Economic Impact of Asia’s Security Risks

Analysis of what’s at stake for economies, markets and industries, as tensions increase from North Korea to the South China Sea.
Missile advancements by North Korea and unsafe encounters between U.S. and Chinese jets over the South China Sea illustrate the new uncertainties. China’s sanctions on South Korea, its coal import ban on North Korea, and its investment in Southeast Asia show what’s at stake for the economies of the region.

More than anything else, it’s the rise of China that’s redrawing the map. Ten years ago, China’s GDP was less than half that of the next ten largest Asian economies combined. Now it’s bigger. With that shift in the balance of economic power has come a new reach and ambition in foreign policy.

Deng Xiaoping’s famous maxim — “hide our strength, bide our time” — is no longer the watchword. On the Korean peninsula, in relations with Taiwan, in an island dispute with Japan, and in the South China Sea, China is increasingly unwilling to countenance challenges to its interests.

That’s already shaping economic trajectories and market outcomes across the region:

- South Korea’s tourism stocks took a blow in March when China blocked tour groups, apparently in retaliation for Seoul’s preparations to install the THAAD anti-missile system.
- North Korea will see its exports to China reduced by more than 50 percent as a result of Beijing’s ban on coal imports from its neighbor. That takes a major chunk out of the rogue regime’s foreign exchange earnings.
- Japan’s automobile makers saw China sales plummet in 2012 after a flareup in the territorial dispute over the Diaoyu Islands, known in Japan as the Senkaku Islands, triggered nationalist ire.
- China announced plans to buy $1.7 billion in fruit and agricultural products from the Philippines following President Rodrigo Duterte’s swing from U.S. toward China. That’s equal to about 2 percent of total exports for the Philippines.

There’s more at stake. The South China Sea is home to one of the world’s busiest trade routes. Taiwan’s technology firms are the starting point of a global supply chain that stretches through China’s factories to Apple stores around the world. The One Belt, One Road scheme means the promise of job-boosting investments for countries that align with China, not for those that bandwagon against.

If the rise of China is the most important factor shaping the region, the reaction of the U.S. isn’t far off. The response of the established power to a rising rival is a process fraught with difficulty. The Obama administration’s Asia pivot was their answer to the problem, an attempt to reassert U.S. influence across the region.

The new U.S. administration has yet to clarify its Asia policy. When it does, the balance could shift. Sweeping trade controls, for example, would hit China’s growth. A 45 percent tariff on all U.S. imports from China — touted by President Donald Trump when he was on the campaign trail — would take GDP growth down by 0.7 percentage point, according to Bloomberg Intelligence Economics’ calculations.

A stronger U.S. military commitment to the region could tip the strategic balance — making China’s rise a bumpier process. Conversely, if exports continue unimpeded, and the U.S. steps back from its global commitments, China would enjoy stronger growth and a freer hand.

In the background is the low probability, high-impact possibility that one of the simmering regional hot spots bubbles into a genuine crisis. A nuclear crisis on the Korean peninsula, or U.S. and China coming to blows over the freedom of navigation in the South China Sea are in no one’s interest. In the context of the current tensions, they can’t be ruled out.

And as policy makers and investors are increasingly recognizing, it doesn’t take Huntington’s civilizational war for tensions to have a major impact on the economy and markets.
**North Korea**

**Description:** North Korea's nuclear capabilities have advanced, threatening stability in North Asia and beyond. Leader Kim Jong Un's unpredictability, a new administration in Washington, Beijing's cooling relations with Pyongyang and a leadership vacuum in Seoul all add uncertainty.

**Trump Tweet:** “North Korea is behaving very badly. They have been "playing" the United States for years. China has done little to help!” (March 2017)

**U.S. Statement:** “North Korea and its people need not fear the United States or their neighbors in the region who seek only to live in peace with North Korea. With this in mind, the United States calls on North Korea to abandon its nuclear and ballistic missile programs and refrain from any further provocations.” — U.S. Secretary of State Rex Tillerson (March 2017)

**China Statement:** “The nuclear issue on the Korean Peninsula is mainly between the DPRK and the United States. China is a next-door neighbor with a lips-and-teeth relationship with the peninsula, so we're indispensable to the resolution of the nuclear issue. China has a strong commitment to a denuclearizing the peninsula, to maintaining stability there and to resolving the issues peacefully.” — China Foreign Minister Wang Yi (March 2017)

**Parties Involved:** North Korea, South Korea, China, Japan, Russia, U.S.

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**North Korea**

**Description:** The barren islands and reefs of the South China Sea have become a source of contention as China seeks to expand its influence in the region. At stake are freedom of navigation in key commercial shipping lanes, fishing rights, and potential oil and natural gas resources.

**U.S. Statement:** “We're going to have to send China a clear signal that first, the island-building stops, and second, your access to those islands is also not going to be allowed.” — U.S. Secretary of State Rex Tillerson (Jan. 2017)

**China Statement:** “We hope parties outside the region will respect the aspiration and interests shared by countries in the region.” — China Ministry of Foreign Affairs chief spokesman Lu Kang (Jan. 2017)

**Parties Involved:** China, Taiwan, Philippines, Malaysia, Vietnam, Brunei, U.S.

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**Taiwan**

**Description:** President Trump questioning the One China policy, a return to power for Taiwan's pro-independence Democratic Progressive Party, and Beijing in no mood for challenges to its sovereignty all add uncertainty to cross-strait relations. Trump later walked back his comments.

