Economic Growth in East Asia: Prospects & Policy Issues

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Introduction

East Asia remains the growth leader of the global economy. The *Table* shows that growth in the majority of the economies in the region surpassed the global average of 3.4% in 2014. The majority of the economies of East Asia, which here refers to the 10 ASEAN members plus China, Japan, South Korea, Hong Kong and Taiwan, are also forecast to surpass the global average in 2015 and 2016. This article describes the recent growth performance of East Asia and its main underlying causes. Country specific analysis is limited. The third section analyzes the major short-term risks including the possibility that oil prices will revert to high levels. The penultimate section looks into policy issues related to sustainable economic growth prompted by decelerating output expansion, particularly in China. The critical issue relates to avoiding the middle-income trap.

TABLE

Economic growth in East Asia & selected regions & countries (%)

	2013	2014	2015	2016
World	3.4	3.4	3.5	3.8
US	2.2	2.4	3.2	3.0
Eurozone	-0.4	0.9	1.1	1.4
China	7.7	7.4	7.2	7.0
Japan	1.6	0.0	1.1	1.7
South Korea	3.0	3.3	3.5	3.7
Brunei	5.1	4.4	4.9	5.3
Cambodia	7.4	7.0	7.3	7.5
Indonesia	5.6	5.0	5.5	6.0
Laos	7.9	7.4	7.0	7.2
Malaysia	4.7	6.0	4.7	5.0
Myanmar	8.3	7.7	8.3	8.2
Philippines	7.2	6.1	6.4	6.3
Singapore	4.4	2.9	3.0	3.4
Thailand	2.9	0.7	3.6	4.1
Vietnam	5.4	6.0	6.1	6.2
Hong Kong	2.9	2.3	2.8	2.9
Taiwan	2.2	3.7	3.7	3.6
India	6.9	7.4	7.8	8.2

Source: Table A.1 and Table 1.1.1 of ADB Asian Development Outlook 2015, except for world economic growth which is sourced from IMF World Economic Outlook, April 2015

Recent Economic Performance

Economic growth in East Asia slowed somewhat in 2014 but has remained resilient. This resilience can be attributed to the sharp fall in oil prices beginning in the middle of 2014, structural reforms that addressed infrastructure bottlenecks, and policies intended to rebalance economies. China remains the region's center of gravity. Its slowdown is the primary reason behind the mild deceleration in both regional and global economic growth. Experts attribute the slowdown in China to the winding down of previous excesses in real estate, credit, and investment. The result, however, will be lower but better quality economic growth.

Only a few countries in the region experienced marked slowdowns compared with their performance in the last decade. One of them is Thailand, which eked out 0.7% growth in 2014. Heightened political uncertainty disrupted economic activity especially in the first half of the year. Meanwhile, the slowdown in Singapore from 4.4% in 2013 to just 2.9% in 2014 could be attributed to declining labor productivity.

Japan and other advanced economies continued to grapple with a lower equilibrium growth path. Owing to the April 2014 hike in its value-added tax, Japan's consumption fell sharply and GDP recorded zero growth last year. The United States economy continued its steady recovery from the 2008 global financial and economic crisis (GFC). The main driver of US growth is still consumer spending which has benefited from stable job creation and income growth, lower oil prices, and improved consumer confidence. Meanwhile, the euro zone recovered from a contraction in 2013, with investment contributing significantly. However, some countries in the region are still in the process of consolidating their debt and this will put a lid on further expansion.

While growth in the US is forecast to be close to the global average, Japan and the euro-zone countries will still experience slow economic growth. East Asia, therefore, cannot rely on trade with advanced economies to be a source of faster economic growth. Fostering trade relations with other partners should be part of the general strategy towards economic diversification. The latter includes a rebalancing of economic growth.

Short-term Risks

The most salient short-term risks to economic growth in East Asia are a rapid rise in oil prices, disruptive asset price shifts in financial markets, a sharper deceleration in China's economic growth, and lower economic growth in the advanced economies. These factors can derail economic activity in the region. However, the impact across different economies will not be the same. For example, net oil importers and net oil exporters will be affected differently by a rise in fuel prices.

Oil prices are forecast to rise gradually in the next two years. So long as the levels are below the June 2014 prices, the impact on economic growth should be minimal. However, oil prices can deviate from current projections owing to changes in supply or demand conditions. Heightened geopolitical concerns especially in the Middle East can readily disrupt the supply of fuel. A surge in demand for oil owing to rapid infrastructure growth among net oil importers can also cause fuel prices to escalate.

