# Looking East with Hope

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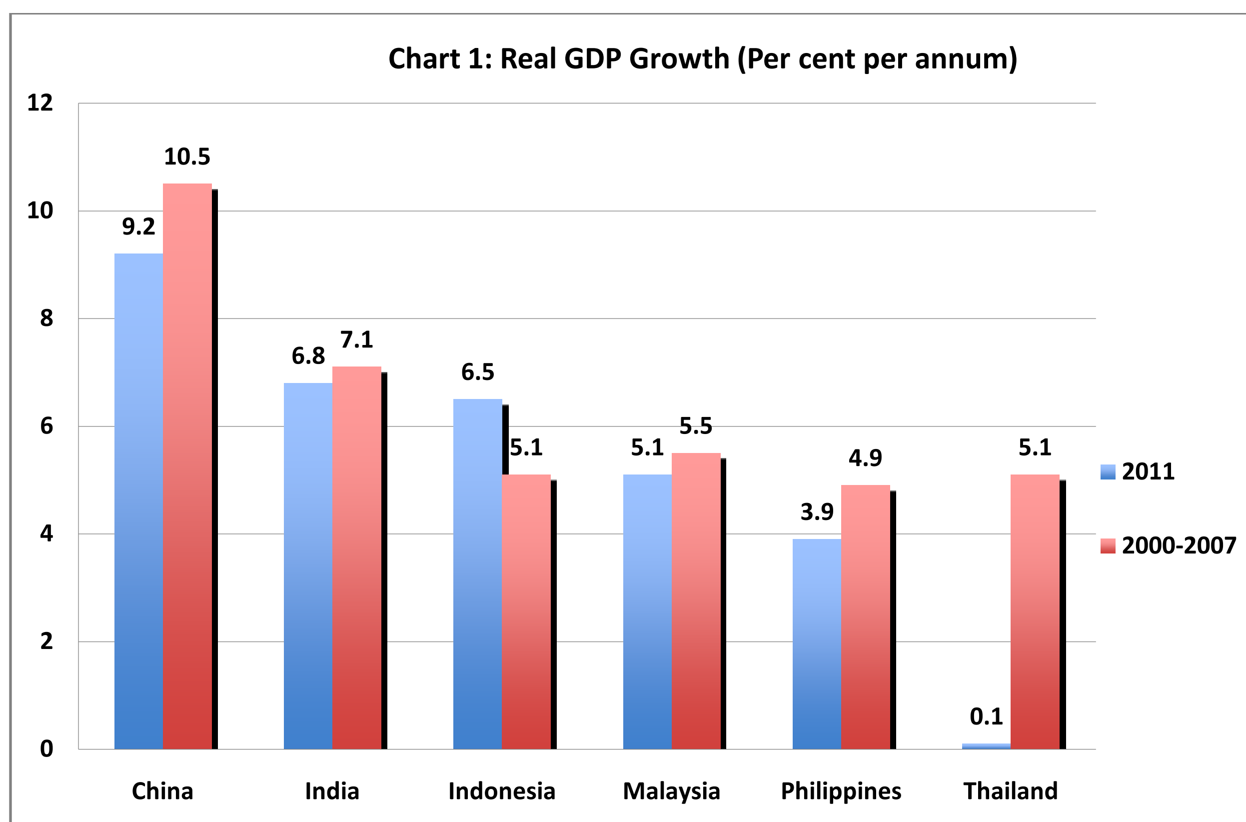
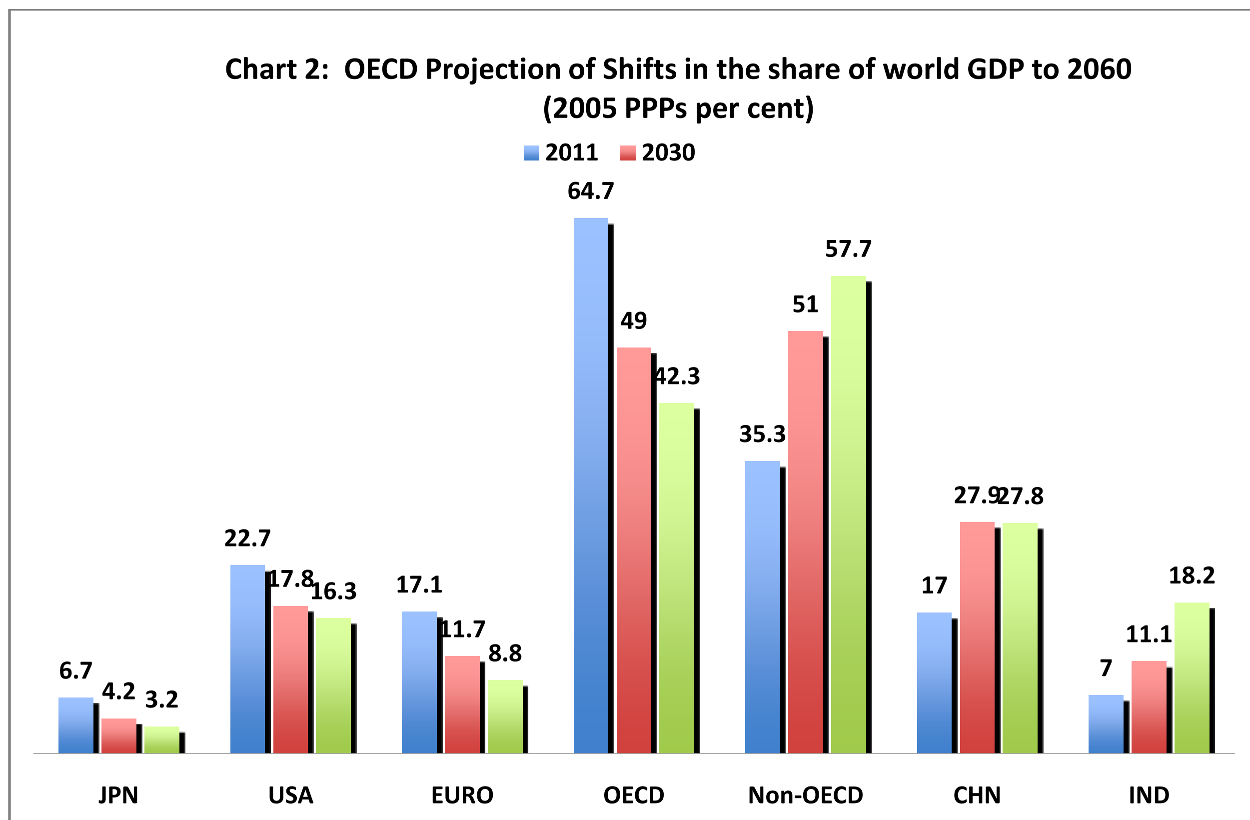
The world's attention is focused on Asia, especially East Asia. Global leaders, including India's Prime Minister Manmohan Singh, recently rushed to Phnom Penh to attend the East Asian Summit and staked their claim to being among the countries with which the region would increasingly integrate. Their intention was clearly to tether themselves to a region expected to expand in the coming years.