**U.S. Statement #1:** “Everything is under negotiation including One China.” — U.S. President Donald Trump (Jan. 2017)

**China Statement:** “The one-China principle, which is the political foundation of the China-U.S. relations, is non-negotiable.” — China Ministry of Foreign Affairs chief spokesman Lu Kang (Jan. 2017)

**U.S. Statement #2:** “President Trump agreed, at the request of President Xi, to honor our “one China” policy.” — White House Office of the Press Secretary (Feb. 2017)

**China Statement #2:** “The one-China principle is the political foundation for China-US relations. To adhere to the one-China policy ... is the obligation of the US administration. It is also China's consistent position. We commend President Trump's statement in the phone call that the US administration will honor the one-China policy.” — China Ministry of Foreign Affairs chief spokesman Lu Kang (Feb. 2017)

**Parties Involved:** China, Taiwan, U.S.

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**Senkaku/Diaoyu Islands**

**Description:** Recurring tensions over the Senkaku/Diaoyu Islands threaten to become a flashpoint between China and Japan, East Asia’s main two economies. The most recent spat in 2012 saw Chinese protests and goods boycotts against Japanese firms.

**U.S. Statement:** “I made clear that our long-standing policy on the Senkaku Islands stands — the U.S. will continue to recognize Japanese administration of the islands. And as such, Article 5 of the U.S.-Japan security treaty applies.” — U.S. Defense Secretary Jim Mattis (Feb. 2017)

**China Statement:** “We urge the U.S. side to take a responsible attitude, stop making wrong remarks on the issue involving the Diaoyu islands’ sovereignty, and avoid making the issue more complicated and bringing instability to the regional situation.” — China Ministry of Foreign Affairs chief spokesman Lu Kang (Feb. 2017)

**Parties Involved:** China, Japan, Taiwan

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**Sources:** IMF, Stockholm International Peace Research Institute, News reports, Bloomberg Intelligence
Political Shock Would Split Regional FX: Yen Would Surge, Others Slide

By YUKI MASUJIMA, BI Economist

Asian currencies are vulnerable to economic and political jolts. The Japanese yen is prone to surge, and the Chinese yuan, South Korean won, and Indonesian rupiah fall when markets swing into risk-off mode.

In a region with security strains from North Korea at one end to the South China Sea at the other, the risk is that political and currency pressures could compound. Analysis by Bloomberg Intelligence Economics indicates the “safe-haven” yen has overshot to the downside, increasing the risk of a spike in the event of a shock.

Asia’s trouble spots are in simmer mode – with a low risk of boiling over into crisis, but high impact should one occur. A nuclear crisis on the Korean peninsula, where the North has been stepping up missile launches, is the most pressing concern. Deterioration in relations between China and Japan over disputed East China Sea islands or a clash over South China Sea shoals also have potential to upset markets.

In the near term, the highest probability risks lurk outside the region. Upcoming elections in France, Italy or Germany could test the resilience of the euro area. In the U.S., the election is over, but President Donald Trump’s administration is off to an erratic start and the Federal Reserve is poised to continue hiking rates, adding uncertainty to the outlook.

Sharp moves in currencies triggered by risk-off events have the potential to exacerbate underlying economic or political tensions. A nuclear threat from North Korea could — if serious enough — spur capital flows out of China and South Korea, and safe-haven flows into the yen. The result would be increased financial stress on those economies, compounding the impact of security problems. Japan’s earthquake and nuclear disaster in March 2011 underlines the dynamic: the yen climbed 6 percent in the following six months, crimping exports and intensifying deflationary pressures — putting further pressure on the stricken economy at exactly the time the government didn’t need it.

BI Economics has used a rolling regression of the VIX, the two-year yield differential between each Asian country and the U.S., and the exchange rate, to determine which Asian currencies have “safe haven” versus “risk currency” status. The analysis runs from the beginning of 2001 through Jan. 26, 2017, with a 250 business day window. The results indicate the yen is Asia’s main safe-haven play, while other Asian currencies tend to be vulnerable during the risk-off episodes.

The yen has depreciated by 8 percent since Nov. 7, the day before Donald Trump’s win in the U.S. presidential election — the most among four East Asian currencies. The fall reflects a risk-on mood, with the VIX falling and stocks rising. The widening U.S.-Japan yield gap — on expectations of Fed rate hikes — is also a significant factor. Yen depreciation is providing a welcome boost to Japan’s exports and reflation. It is also prone to a sudden reversal, if events in the U.S. or Europe or (less likely) Asia’s security tensions, trigger a risk-off reaction in the markets.

The South Korean won and Indonesian rupiah – which tend to suffer in adverse market environments — tend to perform relatively well when investors are taking on risk. When things turn sour, China’s yuan — already under pressure from capital outflows — would suffer further stress, to the benefit of the dollar, bitcoin, gold, and the yen. With China a key actor in many of Asia’s security dramas, the country looks exposed to compounding security and currency risks, if one of them spirals out of control.
Based on an analysis by Bloomberg Intelligence Economics, South Korea and Malaysia are among the most vulnerable in the region to economic arm twisting from China. Japan and Vietnam look relatively robust.