The most notable downside risk is the anticipated continuation of tapering by the US Fed. In May 2013, the tightening of interest rates in the US, popularly known as quantitative easing (QE) tapering, ushered in a period of capital flow reversal which had a significant impact on East Asia. This process was postponed temporarily but the resumption of tapering sometime in 2015 is expected to adversely affect economies in the region.

According to the most recent IMF World Economic Outlook (April 2015), two reasons underpin this risk. One, the term premiums and risk premiums in bond markets are still on the low side. Meanwhile, financial market volatility, although slightly higher than in the last quarter of 2014, has also been low based on historical trends. The other reason, which is related to tapering, is that the accommodative monetary policy that has resulted in the current asset price configuration is expected to start changing in 2015. News that alters expectations of asset prices and unexpected portfolio shifts could trigger turmoil in financial markets. One clear example is the unanticipated end to the Swiss National Bank's floor for the Swiss franc-euro exchange rate.

A related concern is the rise of external debt in some East Asian economies. A large amount of global liquidity and expansionary monetary policy after the GFC supported the surge in credit. The economies in the region that experienced a substantial rise in their debt/GDP ratio between 2009 and 2013 are Hong Kong, Malaysia, Singapore, and Thailand. There are concerns that the increase in debt has inflated asset bubbles which could cause financial instability.

Emerging market economies including those in East Asia are therefore vulnerable to the tapering process: capital flows can be reversed particularly if US long-term interest rates increase rapidly, as they did in May-August 2013. Capital flow reversals that would result in significant currency depreciations can cause difficulty in repayment of the external debt. There is also a danger in terms of an abrupt swing in the mispricing of risk: from a large underpricing of risk to a significant overpricing of risk which happened in both the 1997 Asian Financial Crisis (AFC) and GFC.

Meanwhile, China's role as the engine of economic growth in the region and the world has been gradually receding. The Chinese authorities have been putting more emphasis on reducing vulnerabilities from recent rapid credit and investment growth. However, ongoing implementation of structural reforms and lower oil and commodity prices are expected to expand consumer-oriented activities, partly mitigating the slowdown.

The downside risk is that the shift to consumption-led economic growth may be hampered and output expansion may fall further than predicted. It is also possible that efforts to cool the real estate market may be excessive, leading to inadequate liquidity and a rise in interest rates. Being the focal point of many regional production networks, disruptions in the Chinese economy will spill over into the rest of the region.

Advanced economies remain the main export market of these regional production networks. Hence, one reason for the aggregate slowdown in East Asia has been the lower economic growth in the US, Japan, and euro-zone economies, particularly in the aftermath of the GFC. If economic growth in these economies continues to stagnate, East Asia would not be able to rely on them to boost the region's sagging growth.

Policy Issues in Short & Medium Term

This section looks into policy responses that address short-term risks and create opportunities for faster economic growth in the region. The latter are mostly medium-term issues. The underlying theme for most of these policies is economic diversification in terms of markets and products.

Addressing short-term risks

Policymakers in the region are not overly concerned about the rapid rise in debt in East Asia. One reason is that the concentration of the increase in liabilities is in economies with developed financial sectors. Another reason is that macroprudential measures seem to have prevented excessive lending to particular sectors.

Macroprudential policy has therefore acted as a safeguard for financial stability, in particular to deal with the credit and asset price cycles driven by global capital flows. The experience with both the GFC and AFC showed that macroprudential policy should be implemented in order to prevent financial volatility from overcoming sound macroeconomic fundamentals. Studies have shown that over time Asian economies appear to have made greater use of macroprudential tools, especially housing-related measures, than their counterparts in other regions (for example "Leaning Against the Wind: Macroprudential Policy in Asia" by Longmei Zhang and Edda Zoli, *IMF Working Paper WP/14/22*, 2014). The analysis suggests that macroprudential policy and capital flow measures have helped curb housing price growth, equity flows, credit growth, and bank leverage. The instruments that have been particularly effective in this regard include loan-to-value ratio caps, housing tax measures, and foreign currency-related measures.

Meanwhile, East Asian economies will receive a boost by the shift of China to consumption-led economic growth. The 12th Five-Year Plan (2011-2015) was more explicit in associating structural reform with the promotion of domestic consumption. The plan has three major priorities: sustainable growth, industrial upgrading, and the promotion of domestic consumption. Specifically, the objectives are "first to rebalance the country's growth strategy by moving away from exclusive export-orientation towards developing the domestic market, and secondly, to move the economy up the value chain in the coming years so as to enhance its technological independence."

