15 Prospects for rebalancing growth in East Asia

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The global economic downturn has sharpened focus on the global imbalances, with policymakers in East Asia no exception. This chapter argues that the region's leaders are at a cross roads. On the one hand, they can make concerted efforts to restructure their economies. On the other, they can return to the pre-crisis regime of export promotion.

Throughout East Asia, there has been a reexamination of the viability of the region's export-led growth. Exports would not have been a major source of aggregate demand had it not been the voracious appetite of US consumers for East Asian exports. Now that demand for the region's exports by US and European consumers is likely to remain weak for years to come, even when the global economy recovers and financial stability is restored, export-led growth may no longer be a practical strategy. This awareness has led to an emerging consensus that East Asia needs to rebalance its growth to depend more on domestic demand than before. Some then expected that this consensus would lead emerging East Asia, which excludes Japan, to restructure its industries,toreform its policies to stimulate domestic demand, and to allocate more resources to the non-tradable sector.

In the eyes of many observers both within and outside the region, however, there have been few visible signs that East Asia has moved in the direction of growth recalibration. Worse yet, all economies in the region-ASEAN, China, Japan, Korea, Hong Kong SAR, and Taiwan-have continued to run large and growing surpluses on their current accounts and to accumulate foreign exchange reserves. Although it may be premature to initiate an exit strategy, some of the East Asian countries have begun unwinding their fiscal stimulation in order to safeguard their sovereign debt sustainability. Other countries are trying to return to the old export-led regime. Countries in East Asia are once again at a cross roads. On the one hand, they can make concerted efforts to restructure their economies. On the other, they can return to the pre-crisis regime of export promotion.

The treacherous road

Notwithstanding its urgency emerging, East Asia is likely to deviate from the rebalancing at the risk of being accused of delaying the recovery of the global economy and exacerbating the trade imbalance and hence escalating trade frictions between East Asia and North America. Why is emerging East Asia taking such a treacherous road?

There are five reasons.

1. One reason is that neither Japan nor China is capable of providing leadership needed to help galvanise region-wide support for the growth rebalancing.
2. Another is that many countries in the region may have exhausted the arsenal of the tools for stimulation of domestic demand. Monetary easing reached its limit a long ago. Although there was a global chorus of approval for fiscal stimulation at the beginning of the current crisis, the effectiveness as well as sustainability of the fiscal-policy-led recovery strategy has been faced with growing skepticism.

East Asian economies have traditionally refrained from spending out of an economic downturn whenever possible. Ever since the 1997-98 Asian financial crisis they have been on guard over fiscal indiscretion as it could sow the seeds of another crisis. Since the eruption of the Eurozone sovereign debt crisis, many of them have become much more conscious about their government debt sustainability.

3. A third reason is the concern over the repeat of a liquidity crisis in the future. Default of any one of the southern European countries could quickly spill over to East Asia through the common link of Western European banks. Although it is highly unlikely that East Asian borrowers would be forced into large-scale defaults on external liabilities even when a reversal of capital flows takes place as a result of the European debt crisis emerging East Asia's policy authorities feel that they must be prepared for such an external shock.
4. A fourth reason has to do with the disagreement on the exchange rate policy appropriate to emerging economies in East Asia. Should they adopt free floating or should they just adjust the nominal exchange rate to prevent undervaluation of their real effective exchange rates in an intermediate regime? In a country like China how does currency appreciation work to reduce the saving-investment gap, if it does at all?
5. A final reason is the apparent confusion over the definition of rebalancing. However it is defined, rebalancing does not mean that East Asia should abandon its export-led growth altogether. The ultimate objective of the rebalancing is not reducing or eliminating East Asia's current account surplus. This is because the region's surplus does not necessarily come from the exceptional success of East Asia's outward-looking export-oriented growth strategy. The surplus may have more to do with high propensities to save in the region.

Moreover, in rebalancing growth it is important to make distinction between export promotion and export-led growth. The former is a strategy in which the underlying incentive structure is biased in favour of exports over non-tradables whereas in export-led growth it is not. Because of comparative advantage and other structural characteristics, some market-oriented open economies may rely more on external demand for growth than others, even though their incentive schemes are neutral. These countries may run either a deficit or a surplus on their current accounts, which is a cyclical phenomenon. In contrast, some of the economies known for pursuing export promotion suffered from a chronic current account deficit during much of the post war period prior to the 1997-98 financial crisis.

So what are the prospects for the rebalancing in East Asia?

Most of East Asia's emerging economies have phased out much of subsidisation of exports including keeping the currency undervalued. Nevertheless the 2008-09 crisis provides an opportunity for these economies to reexamine whether or not its export-led growth is still biased in favour of tradables, that is, whether the relative prices of tradables are kept at artificially higher levels so as to induce allocation of resources to export oriented industries. To this end, rebalancing should be viewed as a process of removing the remnants of tax and other incentives of the old dirigiste regime that favour export-oriented industries.

But while the rebalancing strategy may make emerging East Asia less vulnerable to external shocks, the shift of resources to the less productive non-tradable sector runs the risk of bringing down total factor productivity of the economy. Rebalancing therefore needs to be complemented by measures such as market deregulation and opening that could narrow the productivity gap between the tradable and non-tradable sector. East Asia may have difficulties in finding such measures.

While vanishing export markets will add urgency to the rebalancing process, the prospects for reform to provide internal demand-driven growth in the region are not as promising as they may appear. Emerging East Asia's policymakers are not likely to take the risk of rebalancing unless they are persuaded that a new internal demand-led growth strategy would be as effective as the export-led one in sustaining rapid growth.

There is also institutional inertia. The region may not be able to turn around its export oriented economy through expansionary monetary and fiscal policy to fill the void created by the decline in external demand. In a region where exports account for anywhere between 40% to 70% of its GDP, exporters may well find it difficult to sell in domestic markets what they cannot ship abroad – especially when exports fall by more than 30% in a given year. In a country like Korea, where large industrial groups sell more of their products in foreign rather than domestic markets, rebalancing can hardly be an overriding reform objective as long as the incentive system is not skewed against non-tradables.

Finally, the European debt crisis together with the experience of managing the 2008-09 global economic crisis may have affected the mindset of policymakers in the region. They may have been persuaded to keep their foreign exchange reserve holdings beyond the adequacy level prescribed by the Greenspan-Guidotti-Fischer rule – which requires holding a reserve equal to the amount of short-term external liabilities. This would put emerging East Asia in a dilemma. It would need to continue to generate current account surpluses, which may in turn tempt its policy authorities to keep the real exchange rate undervalued.

The reserve accumulation could be a costly option because it means eschewing free floating in favour of an intermediate regime and returning to capital control. Despite the risks the regime change poses, emerging East Asia may not eschew the reserve option unless the central banks of reserve currency countries, international financial institutions, and regional cooperative arrangements could provide short term liquidity to countries suffering from short-term balance of payment difficulties.

About the Author

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