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New Silk Road by China Binds Asia to Latin America (Update1)
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(Updates with yuan trading in ninth paragraph.)

By Simon Kennedy, Matthew Bristow and Shamim Adam

Aug. 2 (Bloomberg) -- The high-speed rail link China Railway Construction Corp. is building in Saudi Arabia doesn't just connect the holy cities of Mecca and Medina. It shows how Asia, the Middle East, Africa and Latin America are holding the world economy together.

Ties between emerging markets form what economists at HSBC Holdings Plc and Royal Bank of Scotland Group Plc call the "new Silk Road" -- a $2.8-trillion version of the Asian-focused network of trade routes along which commerce prospered starting in about the second century.

Today's world-spanning web is insulating markets such as China from the drag of weak recoveries in the advanced world and providing global growth with a new power source. Stephen King, HSBC's chief economist, predicts the relationships will strengthen and lists them as a reason for his forecast that emerging markets will grow about three times faster than rich nations this year and next on average.

"The potential for inter-emerging market trade is ginormous," said Jim O'Neill, chief economist at Goldman Sachs Group Inc. in London, who coined the term BRIC in 2001 to describe the rising role of Brazil, Russia, India and China.
"That makes it quite difficult to see how you get a sustained global recession because of what's going on in the west."

Share of Trade

The BRIC economies hold a 13 percent share of world trade and have been responsible for about half of global growth since the start of the financial crisis in 2007, according to O'Neill.
He predicted the BRICs will grow about 9 percent this year and next compared with 2.6 percent in advanced nations.

Investors are tuning in. Research by Kieran Curtis, who helps oversee $2 billion at Aviva Investors in London, found growing trade between emerging markets helps explain why they now account for about 30 percent of global final consumption, about the same as the U.S. and up from 10 percent in 1990.

That should increase demand for the Chinese yuan if the government continues to loosen restrictions on settling trade transactions with its currency, he said.

"Go to a market in Nairobi and you'll see Chinese goods on sale," Curtis said. "If emerging market fundamentals continue to be superior, there is the potential for serious currency appreciation against old-guard currencies."

Currency Policy

China’s government signaled June 19 that it will allow a more flexible exchange rate. So far, it’s limited the yuan’s rise to less than 1 percent against the dollar after allowing a 21 percent appreciation in the three years to July 2008.

Jerome Booth, who helps oversee $33 billion of emerging- market assets as head of research at Ashmore Investment Management Ltd. in London, said emerging markets are increasingly starting to denominate trade contracts in currencies other than dollars as commerce between them rises.

Commodity prices that may have been dropped in the past when advanced nations grew less are now cushioned by trade between emerging markets, said Dariusz Sliwinski, head of emerging markets at Martin Currie Investment Management in Edinburgh.

“Commodity prices would have been much lower without the support, which is good for the likes of Russia and Brazil,” said Sliwinski, who helps manage about $15 billion.

Royal Bank of Scotland Chief China Economist Ben Simpfendorfer in Hong Kong says emerging Asian and Middle Eastern economies will account for 75 percent of every extra barrel of oil consumed or produced in the next decade, while copper should gain because it’s a key input in infrastructure and nickel may benefit because of its use in steel.

Impact on Commodities

The Standard & Poor’s GSCI Total Return Index, tracking the net amount investors received from 24 raw materials, climbed 13 percent last year. While the price of oil fell as low as $32.40 a barrel during the recession it has since rebounded, ending last week at $78.95 a barrel. The cost of nickel and copper more than doubled over the same period.

Chu Moon Sung, a fund manager at Shinhan BNP Paribas Asset Management Co. in Seoul, which manages $26 billion, says investors will increase their holdings of emerging-market equities.

“The populations in emerging markets, especially in Asia, are large,” he said. “They are getting more educated and income levels are rising, which make these countries very attractive for companies. China is a favorite for stock investors but we’re seeing more interest in Indian, Brazilian and Russian markets.”

Gains in Trade

The Geneva-based World Trade Organization estimates intra-emerging market trade rose on average by 18 percent per year from 2000 to 2008, faster than commerce between emerging and advanced nations. It totaled $2.8 trillion in 2008, about half of emerging-market trade with all nations.

That performance is especially welcome now given the sluggish recovery in the rich economies, said HSBC’s King, author of “Losing Control: The Emerging Threats to Western Prosperity” and a former U.K. Treasury official.

Chinese exports to the emerging world accounted for about 9.5 percent of gross domestic product in 2008, compared with 2 percent in 1985, he calculated. India’s jumped to 7.3 percent from 1.5 percent and Brazil’s almost doubled to 6.3 percent.

Emerging-market economies will grow 6.9 percent this year and 6.2 percent in 2011, King said, outpacing the 2.4 percent and 1.9 percent projected expansions of developed economies.

Providing Protection

"There are now massive trade connections within the emerging markets and they're becoming increasingly important," said King in a telephone interview. "It means in one sense the emerging world is protected from the worst ravages of the developed world."

Those ravages were born in the global recession of 2008-09 from which the advanced world is proving slow to recover, even after policy makers cut interest rates to record lows. That's prompting businesses and investors to seek other sources of growth.