Looking across East Asia, South Korea, Taiwan, Japan, Malaysia, the Philippines and Brunei all have security or territorial disputes of one kind or another with China. To see which are most likely to accept China’s offers or retreat from its challenges, BI Economics ranked them across four metrics: trade, tourism, investment and unemployment:

- **Trade:** Economies with a large trade surplus with China as a percent of GDP face costs if Beijing slaps controls on imports. Looking across the region, South Korea with a bilateral trade surplus of about 6 percent and Malaysia with 7 percent look most exposed. Vietnam, which runs a substantial trade deficit with China, scores as most secure. Of course, regardless of the overall trade balance, China could still impose controls on particular products. As Seoul prepares to deploy THAAD, China has banned imports of South Korean goods ranging from cosmetics to bidets — citing health and safety concerns as among the reasons.

- **Tourists:** As China’s middle class grows, tourism is becoming an important source of revenue for countries around the region. South Korea is finding out what it looks like when the visitors stop, as tour groups from China have been cancelled. Looking at annual China visitors as a percent of domestic population, near neighbors Taiwan and South Korea are most exposed to a sudden stop. The Philippines has the lowest number of Chinese visitors as a percent of population.

- **Investment:** China used to have a lot of U.S. Treasuries and not many Asian investments. Now its stash of Treasuries is shrinking and its Asia investment portfolio expanding. In South East Asia, the One Belt One Road scheme could provide game-changing investments for countries that bandwagon with China, not for those that align against. Vietnam has the largest stock of Chinese FDI as a percent of GDP, suggesting it would be most susceptible to the drying up of the project pipeline. With its own advanced infrastructure and a troubled history with China, Japan is toward the other end of the spectrum.

- **Unemployment:** Countries with low unemployment would be relatively immune to economic threats and promises from their big neighbor. Those with a high level of joblessness might be more responsive. On that measure, all the countries actually look relatively robust, with no one suffering severe unemployment. On a relative basis, the Philippines comes off worst with a 4.7 percent jobless rate.

This risk ranking doesn’t provide the final word on who is most exposed to China’s economic sanctions. Rankings based on historical data obviously don’t capture shifts that could occur in the future. Under the One Belt One Road scheme, for example, there’s the possibility of growth-boosting infrastructure investments for South Asian countries that align with China. Promised projects could be withdrawn for those that displease. That’s not captured in a metric that looks at the stock of FDI.

Other vectors are also difficult to capture in a simple number — for example, corporate exposure. South Korean retail conglomerate Lotte has found itself in the firing line after turning over land to the government to house the THAAD system. Some listed firms report sales dis-aggregated by country, meaning it’s possible to calculate what percentage comes from China. Most don’t. For what it’s worth, the data that is available shows South Korean and Taiwanese corporates most exposed.

The data-driven approach has limitations. Even so, in an Asia where China appears increasingly willing to flex its economic muscle to defend its national security interests, the risk ranking does provide a first way into thinking which neighbors are most exposed.
Kim Missiles and Global Shifts Add Peninsula Risk

By JUSTIN JIMENEZ, BI Associate, and TOM ORLIK, BI Economist

Provocations from Pyongyang — the capital of North Korea — have become so familiar that financial markets have become desensitized. Even with nuclear weapons tests across the border, South Korea’s won and Kospi equity index have remained relatively unfazed. Investors, it seems, see little likelihood of disruption to the existing conditions of fractious stability.

North Korea’s escalating moves — with four ballistic missiles fired simultaneously in early March and reports of a failed launch on March 22 — are testing whether that attitude makes sense.

North Korea’s nuclear program has advanced rapidly since its first successful test in 2006, with two detonations in 2016. The outgoing Obama team warned President Donald Trump’s new administration they consider Pyongyang their top national security priority. Against that backdrop, the latest signals from North Korea are troubling. Ballistic missile tests and the assassination of Kim Jong-un’s half-brother point to an increase in aggression and instability.

As recent events have demonstrated, it doesn’t take a major crisis to create significant ripples. South Korean hotel, cosmetics and tourism-related stocks sold off on reports China may be halting sales of holiday packages to its neighbor. The concern is that China could use sanctions in response to South Korea’s planned deployment of the THAAD missile defense system — a joint scheme with the U.S. to defend against an attack from the North. Conditions in the other players on the peninsula are also changing, and not in a way that will make resolution easier:

- President Trump’s foreign policy stance remains erratic in communication and unclear in substance — adding uncertainty to the U.S. position.
- The impeachment of South Korea’s former President Park Geun-hye, a hardliner on the North, has left the country with a power vacuum.
- China’s relations with North Korea have cooled. A ban on coal imports will reduce Pyongyang’s sales to its big neighbor by more than 50 percent, taking a significant chunk out of its FX earnings.
- U.S. plans for the deployment of the THAAD missile-defense system in South Korea and Trump’s back-and-forth on Taiwan policy threaten to undermine trust between Washington and Beijing.

The worst case scenario — armed conflict and a messy collapse of Kim’s regime — is unlikely. An attack by North Korea on the U.S. or its allies would likely be the last thing it ever did. Conflict would also be a disaster for the rest of the region.

South Korea — with its capital Seoul close to the border — would be in the direct line of fire. China would face a flood of refugees, and the risk of a U.S. ally on its northeastern border.

