Will Asian Growth Be Dragged Down By the West?

By Barry Eichengreen

Asia’s rapid economic growth has relied heavily for decades on strong export demand from the US and Europe. In times of cyclical recession in those markets, Asia’s trade-driven growth suffered, but when recovery came, Asia quickly felt the benefits.

With the global recession of 2008-2009, however, the economic calculus has altered in ways that economists are still struggling to assess. Barry Eichengreen analyzes the impact of Western economies on Asia today.

FOR DECADES NOW, the Asian Miracle and global trade have been intimately wrapped together. Asia’s development strategy has been labeled, for convenience but also with more than a modicum of truth, as “export-led growth.” A series of economies, starting with Japan and followed by the four East Asian Tigers, then by China, and now by other East and South Asian countries, have shifted workers into manufacturing by relying on other regions for markets for their industrial goods. China, for example, until recently exported fully 40 percent of its domestic production to other parts of the world, an extraordinary proportion for such a large economy.

“Other parts of the world” is, of course, code for the US and the euro area, which by dint of their size are Asia’s principal extra-regional customers. This means, in turn, that Asian economies are strongly affected by developments in North America and Europe. This point was clearly illustrated by the impact of the global recession of 2008-2009.

But Asian economies survived the global crisis without serious setbacks to their growth. Their banks had not dabbled in the toxic derivative securities originated by US financial institutions and, consequently, were not laid low by the crisis. Most Asian governments had strong budgets and ample international reserves. They could ramp up infrastructure spending to sustain demand, and when output began to rise again in the advanced economies there was every reason to think that the demand for Asian exports would rise as well.

But herein lies the worry. In the US, economic recovery, while sustained, has failed to match the pace typical of recoveries from recessions. The American economy grew by barely 2 percent in 2014, just half the rate typical of recovery phases of the business cycle. And this mediocre performance followed several preceding years of equally disappointing growth.

Europe has done worse still. After two consecutive years of economic contraction in 2012 and 2013, the euro countries eked out growth of less than 1 percent in 2014. Eurozone import volumes shrank in 2012 and rose by less than 0.5 percent in 2013 and a still unimpressive 3 percent in 2014. This is far from the 6 percent annual rate of growth in advanced-country imports typical of the pre-crisis period. It is not the buoyant external environment to which Asia is accustomed.

LOOKING FOR THE WEST TO BOUNCE BACK Should Asian countries expect the unfavorable external conditions currently weighing on their export sectors to persist? The answer depends on whether slow growth in the US and the euro area is a temporary or permanent condition. It depends on whether the growth of US and European imports from Asia has declined simply because US and European rates of economic growth have slowed, or whether in addition there has been a shift in spending in North America and Europe away from Asian goods.

It has been argued that slow growth in the US is simply a hangover from the 2008-2009 crisis. Recoveries from financial crises tend to be slower than other recoveries, first and foremost because the operation of the financial system is impaired. The US moved quickly to recapitalize its banks in 2009. But the banks, having been burned, turned cautious. Bank lending has grown by a pathetic 1.7 percent per annum since 2007, slowing economic expansion. Reflecting the banks’ stricter lending standards and the earlier boom in home-building, construction has been slow to recover. Heavily indebted households have sought to “deleverage,” or reduce their debts as a share of their incomes, which makes for less retail spending. Lower home values and stagnant real wages have weighed further on consumption. Finally, the expiry of tax cuts brought in by the Bush administration and of a payroll tax holiday instituted during the crisis, together with spending restraint instituted by the Budget Control Act of 2011, have reduced the public-sector contribution to aggregate demand. Given this combination of adverse supply and demand shocks, it is no surprise that US growth has been lethargic.

Europe’s financial crisis may have been less dramatic than America’s, but it was no less severe. In contrast to their Asian competitors, European banks loaded up on subprime securities. Lacking a single bank supervisor, the euro area was then slow to fix its broken banks, something that was especially problematic given its bank-based financial system. European regulators allowed the banks to repair their balance sheets by liquidating existing assets rather than requiring them to raise new capital on the market. Where the growth of bank lending in the US has been tepid, lending to households and non-financial corporations in the euro area has been in open decline in recent years.

Then there are the debt problems of southern European countries and the debt fixation of their northern European counterparts, which have been addressed by policies of budgetary austerity that are harsh even by US standards. There is the reluctance of the European Central Bank to implement unconventional monetary policies in the manner of the US Federal Reserve. And there is the uncertainty created by the euro’s existential crisis, which has been debilitating for consumption and investment.