The evidence from six countries (China, India, Indonesia, Malaysia, Philippines and Thailand) chosen for study shows that barring Thailand, all countries had recorded rates of growth in 2011 which were close to the average annual rate recorded during the pre-crisis years (2001-2007) (Chart 1). Though there are signs of some deceleration in 2012, this does point to a return to growth after the global crisis.




Prompted perhaps by this performance of the Asian countries, especially China and India, during the still persisting crisis, optimism regarding the future of the region runs high. A recently released November 2012 Policy Note from the OECD Secretariat, titled "Looking to 2060: A global vision of long-term growth", projects that divergent growth trends would lead to a radical reshaping of the global economy. The expectation is that the United States will replace China as the world's largest economy as early as 2016. The share of the OECD countries in global GDP measured in purchasing power parity (PPP) prices of 2005 is projected to fall from 65 to 42 per

cent between 2011 and 2060, while the combined share of China and India is estimated to rise from 24 per cent to 46 per cent (Chart 2).

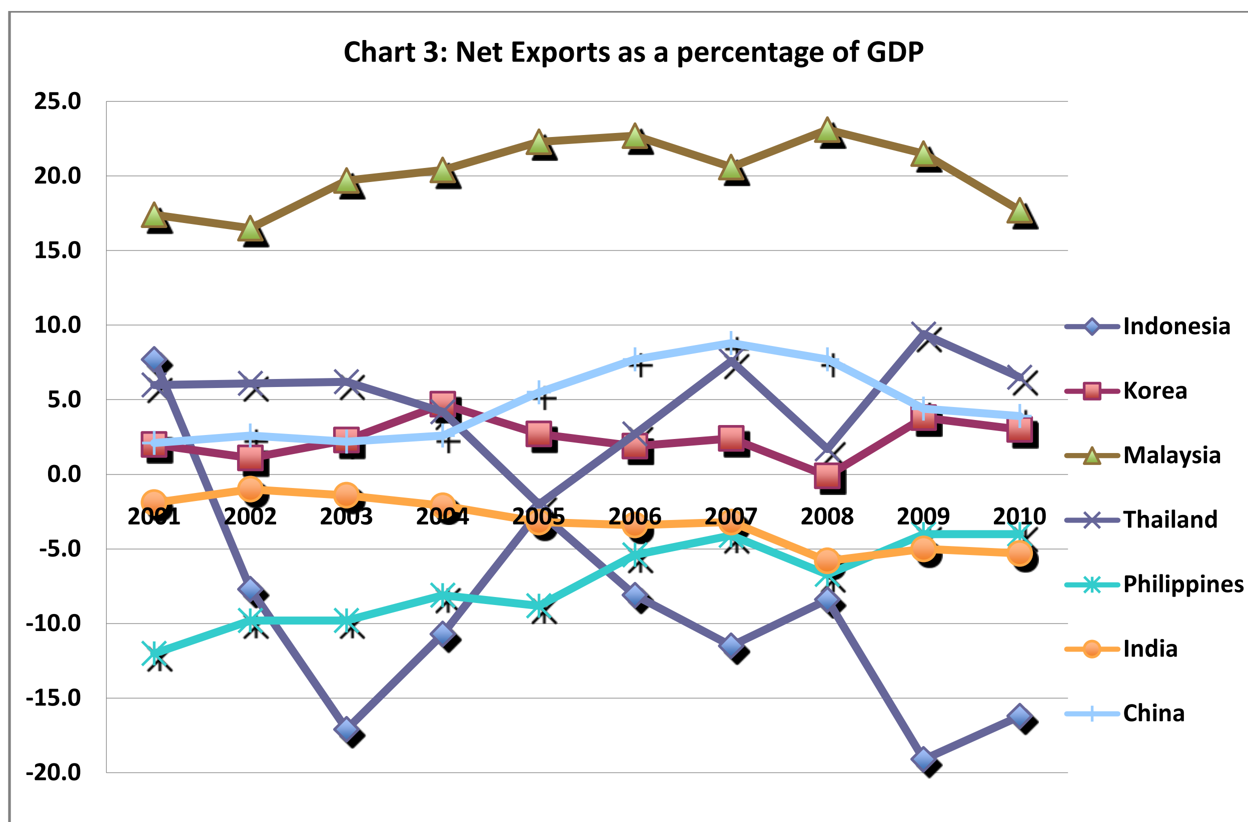



Such optimism suggests that, despite the recent experience to the contrary, Asia is seen as decoupled from the rest of the global economy, especially the G 7 rich-country grouping. The actual situation on the ground is of course more nuanced. Globalisation and the increased role of trade in the economic structures of most developing countries makes them vulnerable to the business cycle in the developed countries. According to one estimate (Park, Y., "The Global Financial Crises: Decoupling of East Asia – Myth or Reality", ADBI Working Paper Series, No. 289, June 2011), during the recessions in the US in 1981, 1991 and 2011, growth in a select group of emerging Asian economies (China, Indonesia, Korea, Malaysia, the Philippines, Chinese Taipei and Thailand) fell by half of a percentage point with each one percentage point fall in US output.

However, there is some evidence that, contrary to conventional wisdom, many emerging economies have sustained high growth based not on net exports to the rest of the world but on domestic sources of demand. This insulates them to some degree from fluctuations in world trade resulting from downturns in the developed countries. Only in as much as their overall growth is adversely affected (to the extent estimated by Park, for example) would domestic demand and growth be adversely affected.

