Special Report

Asia and the world economy

The alternative engine

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A sharp slowdown in the American economy could be offset by the growing and largely unrecognised power of Asia's consumers

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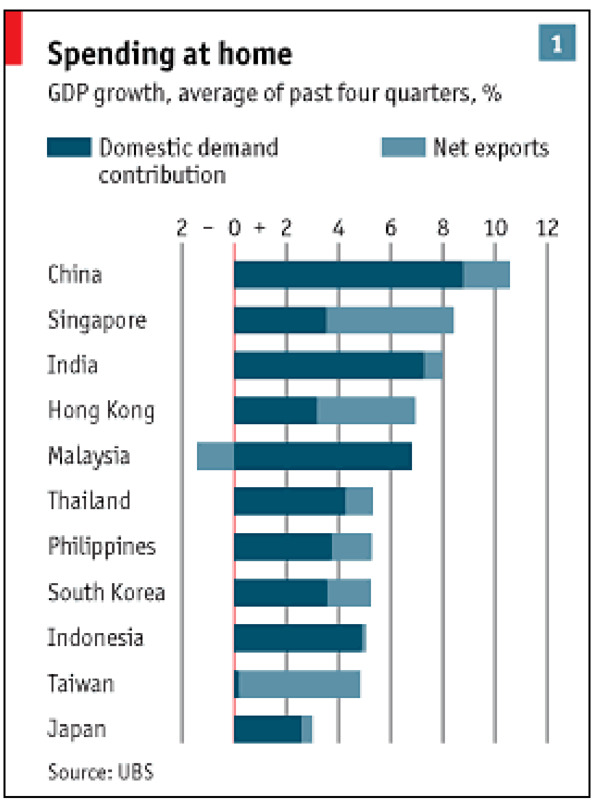
AMERICAN consumers have been one of the main engines of global growth for the past decade. But now, as America's housing boom threatens to turn into a bust, many forecasters expect household spending to stall. A few even worry that America could come perilously close to a recession in 2007. Previous American downturns have usually dragged the rest of the world economy down, too. Yet this time its fate will depend largely upon whether China and the other Asian economies can decouple from the slowing American locomotive.

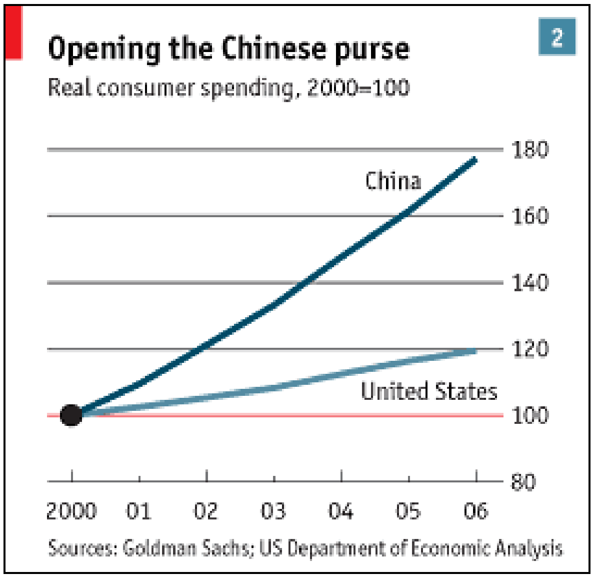
According to conventional wisdom, American consumers have single-handedly kept the world economy chugging along, whereas cautious Europeans and Asians have preferred to save. Yet the importance of America's role in global growth is often exaggerated. During the past five years America has accounted for only 13% of global real GDP growth, using purchasing-power parity (PPP) weights.

The real driver of the world economy has been Asia, which has accounted for over half of the world's growth since 2001. Even in current dollar terms, rather than PPP, Asia's 21% contribution to the increase in world GDP exceeded America's 19%. But current dollar figures understate Asia's weight in the world, because in China and other poor countries things like housing and domestic services are much cheaper than in rich countries, so a dollar of spending buys a lot more. If you want to compare consumer spending across countries, it therefore makes more sense to convert local currency spending into dollars using PPPs rather than market exchange rates.



However, the doomsayers argue that Asia's growth has itself been based largely on exporting to America, whereas domestic demand in the region has languished. Their evidence for this is that Asia is running a combined current-account surplus of over $400 billion, implying that it is contributing much more to world supply than to demand. Thus if America's demand stumbles, the growth in Asia's exports and output would also plunge.