Conflict might not be in anyone’s interest. But with increasing pressure on North Korea as its export lifeline is cut off, increased uncertainty about U.S. policy, and diminished trust between Washington and Beijing, the chances of a mis-step by one of the parties have surely increased.

Continued muddling through — which remains the most likely option — also comes with costs, especially for South Korea. Living in the shadow of the North represents a continued burden, across multiple axes. The drag on consumer and corporate confidence is difficult to measure, but is surely there. Mandatory conscription for South Korean men is a negative for the labor market. Political energy that could be expended on economic reforms or expanded trade deals is instead tied up in security concerns.

Tensions with China can also be costly. China sent 8.1 million visitors to the country with a population of 1.3 billion in 2016 — a significant contribution to demand.

In the best case scenario, market reforms similar to China’s during the 1980s could put North Korea’s economy onto a path of rational development. Optimists point to increasing trade and small-scale manufacturing activity on North Korea’s border as hopeful signs. Even so, the chances Pyongyang will move from rogue to developmental state appear slim.

North Korean Events and South Korean Won

<table>
<thead>
<tr>
<th>Event</th>
<th>Date</th>
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<tbody>
<tr>
<td>N. Korea announces first successful nuclear weapon test</td>
<td>Oct. 2006</td>
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<td>N. Korea agrees to end nuclear program for aid</td>
<td>Feb. 2007</td>
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<tr>
<td>N. Korea fires artillery near maritime border with S. Korea</td>
<td>Jan. 2010</td>
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<td>N. Korea conducts fifth nuclear test</td>
<td>Sept. 2016</td>
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<td>N. Korea announces second successful nuclear weapon test</td>
<td>May 2009</td>
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<tr>
<td>N. Korean submarine reportedly sinks S. Korean warship</td>
<td>March 2010</td>
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<tr>
<td>Kim Jong Il dies and his son, Kim Jong Un, assumes power</td>
<td>Dec. 2011</td>
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<tr>
<td>Kim Jong Un declares “semi-state of war” with S. Korea as tensions rise over landmines that wounded two S. Korean soldiers</td>
<td>Aug. 2015</td>
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<tr>
<td>N. and S. Korea engage in first high-level talks since 2007</td>
<td>Feb. 2014</td>
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<td>N. Korea conducts fourth nuclear test, claiming it was a hydrogen bomb</td>
<td>Jan. 2016</td>
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<tr>
<td>N. Korea conducts third successful nuclear weapon test</td>
<td>Feb. 2013</td>
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<tr>
<td>N. Korea conducts second successful nuclear weapon test</td>
<td>Nov. 2010</td>
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<tr>
<td>N. Korea fires artillery at S. Korea’s Yeonpyeong Island</td>
<td>Nov. 2010</td>
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Source: Bloomberg Intelligence

USD/KRW


900 1,000 1,100 1,200 1,300 1,400 1,500
Angry China Puts Economic Squeeze on South Korea

By BRUCE EINHORN

China is fuming about the U.S. deploying a missile defense system in South Korea — and Korean companies are feeling the impact. While the U.S. says the system, known as THAAD, is meant to defend against attack from North Korea, the Chinese see it as a threat. Now China is curbing travel to South Korea and targeting Korean companies that operate in the mainland.

1. Weren’t South Korea and China growing closer?
Until recently, yes. Chinese President Xi Jinping boasted in 2014 the two countries were “shoulder-to-shoulder good neighbors and good partners.” A free-trade agreement went into effect in 2015, with China agreeing to end $54.5 billion of duties on imports from South Korea. China is South Korea’s largest trading partner, buying a quarter of the country’s exports.

2. Why is China so upset now?
While the U.S. regards THAAD as a counter to recent missile launches by North Korea, China says the system will break the regional strategic balance. With South Korea and the U.S. moving ahead despite China’s objections, state-run Global Times said March 1: “Chinese consumers should become the main force in teaching Seoul a lesson.”

3. Which Korean companies are most vulnerable?
The tourism sector faces an immediate threat. More than 8 million Chinese visited South Korea last year and Chinese make up 85 percent of tourists to the resort island of Jeju. Curbs on visitors to South Korea could cut tourism revenue by about $5 billion, Goldman Sachs estimates, hurting cosmetics companies like Amorepacific Corp. and retailers like Lotte Shopping Co. A Lotte official said the Chinese authorities had suspended the operations of 67 stores in the mainland because of alleged fire-safety violations, and around 20 stores voluntarily stopped operations due to sporadic protests. Some Chinese websites have stopped selling Lotte products. Lotte Shanghai Foods, a joint venture with Hershey Co., has been told by Chinese authorities to stop production at its factory for a month.

4. Will the backlash hurt Korea’s automakers?
The timing could be bad for Hyundai Motor Co. China is the automaker’s largest market and by 2018 Hyundai will raise its capacity there by more than 50 percent. Parts-makers like Hanon Systems, which manufactures auto heating and cooling systems and earned 53 percent of its 2015 operating income in China, will suffer if consumers avoid Korean cars. China in 2015 accounted for 63 percent of operating income for Mando Corp., which makes brakes and steering systems, and 24 percent for parts-maker Hyundai Mobis.

5. Will Chinese policy hurt local companies, too?
Korean TV shows are popular in China, so streaming services that deleted Korean content may lose viewers. Two of Tencent Holdings Ltd.’s top three PC games are from South Korean developers, according to Nomura. The Chinese regulator now will likely take a “much longer time” approving applications for Korean game licenses, Nomura said.