One striking feature of growth trends in the region is that in most of the important economies, net exports (or the excess of export over imports) is not an important contributor to GDP, and therefore a major stimulus to growth. It amounted to less than 10 per cent of GDP in China and

Thailand and less than 5 per cent in Korea during the 2000s (Chart 3). Malaysia is an outlier, with its ratio of net exports to GDP fluctuating between 16 and 23 per cent in this period.

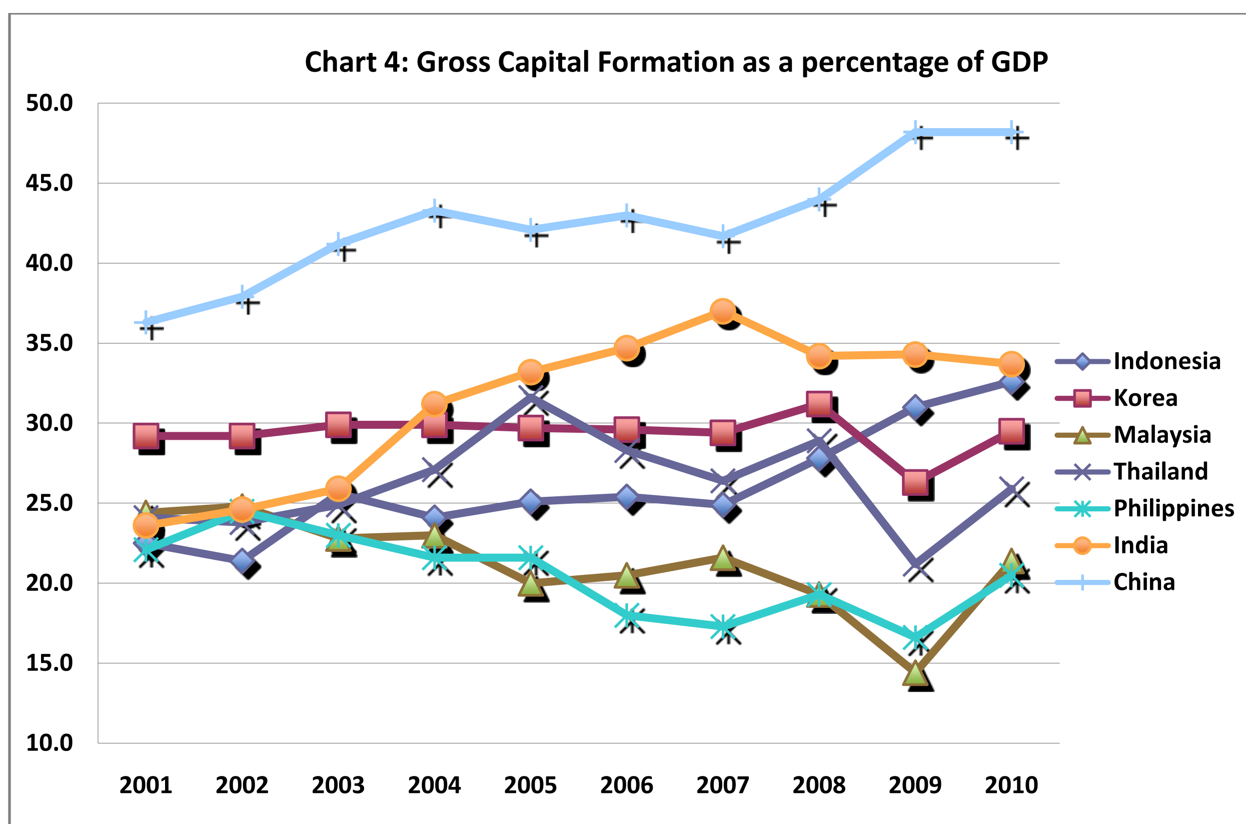



Finally, India, the Philippines and Indonesia have consistently recorded a deficit on their trade account, implying that trade was a growth dampener, with that effect being particularly strong in the case of Indonesia. In sum, the perception that the leading economies of the Asian region are benefiting from a stimulus from external markets is true, if at all, only of China and to a much lower extent Thailand. On the other hand, the high ratios of exports and imports to GDP suggest that economies in the region are exploiting the possibilities of transformation through trade, which not only increases their own manoeuvrability, but also benefits the rest of the world to the extent that countries are integrated with higher growth region. Hence the interest in Asia, in general, and East Asia, in particular. Trade matters, but not as the dominant stimulus for growth.