Optimists will argue that Europe has now put the worst of these problems behind it. The ECB’s comprehensive audit, released in late 2014, induced the vast majority of weak banks to raise additional capital in anticipation, in order to avoid being called out. It compelled the handful of problem children to do likewise or else accept government funds. The central bank has shown new readiness to expand its balance sheet, if not by buying government bonds then by purchasing private-sector securities. The danger that Greece or another crisis country may abandon the euro, placing the entire monetary project at risk, is
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In the 1930s, another period of near-zero interest rates and slow growth in the advanced counties as a secular rather than a cyclical phenomenon, real interest rates — that is, nominal interest rates adjusted for inflation — were trending downward in the advanced economies even before the financial crisis. Since interest rates rise and fall to equate saving and investment, this was symptomatic of the fact that the demand for investment was insufficient to absorb the available supply of saving. This reality was disguised by breakneck credit growth in the years leading up to the financial crisis, which fuelled artificial housing and spending booms in the US and Europe alike. But the age of bubbles and artificial booms was brought to an abrupt end by the crisis. The result is a new normal in which investment demand is depressed and as a result so is economic growth.

In the 1930s, another period of near-zero interest rates and depressed demand, the originators of this theory of “secular stagnation” pointed to slow population and labor force growth as discouraging capital formation. Investment, they argued, is less attractive when new capital has less labor with which to work. This factor is again relevant in the US and especially in Europe, with populations aging and labor supply growth slowing.

A more provocative contention is that the underlying rate of productivity growth in the advanced economies has declined since the 1970s and 1980s, more or less the same point in time, recall, when the secular decline in real interest rates began. While the tech-no-pessimists do not deny that innovation is everywhere, they question whether it will add as much to the productivity of the economy as the great inventions of the past (electricity, the internal combustion engine, chemicals, petroleum and indoor plumbing). Information technology of the 21st century, in this view, is good for playing games, but in comparison with these earlier innovations does less to stimulate economy-wide productivity growth and therefore investment demand.

The secular stagnationists of the 1930s were similarly convinced that the era of rapid productivity was over, but in fact the opposite turned out to be true. It is hard to say whether their intellectual descendants are on firmer ground this time.

**ALTERED TRADING PATTERNS**

A final basis for worry is that the international trade on which Asian economies depend has been stagnant in recent years. World trade grew in 2014 by a modest 3.1 percent in value terms and by less than 2 percent adjusted for inflation. According to the World Trade Organization, it is expected to grow only slightly faster in 2015. The International Monetary Fund now forecasts that global trade will grow by just 4.2 percent per annum between 2015 and 2025, compared to 6.7 percent annually in the decade leading up the financial crisis.

Asia’s exports are still the fastest-growing of any region, but are driven increasingly by sales to Asian economies themselves, with demand from the advanced countries remaining depressed. Where intra-regional trade accounted for 47.8 percent of Asia’s exports in 2008, it accounts for 52.3 percent today.

The recovery of US and European imports from Asia has been even slower than the recovery of the US and European economies, suggesting that there may have been a structural shift in spending in the advanced economies away from Asian exports. The advanced economies have responded to their economic difficulties by imposing barriers to trade. US anti-dumping duties on Chinese steel and solar panel exports being a case in point. The positive momentum of trade liberalization that allowed Asian exports to grow so fast before the financial crisis has been lost as progress on the WTO’s trade facilitation agreement and regional arrangements has stalled. Re-shoring, to the extent that it has actually occurred, may have involved more the relocation of production from Asia not to the US but to Mexico, and not to western but eastern Europe, reflecting enhanced appreciation of the advantages of proximity. But the implications for Asia are the same: fewer exports to the advanced countries, other things being equal.

Finally, there is the ongoing shift in the composition of trade from merchandise to services. Services are now the most dynamic and rapidly growing component of cross border transactions. (Here at least is one context in which information technology has played a productivity-enhancing role.) Asian economies may be champions at exporting merchandise, but they have been less successful as exporters of services. India, the Philippines, Hong Kong and Singapore may be limited counter-examples, but these are also the Asian economies where English-language facility is greatest, highlighting the nature of the problem going forward.

So what should Asia do? In the circumstances, the best advice is for countries to hedge their bets by diversifying their export destinations to encompass emerging markets, including in Asia itself. A further increase in the share of intra-Asian trade should not be seen as a measure of failure, in other words. And in countries where dependence on external markets remains heavy, rebalancing in the direction of domestic consumption will be essential. China, that means you!

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