Global economic instability – what impact on the Asia Pacific logistics industry?

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With the US and Europe already experiencing a pronounced economic slowdown, there are major concerns that Asia Pacific markets will be dragged into a worldwide recession. Despite that, the impact on the region is still very unclear and will be influenced by a number of complex macro-economic factors which will be discussed in this article.

Although the reasons behind the economic downturn are familiar to most industry observers, it is useful to reprise some of the underlying issues. Most of the blame for the present economic malaise has been placed on the US 'sub-prime' mortgage market. The inability of many American householders to repay their debts when faced with a relatively minor slowdown resulted in a lack of liquidity in the global finance markets as a whole. Banks throughout the world had exposure to that market and wrote down billions of dollars in bad debts. The so-called 'credit crunch' arose due to the unwillingness of banks to lend money to each other and the result was that consumer lending also dried up. In turn, that led to falling house prices and declining consumer confidence which impacted on retail sales.

At the same time, spiralling fuel costs, as well as increasing commodity prices, have created inflationary pressures, putting up prices at a time when consumers are least able to afford them. Currency fluctuations have also played a role in the crisis. The weakness of the US dollar has meant that US imports have become more expensive, although in turn that has helped US exports. UK sterling has also fallen dramatically against other currencies.

However, although the effects of that crisis in the western world are evident, what is not so obvious is the extent to which the downturn in the US and Europe will impact on the economies of the Far East. Another way of putting that is, to what extent has globalisation embedded the region in the global trading system?

That question can perhaps best be answered by examining international trade flows. Analysis of eight main product categories, undertaken by *Ti* in its 'Global Freight Forwarding 2008' report, shows that intra-Asian trade amounted to $1,188bn in 2006 compared to inter-continental trade of $2,322bn. With the main western markets of North America and Europe accounting for roughly two-thirds of trade originating in Asia Pacific, the figures show that a slowdown in those markets will be keenly felt.

Indeed, Asia Pacific exporters have more to worry about than just a reduction in demand for their products. In addition to the problems being experienced in their export markets, countries such as China and Vietnam also have to contend with their own inflationary pressures, not least of all wages. Annual wage inflation in China has averaged about 19% since 2003 and the gap now between what Chinese workers and, for example, their Mexican counterparts take home is negligible. In 2003, Mexican workers were twice as expensive. Rising employee remuneration has been reflected in product costs, resulting in inflation being exported to the West. That in turn has added to the downward cycle of demand.

The rising oil price has also hit the region particularly hard. As reported earlier in the year in Ti *Logistics Briefing*, Canadian investment bank CIBC asserted that since 2005, every one dollar rise in world oil prices has fed directly into a 1% rise in transport costs. The bank pointed out that the cost of

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moving a container from eastern China to the eastern seaboard of the US, for instance, had risen by more by 100% and said the impact was already being seen in falling import volumes for commodities such as steel, which is at present declining by 20% on an annualised basis.

Reinforcing those points, leading consultancy McKinsey recently undertook a study which showed the impact that rising costs for off-shored production have on global supply chains. The company analysed a range of high tech goods, identifying the cost structure in 2005 and in 2008. In that way it was able to establish which goods could profitably be produced in Asia Pacific (off-shored), Mexico (near-shored) or in the US itself.

As an example, it found that in 2005, manufacturing a midrange server in China provided a 60% saving in wage costs compared with manufacturing in the US which was offset by a 36% increase in the cost of logistics. In 2008, however, McKinsey found that the savings had become negative.

Inflation had substantially reduced the wage savings, whilst at the same time logistics costs had risen. The consultancy therefore recommended that the same product be built in Mexico, which had similar wage costs to China but far lower logistics costs.

Of course, in many other industries, production in the Asia Pacific region is still an obvious option. However, manufacturers need to be conscious of the fact that with the market environment changing so quickly, they must maintain a firm awareness of their supply chain costs.

Indeed, there is evidence of increased awareness amongst the largest consumer goods manufacturers such as Unilever and Procter & Gamble. Those companies seem to be seriously examining their production and distribution strategies with a view to pursuing a more distributed sourcing network as a result of higher transport costs. One P&G supply chain executive pointed out that its distribution requirements had been established in the 1980s and 90s when oil was around $10 a barrel, compared with $140 earlier this year at its peak.

However, the effects even a root and branch overhaul of supply chains by multinationals would have on the associated Asia Pacific logistics industry is not clear cut. Production locations based in the region are far less reliant on the US and European export markets than they were, say, ten years ago when many were established. The development strategies of major multinationals rely heavily on the nascent consumer markets of China, Indonesia, India, Thailand and Malaysia for example, and so any shift of production to near-sourcing markets would be mitigated by strong local growth.

That last observation gives some indication as to why Asia Pacific may well help drive the global economy through its downturn and at the same time escape largely unscathed. Although the principal axes of world trade run along the routes China-North America and China-Europe, there are increasingly important trade routes feeding into China from the major economies of north and south-east Asia.

Japan, South Korea, Malaysia and other nations in the region have big trade surpluses with China as components of varying levels of complexity are delivered into the country for final assembly. The shipping and logistics infrastructure that supports those trade flows is huge. It is estimated to account for about 20% of all global container shipping volumes. Shipping consultancy Drewry asserts that trade will grow into one of the most significant in global shipping, with a projection that the annual volume will almost double to 50m TEUs in the next five years.

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In addition to the intra-Asian aspect to international trade, domestic growth is also important. Exports account for just a third of China's GDP and 15% of Japan's. What that shows is that in addition to the influence of international trade, those countries have their own internal dynamics and markets, which are less directly impacted by the global environment.

In conclusion, there is no doubt that the Asia Pacific region will be, and in fact already is, affected by the global economic slowdown. *Ti* estimates that growth in the region's freight forwarding market slowed from 17% in 2006 to 12% in 2007. It is also inevitable that trading patterns will change, with the development of a counter-trend of near-sourcing to markets such as Mexico, Central & Eastern Europe or even North Africa. However, it would be easy to overstate the impact of the global slowdown on the region. Trade growth will become increasingly decoupled from western markets and that, along with domestic growth dynamics, will ensure that the region survives the recession in good shape.

Interested in the future of the Asia Pacific Logistics market? To find out more about the issues discussed in this article – plus many more to be highlighted in the next few weeks – book your place at Global Distribution Strategies Conference 2008 – Asia Pacific at the Langham Place Hotel, Hong Kong 2-4 December. This unique event combines insightful presentations by leading industry experts and Ti analysts, the leaders in knowledge delivery for the logistics and transportation sectors. Follow the link for more information and to claim your early bird discount.

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