6. Has this happened before?
In 2012, after a territorial dispute with Japan fueled Chinese street protests and calls for a boycott of Japanese goods, sales by Japanese automakers slumped. Last year, relations with Taiwan soured with the election of President Tsai Ing-wen, contributing to a 16 percent year-on-year decline in mainland Chinese tourists. On the other hand, visits to the Philippines surged 76 percent in January, thanks in part to President Rodrigo Duterte’s promotion of detente with China.

7. What can South Korea do about China’s threats?
The government will offer emergency loans to local exporters adversely affected by the showdown. South Korea is also considering going to the World Trade Organization, according to Trade Ministry official Kang Myung-soo. Finance Minister Yoo Il-ho says the government will expand economic and diplomatic efforts to minimize the impact.

8. Do other countries stand to gain?
South Korean companies may invest more in Southeast Asia. With wages in China on the rise, companies like Samsung Electronics and LG Electronics were already focusing on Vietnam, taking advantage of its low labor costs.
KIM JONG UN

Leader Lights Fires Across Asia, Raising Dilemma for Trump

By DAVID TWEED

MURDER IN MALAYSIA. Protests in China. And missiles flying toward Japan.

All can be traced back to North Korea and show how Kim Jong Un is managing to stir up tensions in the region while trying to provoke a reaction from U.S. President Donald Trump. The question for Trump, Xi Jinping and other leaders is how to respond, given sanctions, cajoling and military pressure have all failed to rein Kim in.

While Trump initially signaled he’d be open to talks, more recently he’s indicated he could follow Barack Obama’s lead in insisting North Korea abandon its nuclear program before negotiations can occur.

The stakes for Trump are potentially higher than Obama, given Pyongyang’s progress in developing an intercontinental missile capable of hitting the U.S. with a nuclear warhead. The recent events are probably Kim’s way — after a hiatus in his provocations — to try and force Trump to the table with concessions, analysts said.

“They decided to lay low doesn’t make sense, and that being on good behavior isn’t going to make any difference to the United States,” said John Delury, an associate professor of Chinese studies at Yonsei University in Seoul.

“I do think they want a negotiation,” he said. “They can read the reports. They know there is a North Korean policy review going on in Washington. This is a way to have an input into the discussion.”

On March 6, Kim oversaw the launch of four ballistic missiles, prompting phone calls between Trump and the leaders of Japan and South Korea. A day later his regime banned Malaysians from leaving the country amid a spat over the murder of his half brother, prompting Prime Minister Najib Razak to warn North Korea is “effectively holding our citizens hostage.”

Trump pledged “very dire consequences” for Kim’s provocations while affirming support for Japan and South Korea, which rely on the U.S. military presence in North Asia.

The U.S. announced meanwhile that it had started to deploy its THAAD missile-defense shield in South Korea, a move that has riled China.

While the U.S. military said the system was aimed solely at defending South Korea against North Korean missiles, China sees THAAD as a threat to “the strategic equilibrium in the region.”

North Korea’s provocations resumed last month after a relative lull. It stopped firing missiles in the last two months of the year after launching at least 24 projectiles and detonating two nuclear devices.

On the campaign trail, Trump sent signals he’d be open to discussions with Kim. “What the hell is wrong with speaking?” he said in June. There had also been calls for talks from North Korean watchers who increasingly saw Obama’s strategy for dealing with North Korea — sanctions and pressure on Kim’s ally China to do more — as a failure.

“Efforts over the past eight years to slow the North down and prevent it from achieving this goal, relying on a mix of pungy sticks and carrots plus otherwise trying to ignore the problem, have been unsuccessful,” Joel Wit, a former state department official who met North Korean diplomats in Geneva, wrote in The Atlantic in November after the meeting.

Yet at the start of the year, Trump signaled he’d revert to Obama’s policy. He vowed to prevent Pyongyang from developing the capability to strike the U.S. with a missile — without saying how — and harangued China for not doing enough to deal with North Korea.

“Given North Korea’s recent behavior, we’re not at the point where we’re looking at direct engagement,” State Department spokesman Mark Toner said at a briefing.

While Pyongyang spars with its North Asia neighbors there’s also friction with Malaysia after Kim Jong Nam — Kim Jong Un’s half-brother — was killed at a Malaysian airport. Authorities found evidence he was murdered using VX nerve agent, and sought to question a North Korean diplomat who has been holed up at the embassy.

North Korea banned all Malaysians from leaving until it could ensure its citizens were safe. Najib called the act “abhorrent” and said Malaysia “will not hesitate to take all measures necessary” to protect its citizens. Malaysia has said it will now ban North Koreans in the country from leaving.

The murder had other ramifications. China, which was reportedly protecting Kim Jong Nam, banned all coal imports from North Korea, prompting the regime to lash out. The U.S. also reportedly canceled another round of informal talks with North Korean officials that had been scheduled for early March.