Of the foreign direct investment flowing into south, east and southeast Asia alone, China was a source of 13.3 percent in 2008, compared with the U.S.'s 7.9 percent and up from 0.4 percent in 1991, according to a report last month from the Geneva-based United Nations Conference on Trade and Development.

China, the world's fastest-growing major economy, dominates the push into fellow emerging markets, passing the U.S. as the biggest exporter to the Middle East in 2008.

Huawei in India

Shenzen-based Huawei Technologies Co., its biggest maker of phone equipment, had orders of $1.7 billion from India in 2008 and said in January that it will invest $500 million in its research center in Bangalore.

China Mobile Ltd. of Hong Kong, the world's biggest phone carrier, is "interested in doing business in Africa," where it can boost services in rural areas, Chairman Wang Jianzhou said in a June 26 interview.

Elsewhere in Asia, a group led by Korea Electric Power Corp., South Korea's largest utility, beat off competition from General Electric Co. and France's Areva SA to win a $20 billion UAE nuclear contract. The Saudi Railways Organization last month awarded a contract to China South Locomotive and Rolling Stock Corp. to supply 10 cargo locomotives. The Mecca-Medina rail contract went to Beijing-based China Railway as part of a Saudi- Chinese consortium.

Brazil in Africa

In Latin America, Brazil's Vale SA has been on an international spending spree, helped by booming commodities demand from China and a currency that has doubled against the dollar since 2003. The company estimates that its $1.3-billion coal mine in Mozambique will have a capacity of 11 million tons per year three to four years after it enters production in the first half of 2011.

Vale in 2009 acquired stakes in three copper projects, in Zambia, Africa's largest producer of the metal, and the Democratic Republic of Congo. In April this year, the company agreed to pay $2.5 billion for iron ore deposits in Guinea, including assets the country confiscated from the Rio Tinto Group.

"We saw the same phenomenon with American and European companies 50 to 100 years ago as they went global," said Shane Oliver, head of investment strategy at AMP Capital Investors, which manages about $95 billion in Sydney. "Emerging-market companies are now big enough and they have the choice of going to developed countries where they may be more constrained or to the emerging world where the growth potential is."

Competition Rises

They are also jostling with each other. Brazil's Empresa Brasileira de Aeronautica SA, or Embraer, is braced for increased competition from new Chinese and Russian rivals.

In December 2009, 32 percent of the backlog of orders for Embraer's medium-range E-Jet airliners was from emerging markets, up from 1 percent in 2005. Over the same period the company's backlog of orders from North America and Europe fell to 53 percent of the total, down from 91 percent.

"We are selling less, on a proportional basis, to the U.S. and Western Europe, and we have a growth in sales in Latin America, Asia and Asia-Pacific," said Paulo Cesar, Embraer's executive vice president-airline market, in a telephone interview.

Embraer is braced for new competition from Russia's Sukhoi Co. and the Commercial Aircraft Corporation of China, or Comac, particularly in their home markets, Cesar said. Both companies are developing civilian airliners.

Middle East Link

Royal Bank of Scotland's Simpfendorfer, whose book "The New Silk Road: How a Rising Arab World is Turning Away from The West and Rediscovering China" was published last year, says the trade ties between China and the Middle East alone make for a modern Silk Road.

The original was more than 4,000 miles (10,200 kilometers) of trade routes crossing Asia and into southern Europe and north Africa. Based around China's silk industry and once traveled by Marco Polo, the commerce it enabled also helped power the growth of civilizations from Egypt to Rome.

Governments are seeking to take advantage of the modern version. India said in May that it will open an economic division at its embassy in China's capital as the two countries seek to increase bilateral trade to $60 billion this year from $43 billion last year. Since taking office in 2003, Brazilian President Luiz Inacio Lula da Silva has visited about 68 developing nations, more than any of his predecessors.

With trade nevertheless comes tension. Developing economies in Asia and the Middle East accounted for about 45 percent of new anti-dumping investigations reported to the WTO in 2009, up from 22 percent in 1998.

Trade Tensions

China said in May that India shouldn't discriminate against Chinese telecommunication products, a month after people with knowledge of the matter said contracts for products from Huawei Technologies and ZTE Corp. were vetoed by India's government on national security grounds.

MTN Group Ltd., Africa's largest mobile-phone company, in June halted talks to purchase $10 billion of assets from Orascom Telecom Holding SAE after Algeria's government blocked a sale of the company's local unit, the most profitable in the portfolio.

Orascom, the biggest mobile-phone company by subscribers in the Middle East, also operates in Bangladesh, Pakistan and Egypt.

There is still scope for ties to strengthen. In a study released last week, the Washington-based Inter-American Development Bank concluded “massive bilateral trade” could develop between Latin America and India if tariffs are cut.

Gene Grossman, who succeeded Federal Reserve Chairman Ben S. Bernanke as head of Princeton University’s economics department, sees a repeating pattern of what he called the “home market effect,” in which countries at similar income levels increasingly trade because their consumers have similar tastes and spending power.

India’s Tata Group was the second-largest investor in sub- Saharan Africa in the six years through 2009, according to the Organization for Economic Cooperation and Development.

“Once an Indian firm enters and develops expertise based on its sales to its local market it now sees profit opportunities in serving markets elsewhere,” said Grossman.

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