The shift in China's economic strategy will have significant effects on the pattern of regional production networks. For example, some experts have noted that since 2007 the number of machinery final products exported by China to the ASEAN 4 (Indonesia, Malaysia, the Philippines, and Thailand) has increased, but the number imported from the ASEAN 4 has not. This trend suggests that China has become a more important supplier of machinery final products. If China remains a center of processing trade, its shift to consumption-led economic growth will likely reduce the amount of its exports of machinery final products. On the other hand, the amount of imports of machinery — both parts and components and final products — will likely increase. In the context of this example, the ASEAN 4 will have to source their imports of machinery final products elsewhere and/or expand their capabilities in this product category.

There is also the possibility that China's role in processing trade will diminish. This will provide opportunities for other economies in East Asia, particularly Cambodia, Laos, Myanmar and Vietnam. Intra-regional trade will then be geared towards China as a destination of finished goods. Trade with industrialized countries in the West will decline. This will be the essence of decoupling in East Asia. The formal establishment of the ASEAN Economic Community (AEC) in 2015 should be an important factor in this transition. The AEC will generate more production and investment in ASEAN member countries through reforms affecting customs, tariffs and movement of skilled labor.

Middle-income trap

The middle-income trap is a theorized economic development situation where a country which attains a level of income considered to be at the "middle" of the development spectrum will get stuck at that level. The concept was coined in 2007. The World Bank estimates that of 101 middle-income economies in 1960, only 13 became high income by 2008 — Equatorial Guinea, Greece, Hong Kong, Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, South Korea, Singapore, Spain, and Taiwan.

The primary reason for these countries being trapped in this level is that they have lost their competitive edge in the exportation of manufactured goods because their wages are on a rising trend. At the same time, they are unable to keep up with the advanced economies in the high-value-added market. As a result, newly industrialized economies such as Malaysia and Brazil have not exited what the World Bank defines as the "middle-income range" since their per capita GNP has remained between $10,000 to $12,000 at constant 2011 prices. They suffer from low investment, slow growth in the secondary industry, limited industrial diversification and poor labor market conditions.

Getting out of the middle-income trap can be an opportunity to generate faster economic growth. This would entail identifying "industrial policies" to introduce new processes and find new markets to maintain export growth. Expanding domestic demand is also important because a rising middle class can use its increasing purchasing power to buy high-quality, innovative products and help drive output growth.

An IMF report (*IMF Regional Economic Outlook: Asia and the Pacific*, April 2013) suggests four ways to escape the middle-income trap (as summarized in *The Wall Street Journal*, April 30, 2013): "1) Invest in infrastructure. The analysis suggests that sub-par infrastructure is a key factor that can check an emerging economy's growth. India, the Philippines and Thailand are particularly exposed in this area and should focus on building new and upgrading existing public transit systems, freight channels, ports and energy infrastructure. 2) Guard against excessive capital inflows. Money flows from abroad can energize an economy and give domestic consumption a boost, but can send an economy south if investors retreat in a hurry. Policy makers should have macroprudential controls in place to mitigate potential rapid outflows. 3) Boost spending on research and development and postsecondary education. Both are needed to foster the innovation that's a hallmark of advanced economies. Malaysia and Thailand have the highest college enrollment rates among emerging Asian economies, but China is rapidly catching up. China far outstrips other developing Asian countries on R&D, with 2009 spending at more than 1.5% of GDP. 4) Get more women into the workforce and raise the retirement age. Aging populations are a problem in much of Asia. Governments can take steps to reduce 'dependency ratios' by raising the age when workers are eligible for pensions and encouraging girls to enter university and vocational training."

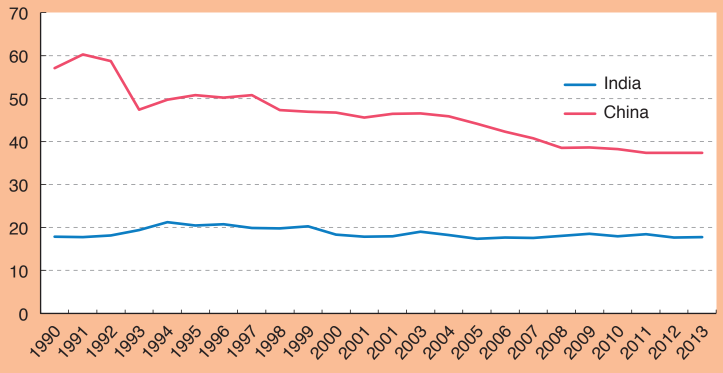
Fostering regional economic cooperation & integration

The *Chart* shows that trade between China and the rest of East Asia has been declining through the years. East Asia's share in China's trade fell from a peak of 60.3% in 1991 to only 37.4% in 2013. Meanwhile, India's trade with the 14 East Asian economies has hovered between 17% and 21% during the same period.