The rhetoric from North Korea is as dire as ever. In a letter to the United Nations Security Council, North Korea’s ambassador to the UN complained about U.S.-South Korean military exercises that began in early March, warning they risked driving the peninsula and northeast Asia toward a “nuclear disaster,” the Associated Press reported.
At stake is control of the world’s busiest shipping lanes, as well as energy resources and fisheries. For the smaller countries involved, standing in opposition to China can have heavy costs, as trade, investment and tourism flows slow. Lack of clarity from the new U.S. administration increases the chances smaller states will accept China’s carrots, rather than risk its sticks.

China’s activities and interests in the South China Sea continue to grow. In recent years, that’s included an oil rig in waters claimed by Vietnam, and island building in areas claimed by the Philippines. Military facilities have sprung up, and the number of Chinese naval and coast guard vessels has grown.

A United Nations ruling in favor of the Philippines in July last year appears to have done nothing to change the facts on the ground. In the period after the U.S. election, China and U.S. aircraft had an ‘unsafe’ encounter and China seized then returned an unmanned U.S. underwater drone.

The disputed area encompasses virtually the entire South China Sea - from Malaysia in the south to Taiwan in the north and from Vietnam in the west to the Philippines in the east. Beyond national pride (which is important in itself), there’s a lot at stake:

- **Trade:** the South China Sea provides a conduit for trillions of dollars in trade each year. About half the world’s merchant fleet and oil tankers travel through the area.
- **Freedom of navigation:** a maritime link between the Pacific Ocean and the Indian Ocean allows the U.S. to send warships from its Pacific fleet to support military operations in the Middle East.
- **Energy:** proven oil reserves of over seven billion barrels and an estimated 900 trillion cubic feet of natural gas, according to the World Bank.
- **Local livelihoods:** coastal populations rely heavily on fisheries for food and employment, and tourism as a source of revenue.

It was the U.S. pivot to Asia under the Obama administration that shifted the dynamic in the region, prompting an acceleration of activity from the Chinese side. The arrival of the Trump team could shake things up again. Clarity on the U.S. approach though, is so far lacking. On the campaign trail, Trump hinted that Asian allies should do more to look after themselves. Post-election, he complained about China’s island building. Secretary of State Rex Tillerson hinted at a tougher stance. Secretary of Defense James Mattis said there’s no need for dramatic military moves.

Whilst the U.S. ponders whether a more isolationist or aggressive posture makes sense, China remains hard at work in an area it regards as its backyard. For the other countries with claims to the disputed territory, the decision to bandwagon for or against China can be critical to the economic outlook. For the Philippines, Malaysia, Vietnam and Taiwan, China is the most important trade partner, and a growing source of direct investment and tourism revenue. The Asian Infrastructure Investment Bank and One Belt One Road scheme expand Beijing’s tools of influence.

That provides Beijing with a formidable array of sticks and carrots it can use to pursue its interests in the region. The response of the Philippines might prove symptomatic. Manila’s decision not to follow through on the United Nations ruling has meant markedly warmer relations with China. President Rodrigo Duterte enjoyed a state visited to Beijing.

China’s ambassador floated the suggestion of joint work on a new industrial park, and there’s a promise of $1.7 billion in agricultural imports. By comparison, the U.S. does not appear to be putting much on the table. Indeed, the decision to withdraw from the Trans-Pacific Partnership trade deal means it is taking something away.
A major rupture is unlikely, but a period of heightened tension as relations are realigned is a definite possibility. That adds risk to Taiwan’s nascent recovery, and to a global smartphone supply chain that starts in the island’s technology firms.

Trump didn’t take long before starting to make waves. Back in December, the President-elect broke diplomatic protocol by taking a phone call from Taiwan’s president Tsai Ing-wen. He followed that by suggesting support for the One China policy is conditional on trade concessions from China. The history of the policy stretches back to 1972 and the historic detente between Nixon and Mao. The formula, to which successive U.S. Presidents have signed up, is that “there is one China, and Taiwan is part of China.”

Trump’s comments were quickly walked back. In February, in his first conversation with China’s President Xi Jinping since taking up residence in the White House, he committed to respect the One China policy. What won’t change is a shift in the underlying dynamics of the relationship. Back in 1972:

- Taiwan was not yet a democracy – it didn’t get its first democratically-elected leader until 1996. Now it has more than two decades of democratic experience and a younger generation that has known nothing else.
- China’s reform and opening were still a decade in the future, which meant internal challenges to deal with and limited resources to project influence. Now, with the world’s second largest economy, it is already a regional and increasingly a global power.
- The Cold-War struggle with the USSR, the U.S. had an expansive conception of its international role. Now the global security map looks more complicated and the U.S. is stretched across multiple regions.

In other words, Taiwan is more attached to its democratic traditions, China more confident in its reach, and the U.S. less willing and able to engage than when the current arrangements were agreed.

On the economics, it’s Taiwan that has most to lose if stresses increase. Taiwan exports to China in 2016 equaled a substantial 14 percent of GDP. In the same year, there were more than 3.5 million visitors from the mainland — a significant amount of additional spending power for an island of 23.6 million. The economy is in the midst of a mild recovery. GDP growth accelerated to 2.9 percent year on year at the end of 2016, reversing a 0.8 percent contraction at the end of 2015. A blow to either exports or tourism could knock that off course.

The ripples though, would be felt more widely. Taiwan Semiconductor Manufacturing Co. is among the world’s largest chip firms. Hon Hai Precision Industry — a Taiwanese firm with factories across mainland China — assembles a large number of the world’s smartphones and tablets. In other words, a Taiwan shock would also be a shock to the global technology supply chain – hitting China’s own export sector and U.S. companies like Apple, whose products contain inputs from TSMC and other Taiwanese firms and are assembled by Hon Hai.

