Centre for Asset Management Research & Investments
NUS Business School

CAMRI Global Perspectives

Monthly digest of market research & views — Issue 2, Apr 2013

Trade over Conflict

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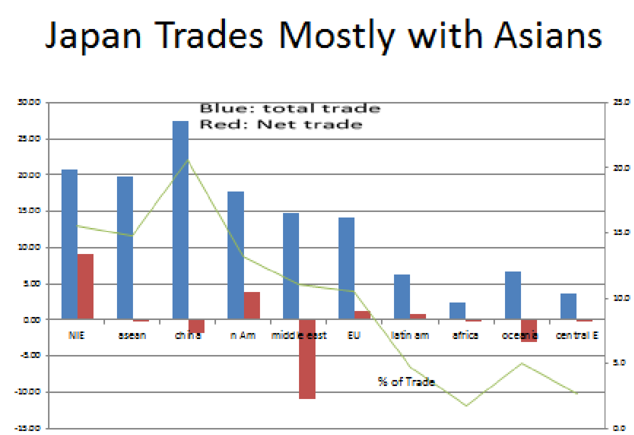
Historians have often theorized that most wars throughout history have been fought over economics (money and resources) rather than ideology, politics or religion. Today's most pressing and dangerous international disputes in Asia are also mainly about economics; the potential rich resources that geologists believe lie under the sea surrounding the islands in the Pacific between Korea, Japan, China, the Philippines and Vietnam. Once again trade among the contestants for island ownership will probably be the mitigating factor that thwarts any military solution. The amount of dollars in trade among these countries today dwarfs the uncertain potential of recovering resources from under the sea many years into the future. Trade and investment between China and Japan has already been disrupted by political agitation over ownership of the disputed islands. Now the new leaders in China are agreeing to at least discuss the situation with Japan to protect present trade arrangements between the two giant Asian economies.



Japan's trade partners

Trade statistics from Japan's Ministry of Finance reveals that China is Japan's biggest single country trade counterparty. It accounts for 20.6% of Japan's total trade, and it is bigger than all trade with North America, or with Europe. Moreover, Japan's external trade with all Asian nations is also greater than it is with other Western economies. The combined trade with the NIEs, China and ASEAN accounted for 50% of Japan's external trade. Since so much of

Japan's trade is sourced throughout the region, a breakdown in trade with China will affect trade with many other Asian economies. China also enjoys a large trade surplus with Japan. Consequently, there is an enormous present business benefit that is at risk for both countries.

Trade troubles

The islands dispute has already affected trade between these two giant Pacific economies. After years of consistent growth, Japan's total trade with China declined 10.8% in 2012 and an additional 7.9% in the first two months of 2013 as compared to the first two months of 2012. Most of this loss in trade is a result of increased political friction between these two countries. External trade is very important to both economies. It accounts for an average of 25% of Japan's GDP and it has been rising over the past decade. The number is nearly double that for China. Moreover, Japan has enjoyed a consistently large annual trade surplus for decades, but it ended in 2011.

Investment at risk as well

One auspicious trend has been the miniscule direct investment each country has made in the other, especially relative to the size of their trade and current account surpluses. Greater China's direct investment in Japan through 2011 was only $4.2 billion, accounting for 2.2% of total direct investment (DI) in Japan. This reflects both a historical bias as well as alternative opportunities. Japan's DI in China and HK is slightly more significant, totaling $82 billion, or 10.4% of their total DI. However, in the heat of the islands dispute, many leading Japanese companies are planning to shift their present and future investment to other Asian countries.

Negotiating a solution

In 2013 Japan and China have new governments and both are committed to improving their countries' economic growth as a key tenet of their administrations. With so much of GDP presently at stake, and with only unproven future economic resources under the sea, I believe that these two rational and highly pragmatic countries ***will soon*** find a convenient solution to suppress political disagreements, and maintain valuable trade relationships over conflict.

For more information, please contact camri@nus.edu.sg

	KEY INDICATORS TABLE (AS OF 31 MAR 2013)					
INDEX	**LEVEL**	**%1MO**	**%1YR**	**INDEX**	**LEVEL**	**%1YR**
S&P500	1569	3.75%	13.96%	3MO LIBOR	0.2804%	-40.1%
FTSE	9739	1.41%	10.27%	10YR UST	1.85%	-16.29%
NIKKEI	132	5.82%	9.74%	10YR BUND	1.29%	-27.93%
HANG SENG	2873	-2.90%	12.54%	10YR SPG	5.06%	-5.42%
STI	2668	1.11%	14.84%	10YR SGS	1.54%	-7.23%
EUR	1.28	-1.82%	-3.93%	US ISM	51.3	-3.75%
YEN	94.22	-1.79%	-13.70%	EU PMI	46.8	-1.89%
CMCI	1536	-0.78%	-4.22%	JP TANKAN	-8	33.3%
Oil	92.73	5.16%	-7.06%	CHINA IP	10.3	-19.5%

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK3)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
Source: Japan's Ministry of Finance for data on direct investment; and World Trade Organization for the trade data used in the chart