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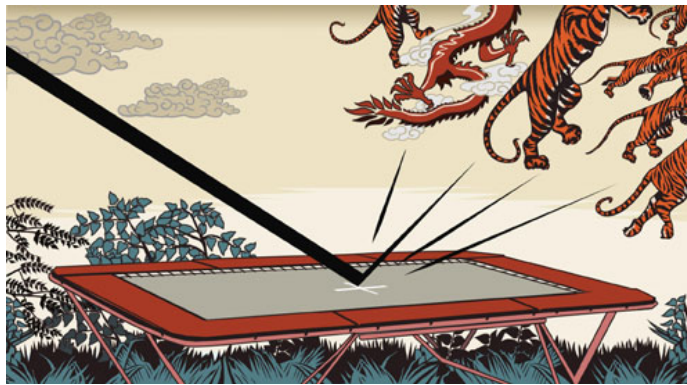
## Emerging Asian economies

## On the rebound

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Asia's emerging economies are recovering much more quickly than economies in other parts of the world. Can they keep it up?

Illustration by Bill Butcher



MORE green shoots have appeared in America in recent weeks, but they are nothing by comparison with the lush jungle sprouting in the East. Asia's emerging economies probably grew at an average annualised rate of over 10% in the second quarter, while America's GDP fell by 1%. In 2009 as a whole, recent forecasts suggest that emerging Asia could grow by at least 5%, while the G7 economies contract by 3.5%. The growth gap between the two has never been wider. How have these export-dependent economies managed to decouple from the developed world? And can their recovery last?

Average growth figures conceal big differences within Asia over the past year. China, India and Indonesia were among the few economies in the world that continued to expand throughout the global downturn (though China's virtually stalled late last year). But the smaller, more open Asian economies were badly hit. Between September and March real GDP fell by an average annualised rate of 13% in Hong Kong, Malaysia, South Korea, Singapore, Taiwan and Thailand.

Yet the countries that have so far published second-quarter GDP figures show an impressive bounce. Comparing the second quarter with the first at an annualised rate, China's GDP grew by 15%, South Korea's by almost 10%, Singapore's soared by 21% and Indonesia's managed a respectable 5%. Other countries in the region are also likely to show a rebound. It is true that output in South Korea and Singapore was still lower than a year earlier, but quarterly changes are more useful for spotting turning points—and this is how growth rates are most commonly measured in America.

The revival in emerging Asia's industrial production is even more impressive, jumping by an annualised rate of 36% in the second quarter. According to Barclays Capital, emerging Asia is the only region in the world where output has regained its level before the crisis (see chart 1). This is largely due to China, where industrial production rose by 11% in the 12 months to July, but all the Asian countries have seen a strong pick-up. In contrast, up to June, America's production continued to fall.

The sharp "V" shape of this cycle, and the fact that GDP started the year well below the average level in 2008, means that growth rates for 2009 as a whole could give a misleading picture. Take Taiwan: JPMorgan predicts that its GDP in 2009 will be 3.8% lower than in 2008, implying another dismal year. But this forecast also implies that GDP will grow by a brisk 5.4% in the year to the fourth quarter. By this measure, Asia's emerging economies are clearly leading the global recovery (see chart 2). Even if America's economy grows during the second half of this year, it is still expected to end the year smaller than it was at the start.

Asia's bounce has taken many forecasters by surprise. In May, for example, the IMF predicted that Asia's recovery was likely to be "tepid" because the developed economies—and hence demand for Asian exports—would remain weak. Forecasters always seem to underestimate the ability of the Asian tigers to rebound from recessions. During East Asia's financial crisis in 1997-98, for example, countries across the region were forced to devalue as a result of large current-account deficits and speculative attacks on their currencies. This caused firms' foreign-currency debts to swell in local terms, resulting in widespread bankruptcies and bank failures. In 1998 the real GDP of Thailand, Indonesia and South Korea fell by an average of 10%.

Many foreigners concluded that Asia's economic success had been a complete sham, based on governments pouring cheap money into favoured firms. Over-borrowing and over-investment had artificially boosted growth, it was argued: doomsayers predicted a decade of lost growth. Instead, the tigers came roaring back. At the end of 1998 *The Economist's* poll of forecasters predicted that South Korea would shrink again slightly in 1999. Its actual growth turned out to be a stunning 9.5%. It was true that Asia's strong growth had concealed wasteful investment, inadequate bank regulation and corruption, but the key ingredients of growth—rapid productivity growth, relatively open markets and a high saving rate to finance investment—remained in place. That helps explain why the East Asian economies recovered more quickly than many expected.

## A case of Asia vs

Likewise, when the global information technology bust dragged Asia into recession in 2001, forecasters turned out to be much too gloomy about Asia's prospects. Once again, emerging Asia bounced back fairly briskly. Westerners have always been too quick to pronounce the death of the Asian economic miracle. This may be wishful thinking, but it also reflects some misunderstandings about the ingredients of Asia's success. This year it was widely predicted that Asia's economies would not recover until after America and Europe had revived. Yet Asia's supposedly export-dependent economies have resumed growth before the rest of the world. How can that be?