Current cross-strait arrangements might be increasingly cumbersome, but forces for stability remain considerable. Taiwan is unlikely to risk the benefits of its current freedoms for the certain risks and uncertain benefits of de jure independence. China passed a law in 2005 authorizing an attack if the island declares independence. China continues to play a long game, counting on growing economic and cultural integration to do its work. The Trump administration has already walked back from its challenge to the One China policy.

Even so, within the ambit of the One China policy, there’s scope for Washington and Taipei to test Beijing’s patience. Anything from upgrading bilateral dialogue between U.S. and Taiwanese officials to another sale of weapons to the island could provoke Beijing’s ire. A crisis appears unlikely. An increase in tensions and uncertainty, with an impact on Taiwan’s economy and the global technology supply chain, less so.
The economic value of the islands themselves is insignificant; the surrounding area though, is rich in natural gas and fishing grounds. Japan has administrative control of the islands, known as Senkaku, Diaoyu or Tiaoyutai. China and Taiwan claim territorial rights. To make its point, China routinely dispatches coast guard vessels to the area, testing Japan’s patience.

**Boycotts**
For now, U.S. officials have effectively put a lid on the risks — Defense Secretary James Mattis and Secretary of State Rex Tillerson said the U.S.-Japan military alliance covers the islands, and President Donald Trump has called Japan a “steadfast ally.”

Still, the history between China and Japan makes it difficult for compromise. When the issue has blown up in the past, Japanese companies have shouldered heavy costs. Tempers flared in China, with anti-Japan demonstrations and boycotts of Japanese goods and tourism, after the government bought the islands from a private owner in September 2012.

Toyota’s sales in China plunged 49 percent in that month, the most in more than 10 years. Honda slashed its annual sales projection for China by 17 percent. The number of Chinese visitors to Japan also tumbled, with arrivals down 23.6 percent in the 12 months after the nationalization — even as the total number of foreign visitors to Japan jumped 21.4 percent.

A similar drop in Chinese visitors now would mean a roughly 700 billion yen ($6 billion) hit to tourism spending in Japan, or 0.1 percent of GDP. In an economy growing at just 1 percent a year with stagnant household consumption, that’s a big deal.

**Fossil Reserves**
Estimates vary on the value of the oil and gas deposits near the islands. In 1968, the United Nations Economic Commission for Asia and the Far East conducted a survey on coastal mineral resources. That indicated the possibility of oil reserves in the East China Sea of up to 109.5 billion barrels of oil, including natural gas — equivalent to about $6 trillion based on the current oil prices.

A 1994 survey by Japan’s Ministry of Economy, Trade and Industry put the potential at just 3.3 billion barrels. Either way, the energy resources are prized by Japan, which has to import 99 percent of its fossil fuel supply. Japan’s trade balance fell into deficit in 2011 — and stayed in the red for five years — after a massive earthquake triggered the mothballing of its nuclear power plants and a surge in fossil fuel imports.
Disruptions Negatively Affecting Asian Companies

By JOSEPH JACOBELLI, BI Analyst

Current and potential geopolitical disruptions are hurting the operations of many Asian corporates. The recent South Korea-China row worsened already-strained relations, and a likely fall in the number of Chinese visitors could cut sales at Amorepacific and LG Household. Spats involving One Belt One Road nations would affect potential new markets for steelmakers like Baosteel and Angang. Another area is coal, given China’s North Korean import ban.

South Korean Political Risk May Deter Chinese Shoppers in 2017

A surge in Chinese visitors to South Korea may dwindle in 2017 amid strained ties between the two nations. Earlier momentum fell back in January as more vacationers decided to visit Japan or Hong Kong instead of South Korea during the lunar new year holidays, based on a survey by the China Tourism Academy and Ctrip. South Korea had been the preferred destination in last year’s holidays. A slowdown in Chinese visitors may crimp duty-free sales and profits at Amorepacific, LG Household and Hotel Shilla.

Korean companies have mentioned difficulties in distributing entertainment content and obtaining new product approvals in China this year. That came after the mainland objected to South Korea’s THAAD missile-defense system in 2016. Chinese arrivals rose 6.8 percent in the fourth quarter of 2016 versus 44 percent nine months prior. — Catherine Lim, BI Analyst

China’s Ban of Coal Imports From Pyongyang May Benefit Russia

China’s ban of coal imports from North Korea until the end of 2017 may be replaced by additional high-grade coal purchases from Russia and Australia. While China’s imports made up about 85 percent of North Korea’s total coal exports in 2016, only 9 percent of China’s coal imports came from North Korea. If Russia grabs the entire North Korean 9 percent share, due to its more competitive pricing and shorter distance, the country would replace Mongolia to become China’s third largest coal provider. — Michelle Leung, BI Analyst

China’s Steeltakers May Go West as New Trade Route Materializes

Building the One Belt One Road trade route to Europe could eventually boost China’s steel industry. The start of construction over the next five years could add as much as 5 percent annually to Chinese steel demand, though only 10 percent of needed funding has been secured. The government is asking China’s steelmakers to “go global” by building plants in Southeast Asia, western Asia and Africa along the new trade link. This would shift China’s steel capacity westward as it gets easier to procure raw materials. — Yi Zhu, BI Analyst

Some of the nations not listed here, with less than 5 million tons of output include: Malaysia, Slovakia, Thailand, Kazakhstan, Romania, U.A.E., Indonesia, Qatar, Philippines, Pakistan, Hungary, Uzbekistan, Slovenia, Albania, Bulgaria, Oman, Serbia and Israel.

