asia Pacific Free Trade Agreement (APTA). Sri Lanka which is also member of the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), aims to achieve a free trade area by 2017 amongst its neighbouring countries (Bangladesh, Bhutan, Burma, India, Nepal, and Thailand). However, the existing trade agreements of Sri Lanka are limited in their scope/coverage and include a handful of Asian countries, mainly from the South Asian region. However, access even to South Asia is rather limited under these agreements; the utilization rates of existing agreements by traders is low while the agreements have failed to progress from mere preferential agreements to high quality agreements covering broader economic cooperation beyond tariff liberalization. For example, the Comprehensive Economic Partnership Agreement (CEPA) between Sri Lanka and India, which covers the liberalization of services and investment sectors has been on a back-burner since 2008 due to reservations on the part of a few lobbyists. Nevertheless, there have been efforts to deepen bilateral and regional trade recently.[92] It is also commendable that Sri Lanka has taken initiatives to further improve trade links within the region by considering an FTA with China, Sri Lanka's important trading partner in Asia after India.

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91 The ETI assesses the extent to which economies have in place institutions, policies, infrastructure and services facilitating the free flow of goods over borders and to their destination.

92 For example, the first meeting of India-Sri Lanka Joint Task Force (JTF) was held to explore means of improving bilateral trade and investment between the two countries in 2013, while the fifth technical meeting on the Pakistan-Sri Lanka FTA was held to resolve outstanding issues during the year.