Sceptics argue that the pick-up simply reflects a temporary boost from rebuilding inventory, with no real increase in demand. Firms had cut production to below the level of sales in order to shed excess inventories, so now they need to reopen factories. This may be a factor in some countries, but in others firms are still running down their stocks.

In South Korea the decline in inventories accelerated in the second quarter, and the leanness of stocks bodes well for further gains in production over the rest of this year. Instead, the recovery has been led by investment and consumer spending. South Korea's private consumption rose by an annualised 14% in the second quarter. In China fixed investment (on a GDP-consistent basis) is running more than 20% higher than a year ago, real consumer spending in urban areas is up by almost 11% and car sales have surged by 70%.

One reason why Asia's emerging economies have been able to rebound well before those in the rich world is that their downturn was caused only partly by the slump in America. In 2008 domestic spending was squeezed by higher prices for oil and food (which account for a much higher share of household budgets than in other countries) and by tighter monetary policies, aimed at curbing inflation. China's growth, for instance, began to slow well before global demand stumbled, as tight credit policies to prevent the economy overheating caused the property market and construction to collapse.

Across the region, aggressive fiscal and monetary stimulus has helped revive domestic demand. Asia has had the biggest fiscal stimulus of any region of the world. China's package grabbed the headlines, but South Korea, Singapore, Malaysia, Taiwan and Thailand have all had a government boost this year of at least 4% of GDP. Most Asian countries, with the notable exception of India, entered this downturn with sounder budget finances than their Western counterparts, so they had more room to spend. Bank of America Merrill Lynch forecasts that the region's public debt will rise to a modest 45% of GDP at the end of 2009, only half of the average in OECD countries.

Moreover, pump-priming has been more effective in Asia than in America or Europe, because Asian households are not burdened with huge debts, so tax cuts or cash handouts are more likely to be spent than saved. It is also easier in a poorer country to find worthwhile infrastructure projects—from railways to power grids—to spend money on.

In China the easing of credit has been even more important than its fiscal stimulus. Although lending slowed sharply in July, new lending by banks in the first seven months of this year was almost three times its level a year earlier. And across the whole of emerging Asia, cheaper money has been more potent in lifting spending than in the West. This is because, unlike in America and Europe, local financial systems are not crippled, so banks are able to lend more. And since Asian households and firms had not previously been on a borrowing binge (South Korea is an exception), they can afford to borrow more.

Growth rates will almost certainly moderate after the second quarter's astonishing bounce. Even so, Mike Buchanan, an economist at Goldman Sachs, has raised his forecast for GDP growth in emerging Asia to 5.6% for 2009 as a whole and 8.6% in 2010. He expects China to grow by a breathtaking 9.4% this year and 11.9% next.

India's GDP is forecast to grow by a more modest 5.8% in this fiscal year (ending March 2010). Exports accounted for only 15% of India's GDP in 2008, compared with 33% in China, so India should have been much less affected by the global downturn. But because of its dire fiscal finances (a budget deficit of 10% of GDP last year), the government has had much less room to spur growth. The poor monsoon rains are also expected to reduce farm output this year. However, Mr Buchanan expects growth to increase to 7.8% next year.

## Bubbling up

Even though these economies are only just starting to feel the upturn, policymakers now face a difficult problem: how to sustain a robust recovery without blowing up bubbles. There are growing concerns that a flood of liquidity is fuelling asset-price bubbles, which could destabilise economies when they burst. In China share prices have almost doubled since their trough last November, and most Asian countries have seen gains of around 50% or more since the start of the year (see chart 3). After falling last year, house prices are now rising rapidly in Hong Kong, Shanghai, Seoul and elsewhere. Home sales have surged by 70% in value in China over the past year. According to one estimate, one-fifth of all new lending this year in China has gone into the stockmarket or property.

Asset prices could rise much further. Despite the recent gains, average house prices in most countries are barely higher than a year ago. And although shares are starting to look pricey, China's stockmarket is still 47% below its 2007 peak. But the lesson from America in recent years is surely that it is better to prevent bubbles forming. Asia's monetary conditions are too loose now that economies are reviving; central banks need to raise interest rates. But with rates close to zero in the rich world, and likely to stay there for a while, this would lure in foreign capital, adding to domestic liquidity. Capital is already rushing in, attracted by the region's growth, which is faster than the rest of the world's.

The basic problem is that although the Asian economies have decoupled from America, their monetary policies have not. In a world of mobile capital, an economy cannot both



manage its exchange rate and control domestic liquidity. By trying to hold their currencies down against the dollar Asian economies are, in effect, being forced to shadow the Fed's monetary policy even though their economies are much stronger. Foreign-exchange intervention to hold down their currencies causes domestic liquidity to swell. Consumer-price inflation is not an imminent threat, because prices are falling in most Asian countries. Chinese consumer prices fell by 1.8% in the year to July. But asset prices look dangerously frothy. The obvious solution is to let exchange rates rise, but with exports still well below last year's level, governments are reluctant to set their currencies free.