Steel Output Along the New Silk Road

<table>
<thead>
<tr>
<th>Million Tons</th>
<th>China 822.7</th>
<th>India 87.3</th>
<th>Russia 71.5</th>
<th>Ukraine 27.2</th>
<th>Iran 16.3</th>
<th>Poland 8.6</th>
<th>Egypt 6.5</th>
<th>Vietnam 5.8</th>
<th>Saudi Arabia 6.3</th>
<th>Czech Republic 5.4</th>
</tr>
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Source: World Steel Association

Steel Output Along the New Silk Road

Source: World Steel Association
Tillerson Reassures Xi on Trump Meeting in Brief China Trip

By NICK WADHAMS

U.S. SECRETARY OF State Rex Tillerson used a trip to Beijing on March 18 and 19 to smooth the way for an expected meeting next month between the leaders of the world’s biggest economies, amid tensions over trade policy and North Korea.

After delivering a sharp warning about North Korea’s nuclear program during earlier stops in Tokyo and Seoul, Tillerson’s tone was more measured in meetings with Chinese officials including President Xi Jinping. At an event with Foreign Minister Wang Yi, he twice echoed Chinese phrasing directly, promising a relationship of “non-conflict, non-confrontation, mutual respect, and win-win cooperation.”

For China, Tillerson’s words will be seen as reassurance the U.S. isn’t looking for a major shift in ties. Officials have been unsure about Washington’s intentions after a series of tweets by President Donald Trump and his threats to punish China over its trade practices.

While the U.S. State Department said Tillerson’s visit was focused on efforts to get China to do more to rein in its ally North Korea, a second goal was to lay the groundwork for a possible Xi visit in April to Trump’s Mar-a-Lago club in Florida. And while Tillerson has interacted with senior diplomats before, the meetings were a chance for China to take the measure of a man who was one of the U.S.’s most prominent oil executives until a few months ago.

Tillerson is “still rather obscure” to Chinese diplomats, said Ruan Zongze, vice president of the China Institute of International Studies run by China’s foreign ministry and an envoy to Washington between 2007 and 2011. “We want to know what his take is on some major issues. We hope to establish a smooth senior level diplomatic channel from the very beginning.”

In his first visit as secretary of state, Tillerson emphasized areas where the countries could work together instead of offering any critiques.

Speaking about the North Korean nuclear program in Seoul beforehand, Tillerson said Chinese moves to punish South Korea economically for its decision to deploy a U.S. missile-defense system were “troubling.” He said Beijing should do more to enforce United Nations sanctions intended to punish Pyongyang for pursuing nuclear weapons.

In China, he said the countries agreed “things have reached a rather dangerous level” on the Korean peninsula.

“We know that through further dialogue we will achieve a greater understanding that will lead to a strengthened, strengthening of the ties between China and the United States, and set the tone for our future relationship of cooperation,” Tillerson said when he met Xi on Sunday.

Improved Ties

In Tillerson’s meeting with Xi, reporters were allowed to linger for opening remarks. That was unusual for Xi, whose security agents normally hustle the media out of meetings with foreign officials after a minute or two.

“You have made a lot of active efforts to achieve a smooth transition in our relationship under the new era,” Xi said. “I also appreciate your comment that the China-U.S. relationship can only be defined by cooperation and friendship.”

While the comments were broad, they suggest ties have stabilized somewhat since Trump caused a furor by suggesting the U.S. may not recognize the “One-China” principle governing relations with Taiwan and accused China of not doing enough to curtail Kim Jong Un. On Sunday, Trump told reporters aboard Air Force One that Kim is behaving “very, very badly.”

Significant issues remain, particularly on trade. Trump has repeatedly said Chinese trade practices are unfair, and the countries continue to spar over China’s claim over uninhabited islands in the East China Sea also claimed by Japan, a U.S. treaty ally.

Trade Tensions

In a troubling sign for China’s recent public advocacy of global trade, finance chiefs of the world’s largest economies set aside a pledge to avoid protectionism and signed up to a fudged statement on trade, in response to the Trump administration’s call to rethink the global order for commerce.

Group of 20 nations said in a communiqué on March 18 they are “working to strengthen the contribution of trade to our economies.” While the U.S. didn’t get all it wanted the statement was a pared-down version of the group’s missive last year, omitting a promise to “avoid all forms of protectionism.”

And while the U.S. believes the threat posed by North Korea’s nuclear program is more urgent, Tillerson made clear more time was needed before China and the U.S. reach any agreement. In Seoul, he didn’t rule out a preemptive strike against Kim’s regime, which relies on China for most of its food and fuel.

Tillerson suggested Xi’s visit could help China and the U.S. set out boundaries on where they’re willing to compromise and where they will stand firm on competing interests.

“Tillerson is testing the bottom line of China,” Ruan said. “The two leaders have to take a step back to rethink their strategies and reach a consensus.”
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