India is poised to record faster economic growth than China in the next few years *(Table)*. Another component of the strategy to boost economic growth in the region would be to expand trade with India. This will also likely facilitate economic diversification as the Indian market entails a different export basket. Expanded trade with India can be achieved under the auspices of the Regional Comprehensive Economic Partnership (RCEP) which involves East Asia plus Australia, New Zealand, and India. The major objective of the RCEP is to consolidate the various ASEAN plus one FTAs. This is a step towards establishing a region-wide FTA. Razeen Sally summarizes the arguments in favor of establishing a region-wide FTA in "ASEAN

CHART

China's & India's total trade with East Asia-14 as a proportion of their total global trade (%)



East Asia-14 = ASEAN; Hong Kong; Japan; South Korea; and Taiwan. Total trade = Exports + Imports

Source: Asia Regional Integration Center Database, ADB and Direction of Trade Statistics Database, IMF

FTAs: State of Play and Outlook for ASEANs Regional and Global Integration" (*The ASEAN Economic Community: Work in Progress*, S. B. Bas et al. eds, Singapore, 2013):

> A clean, comprehensive, deep-integration East-Asian or pan-Asian FTA, with simple, generous and harmonized ROOs, would indeed yield benefits. Ideally, MFN tariffs should be lowered to minimize any trade diversion. If such conditions were met, regional supply and demand would be stimulated, and there would be stronger regional market integration. A structural shift would take place toward manufacturing and services, and away from agriculture and commodities. Economic integration would extend beyond manufacturing parts and components in East Asian production-sharing arrangements to encompass final goods and services. This would be flanked by more integrated markets for labor and capital. And such integration would spread from East Asia to South Asia. In short, there would be regional production for regional consumption.

Economic cooperation and integration in East Asia will receive strong support from the establishment of the Asian Infrastructure Investment Bank (AIIB). As noted earlier, one way to graduate from the status of a middle-income country is to improve physical infrastructure.

The AIIB is also a solution to the excessive holdings of foreign exchange reserves in the region which is a product of the rapid capital inflows. The proposed AIIB is a way to reduce the global macroeconomic imbalances. Instead of using its resources to finance the US current account deficit, China has embarked on a program akin to the Marshall Plan. It should also be noted that the AFC led to the region's shared understanding that the absence of regional capital markets and largely underdeveloped domestic financial systems were the major hurdle to channeling the region's savings into investments within emerging Asia. The latter is also one of the AIIB's main objectives.

Geopolitical Risks

Geopolitical factors involve both short-term and medium-term considerations. Ongoing events in Russia and Ukraine, the Middle East, and parts of Africa could lead to escalation in tensions and increase the likelihood of disruptions in global trade and financial transactions. There can be serious spillovers into East Asia. For example, disruptions in energy and other commodity markets remain a particular concern, given the possibility of sharp price spikes, which, depending on their duration, could substantially lower real incomes and demand from importers. More generally, an escalation of such tensions could take a toll on investor and consumer confidence.

In East Asia, the main geopolitical risk is associated with territorial claims among countries in the region. The most prominent flashpoints are the disputes between China and some ASEAN member countries. The Philippines has already filed a case before the Permanent Court of Arbitration in The Hague in January 2013. China, South Korea, and Japan are also embroiled in territorial disputes. In all these cases, diplomacy will likely prevail as economic interests should readily overcome political rhetoric.

Conclusion

East Asia remains the global leader in economic growth. However, there has been a noticeable deceleration led by China. To sustain economic growth or even increase the pace, policymakers have to be mindful of short-term risks and medium-term policy considerations. The most notable short-term risk is possible disruptive asset price shifts in financial markets brought about by capital flows. Managing these flows largely through macroprudential policies is also a component of an overall strategy to bring countries out of the middle-income trap. The key to economic advancement remains the ability to engage in the high-value-added markets. Closer economic integration and cooperation in the region, which includes the RCEP and AIIB, can foster economic diversification in terms of both markets and products. Trade between India and East Asia should be expanded as the former is poised for higher economic growth.

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