The implication of this is that to the extent that these economies are registering rates of growth that are creditable by international standards, the sources of that growth are domestic. This is the feature that not only leads to speculation about the "decoupling" of Asia, but also triggers optimistic assessments of the role they would play in propping up global growth. Domestic demand comes from two sources: investment and consumption. Some investment is needed for growth, given that increases in output beyond a point must be based on capacity expansion and, therefore, investment. But if investment expands autonomously, as happens, for example, when governments decide to invest heavily in infrastructure, such investment directly and indirectly (through its multiplier effects) expands demand and induces further rounds of investment and drives growth. Private investment is most often seen as induced and not autonomous, needing some external stimulus to occur. However, if governments adopt a strategy of implicitly or

explicitly guaranteeing a minimal, acceptable return in particular sectors, and back this with access to credit, debt financed private investment too can function as a source of autonomous demand.

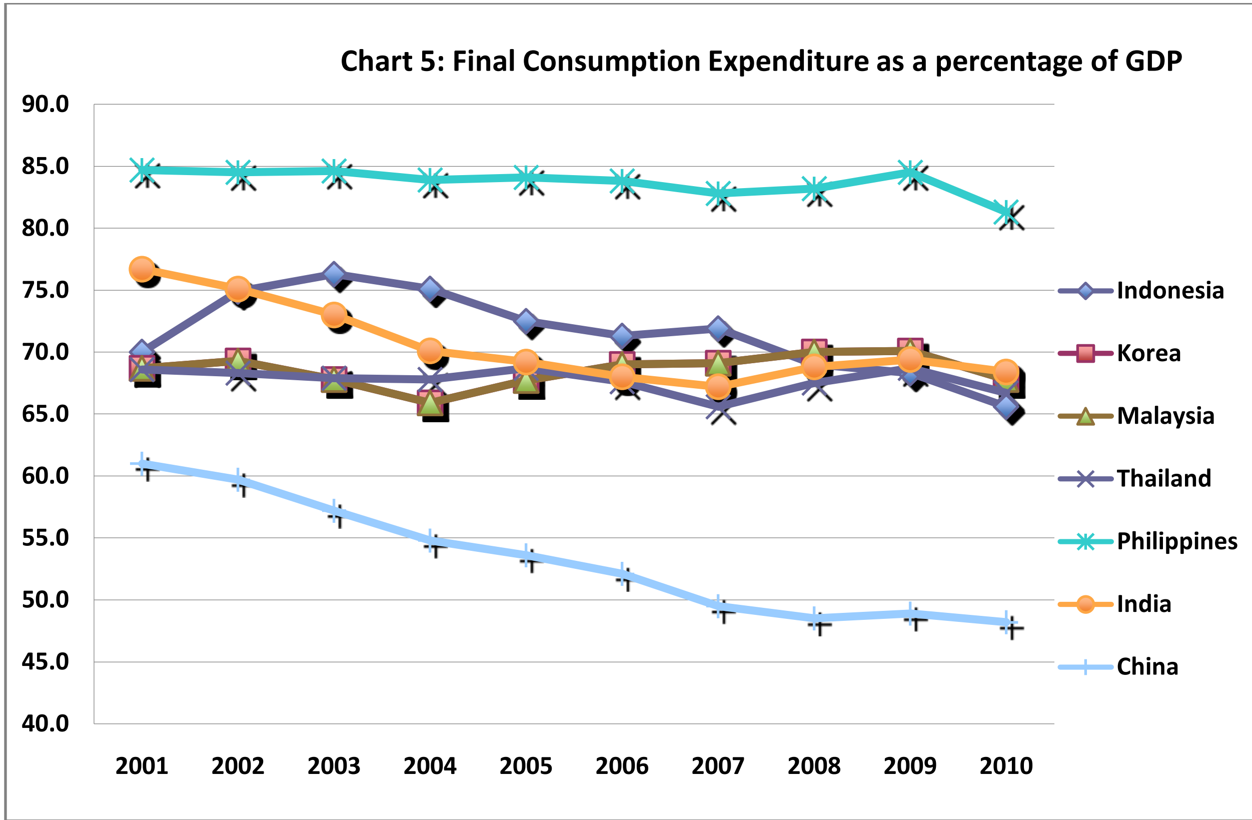
If investment serves as a dominant stimulus to growth via its demand side effects, it is most likely that the ratio of investment to GDP would be rather large. Interestingly, as Chart 4 shows, the two countries that have been topping the growth league tables in recent years, China and India, have indeed been recording increases in their gross capital formation to GDP ratios. The ratio for China, as widely discussed, is way above that in other countries, approaching half of GDP in recent years. The ratio in India rose sharply between 2001 and 2007, but is showing signs of slipping since, resulting in a slowing of the growth process. While Indonesia, Korea and Thailand too have recorded relatively high investment ratios, their levels in the 25-30 per cent range are not such as to warrant the conclusion that autonomous investment has been the principal driver of domestic demand and growth. Investment has played a role, but in combination with other factors that have increased domestic demand.




