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ECONOMIC REPORT

ADB sees Asian recovery leading the way

Writer: JONG-WHA LEE
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While the rest of the world struggles, developing Asia is shifting from recession to recovery.

Latest economic indicators from the world's advanced economies remain mixed. There are some signs of stabilisation - industrial output and consumer spending are, for example, falling much more slowly than they were.

But stabilisation does not mean imminent recovery. The pace of the deterioration may be slowing, but a decline is still a decline. Unemployment is still on the rise. Consumer and business confidence has not recovered. It is clear that the recession has yet to bottom out in the United States and Europe.

By contrast, signs are much more favourable in Asia. Markets, which are typically the first indicators of recovery, are rebounding much more sharply here. While the Dow Jones Industrial Average rose 11% in the second quarter, Japan's Nikkei 225 jumped 23%. Equity markets in China rose 25%, India 53% and Vietnam 60%.Asia's real economy is doing much better, too. Industrial production in South Korea, Singapore and Thailand has been rising in recent months. And while most economies in Asia have suffered their worst performance since the 1997-98 Asian financial crisis, we believe they have hit bottom.

The Asian Development Bank forecasts that growth in gross domestic product (GDP) for emerging East Asia will still be 3.0% this year. While that is a significant reduction from the 6.1% growth in 2008, it is growth nonetheless - and much better than other regions of the world.

Will Asia lead the global recovery? Quite possibly. We expect a V-shaped recovery - growth in the region is likely to rise to around 6.0% next year. However, this is still two percentage points below the 8% average growth between 2003 and 2007.

The reason is that while we expect government stimulus to boost domestic demand, we doubt the external demand that drove exports during the years prior to the latest crisis will return any time soon.

We now see the US economy contracting 3.0% this year while the economies in Europe and Japan will likely shrink 4.3% and 5.8%, respectively.

China is leading the recovery in Asia. Aggressive government spending there - more than 7% of GDP this year and 8% in 2010 - will fuel domestic growth. And that, in turn, should help other Asian economies recover as they fill Chinese demand for their goods. China is the biggest offshore buyer of

Korean products and the second largest for Japan, snapping up about a quarter of Korean exports and one sixth of Japan's.

About 12% of total exports from the five largest Southeast Asian economies - Indonesia, Malaysia, Philippines, Thailand and Vietnam - go to China.

But that won't be enough to restore developing Asia to the growth levels seen in recent years. For that to begin to happen, consumers in the world's major economies also need to start buying Asia's goods again.

The US, Japan and Europe remain major markets for Asian exporters. Intra-Asian trade has grown rapidly in recent years, but remains largely based on parts and components rather than final goods. Asians still don't buy finished products made in their own backyard.

In fact, economic growth in the US, Japan and Europe influences East Asia's regional output at least as much as China's does. Plus, China's ability to sustain economic growth over 8% is also reliant on a global recovery to provide external demand for its exports.

Economic growth that relies on stimulus is not sustainable. Clearly, China or Asia alone cannot be the region's sole engine of growth.

Developing Asia needs two engines - China and, just as important, the major advanced economies.

The implications are clear. First, a rebalancing of the sources of growth is needed. Even if demand in advanced economies recovers to pre-crisis levels, that won't be enough to meet Asia's expanding exports. The key for sustaining long-term economic growth in Asia is how to strengthen Asia's own domestic and regional demand.

Governments can no longer rely on export-oriented development strategies. Strengthening social safety nets, broadening and deepening financial markets, supporting small and medium enterprises (especially in services), and increasing exchange rate flexibility will all help strengthen domestic demand.

But effective re-balancing requires both demand-side and supply-side polices. Developing more competitive and efficient domestic industries to serve domestic markets will take time.

Second, to avoid any repeat of the global financial crisis, the region's policy-makers should improve and streamline their regulatory and supervisory regimes, while reinforcing regional and global cooperation.

By and large, emerging East Asia's financial systems and institutions were shielded from the direct impact of the global financial crisis. The resilience of Asia's banking systems has been attributed to reforms taken following the 1997-98 Asian financial crisis.

Nevertheless, current risk-management and prudential oversight are clearly insufficient. Both banks and regulators must upgrade their systems to prepare for future risks and challenges. The underlying causes of the current global turmoil - emanating from financial innovation and globalisation - stress the need to better supervise financial institutions and protect financial stability.

While Asia may already be on the path to recovery, a return to sustained and rapid long-term economic growth will require a re-balancing of the sources of that growth and the safeguarding of financial market stability.

Jong-Wha Lee is Chief Economist at the Asian Development Bank.