## Making it stick

Several central banks in the region, including the People's Bank of China, the Bank of Korea and the Hong Kong Monetary Authority, have given warnings about the risk of asset bubbles. But there is unlikely to be any significant policy tightening before next year, because boosting growth remains governments' main priority. Indeed, the wealth effects of higher asset prices will help lift spending. Ample liquidity is therefore likely to continue to stoke asset prices. Andy Rothman, an economist at CLSA, a brokerage, predicts the "biggest round of asset-price inflation China has experienced since the command economy was dismantled".

Its credit boom is clearly unsustainable, but China is unlikely to hit the monetary brakes until inflation turns positive and its year-on-year GDP growth tops 10%. Instead, policymakers will try to contain the bubble by tightening lending standards. For example, China's banking regulator has warned banks to stick to rules on mortgages for second homes, which require a down-payment of at least 40% of a property's value. It has also ordered banks to ensure that lending goes into the real economy, not shares.

Fiscal stimulus and the wealth effect of rising asset prices can provide only a temporary prop to domestic spending. Nor can Asia rely on a strong rebound in exports to America, where spending is likely to remain sluggish over the next few years as households are forced to save more in order to repay debt. In the longer term, Asia's growth needs to come more from domestic demand rather than exports.

However, the standard policy prescribed by Westerners—Asian households must save less and spend more—is too simplistic. In China private consumption is indeed unhealthily low, at only 35% of GDP. But the average for the rest of Asia, at 58% of GDP, is not much lower than the OECD average of 61%. South Korean households, which have reduced their saving rate from 23% of disposable income in 1998 to only 3% last year, can hardly be accused of being overly thrifty.

In Indonesia, Malaysia, the Philippines, Taiwan and Thailand it is instead investment that looks too low. Investment as a percentage of GDP is little higher than in many rich economies, even though investment opportunities in a developing country should be far greater. For example, Malaysia's investment has fallen from 43% of GDP in 1997 to only 19% last year, less than in the euro area or Japan and well below China's 44%. Weaker investment is one reason why the trend growth-rates of some Asian economies have slowed over the past decade.

The appropriate measures needed to strengthen domestic demand therefore differ across the region. Although China's goal should be to consume more, some of the other Asian economies need to invest more. That will require an improved regulatory environment, a crackdown on corruption, better infrastructure and—not least—greater political stability.

Even in countries like China, where low consumption is the main culprit, the necessary reforms are more complicated than the standard Western advice that the government needs to spend more on health care and welfare support to encourage households to save less. Companies, not households, have accounted for the bulk of the rise in saving across Asia over the past decade. Households' spending has fallen as a share of GDP, not because they are saving a lot more, but because their share of national income has shrunk as that of corporate profits has grown.

To lift private consumption, governments therefore need to increase households' share of national income by encouraging more labour-intensive services, rather than favouring capital-intensive manufacturing industries with subsidies and undervalued exchange rates. Recent estimates suggest that Asian currencies are among the most undervalued in the world. Stronger exchange rates would help shift growth away from exports and boost households' real spending power.

## Mind the gap

The gap between growth rates in emerging Asia and the G7 is forecast to rise to a record nine percentage points this year (see chart 4). But what of the future? Pessimists argue that Asia's growth over the coming years will be much slower than before the global crisis because its main engine of growth, exporting to America, has broken down and it will take years to find a replacement. But this may overstate the importance of America to the Asian tigers. Between 2001 and 2006 (when America's trade deficit peaked), the increase in emerging Asia's trade surplus with America accounted for only 6% of the region's GDP growth. If those exports cannot be replaced by domestic demand, growth will be slower, but not massively so.

Besides, long-term growth depends on supply factors, not just demand. A country's long-term "potential" or "trend" rate of growth—the speed limit at which GDP can expand without igniting inflation—is determined by growth in its labour supply and productivity. The global financial crisis should not noticeably reduce productivity growth in emerging Asia. Indeed, recent increases in infrastructure spending across the region could boost productivity by reducing transport costs, especially in places such as inland China.

In America and many other rich countries, by contrast, potential growth rates are likely to fall over the next decade as soaring government debt and hence higher taxes blunt incentives to work and invest, the lingering credit crunch dampens investment, and increased government regulation deters innovation. All this could reduce productivity growth at a time when labour forces in these countries will be growing more slowly or even shrinking.

The tigers are unlikely to return to their breakneck growth rate, which averaged 9% during the three years to 2007. But this exceeded their safe speed-limit. Emerging Asia as a whole might enjoy annual growth of 7-8% over the next five years, at least three times the rate in the rich world. The sharp downturn in Asia late last year painfully proved that the region was not immune to America's downfall. But the speed and strength of its rebound, if sustained, show that it is not chained to Uncle Sam either. If anything, the crisis has reinforced the shift of economic power from the West to the East.