When autonomous investment serves as a growth driver, increasing capacity and relaxing supply constraints while expanding demand, the process appears sustainable. However, in recent times, in both China and India, questions have arisen about the mode of financing such investment. Unusually high investment rates are most often financed with large borrowing. This is acceptable so long as the returns from such investment are high enough to ensure a profit after meeting interest and amortisation costs. Initially, this may indeed be true. But as a larger number of projects are brought into the credit ambit, the share of projects offering lower returns would rise. This threatens the viability of the projects and therefore the sustainability of the investment boom. If the boom goes bust, it threatens viability of the financial system as well. In both China

and India concerns are being expressed that the recently observed fall in growth rates may not be the result only of the global recession, but also of such constriction of the investment-led growth trajectory from within.

The more difficult cases to understand are the ones where growth is not only based largely on domestic demand, but much of that demand takes the form of consumption expenditure. As Chart 5 shows, in most economies final consumption expenditure contributes around 65 to 75 per cent of GDP, serving as an important source of demand. The exceptions are the Philippines and China. In the Philippines, weak investment has meant that between 80 and 85 per cent of GDP is accounted for by consumption expenditure. That is by no means a positive from the point of view of growth. In China, on the other hand, extremely high investment rates have meant a decline in the final consumption expenditure to GDP ratio from a low of around 60 per cent to less than 50 per cent in recent years.




It is in the other economies of the region that consumption seems to matter as a source of demand and inducement to investment. However, increased consumption, since it is tethered to increases in income, is not normally seen as a stimulus to investment and growth, but an outcome of the latter. It is true that as per capita income increases beyond some threshold, if inequality is not excessive, increases in income are allocated increasingly to consumption, helping drive further investment and growth. The difficulty is that the level of equality conducive for such a path is uncertain, and so is the threshold beyond which this may occur. In fact, there is no certainty that all of the countries in the set being studied have crossed that threshold.

However, there is one way in which consumption can be "autonomous" in the sense that it is not tethered to current income. That would be true if a significant share of incremental consumption

is financed with credit. In recent times credit has played an important role in financing personal investment (in housing) and consumption in developed and developing economies alike. In fact, pre-crisis growth in the US, for example, which has been characterised by rising inequality and a large trade deficit, is seen as having been substantially sustained by debt-financed household expenditure. This trend is also seen in developing countries after financial liberalisation. To the extent that this tendency operates, "autonomous" consumption can spur demand and growth.

Unfortunately, as the financial and real economy crisis that broke in 2008 made clear, this kind of path is not sustainable. Driving demand and growth with debt-financed personal expenditure requires expanding the universe of borrowers. This brings a host of 'sub-prime" borrowers into the ambit of debtors. As their share in total credit rises, lenders either turn wary or financial failures ensue, and growth falters.

In sum, it is indeed true that domestic demand has played an important role in the observed growth resilience in Asia. That supports the decoupling argument and raises expectations regarding the influence these economies exert on global growth. What is missed by that viewpoint, however, is that the factors explaining the expansion of domestic demand, which supports this growth, are not necessarily sustainable. So even independent of what happens in the rest of the world, Asian growth can decelerate. And that would not be good news for a world steeped in recession and looking East with hope.

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