Asia's export growth would certainly slow sharply, but it is the change in net exports that contributes to a country's growth rate, not the absolute size of that surplus. Since 2001 the increase in emerging Asia's trade surplus has added less than one percentage point a year on average to the region's average growth rate of almost 7%. Contrary to the received view, the bulk of Asia's growth has been domestically driven. True, domestic demand (investment and consumption) has grown more slowly than GDP over the past year everywhere except in Malaysia (see chart 1). But in most cases the gap has been small, especially in China, India, Japan and Indonesia. In contrast, growth in Taiwan, Hong Kong and Singapore has been heavily dependent on external demand over the past year.



It is true that exports account for 40% of China's GDP, but those exports have a large import component; only a quarter of the value of China's exports is added locally. The impact of a slowdown in export growth would therefore be partially offset by a slowdown in imports. China's GDP growth has come mainly from domestic demand, which has been growing by an annual 9% in recent years.

The idea that China's growth is mainly export-led is not the only popular myth. Another, says Jonathan Anderson, an economist at UBS, is that China's consumer spending is feeble. Several recent reports highlight that according to official figures spending has fallen from 50% of nominal GDP in 1990 to 42% today. But this partly reflects an even stronger boom in capital spending. Real consumer spending has been growing at an average annual pace of 10% over the past decade—the fastest in the world and much faster than in America (see chart 2).

There is also good reason to believe that official figures understate consumer spending in China because of their inadequate coverage of services. Purchases of homes by the Chinese have risen rapidly since they were first allowed in 1998, but these are also excluded from the figures. If they are added in, Mr Anderson calculates, total household spending has not fallen as a share of GDP.

How does this square with the common perception that Chinese household saving is extraordinarily high and rising? The truth is that it is not. The saving of Chinese households has in fact fallen from 20% to 16% of GDP over the past decade. The main reason why China's total national saving rate looks so high (at close to 50%) is that Chinese companies have been saving a much bigger slice of their booming profits (see article).

Bags and bags of shopping

Across many other Asian countries, the notion of the frugal Asian consumer is equally flawed, says Mr Anderson. Although consumption has fallen as a share of GDP in most Asian countries, this does not mean that households are saving more. Excluding China and India, household saving has fallen sharply, from 15% of GDP in the late 1980s to 8% today. The paradox is explained by the fact that wage incomes have risen more slowly than GDP as production has become more capital intensive. But this means that Asian consumers are spending a rising share of their income by borrowing or running down their savings. Amazingly, the savings rate of Japanese households has fallen more sharply than that of American households over the past decade.

AFP

Doing their bit to help the world economy

The IMF estimates that in Asia as a whole (including Japan as well as the emerging economies) real growth in consumer spending has averaged a healthy 6.3% a year in 2005 and 2006. This suggests that Asian consumers can help sustain fairly robust GDP growth in Asia even if America's economy takes a dive.

Some pundits have predicted a boom in Asian consumer spending over the coming years, which would help to fill the gap left by American consumers cutting back on their purchases. But if consumer spending is already rising strongly in Asia, there is little pent-up demand ready to explode. On the other hand, spending by firms could pick up. After the Asian economic crisis in the late 1990s, investment plunged everywhere except China. It has remained relatively weak. However, as the overhang of excess capacity and debt has disappeared, capital spending is now starting to perk up across Asia.

Japanese firms' average return on assets now exceeds long-term interest rates by 5%, the widest margin for decades, according to Merrill Lynch. The Bank of Japan's latest Tankan survey of business confidence found firms to be unexpectedly cheery. Big Japanese manufacturers now report insufficient production capacity for the first time since 1991 and plan to increase capital spending by 17% in the year to March.

Another reason for believing that Asian economies can decouple from an American downturn is that most of them have small budget deficits or even surpluses. This means they have plenty of scope to ease fiscal policy to support domestic demand so as to offset some of the fall in exports. The main exception is Japan, which has a massive public debt; Taiwan, where domestic demand is worryingly weak, is also constrained by a large budget deficit. South Korea, on the other hand, which has run a budget surplus for seven years, has plenty of scope to ease up.

The United States of where?

Not only is growth in China and the rest of Asia chiefly domestically led, but America's share of Asia's total exports has fallen from 25% to 20% over the past five years. Regional trade links within Asia have also deepened, thanks partly to growing Chinese demand. Goldman Sachs reports that five years ago China's imports for domestic use were only half as big as those for the assembly and re-export of products, but now they are roughly the same size. So strong domestic demand in China sucks in more imports.

China's exports to America have fallen from 34% of its total exports in 1999 to 25% now (adjusting for the re-exports which are made through Hong Kong). Chinese exports to the European Union are now almost as big as those to America and are growing faster.

When America sneezes, the rest of the world's economies may no longer catch a cold

America takes only 23% of Japan's exports, down from almost 40% in the late 1980s. However, this understates Japan's total exposure. Japanese firms (like those in South Korea and Taiwan) send a lot of components to China for assembly into goods, which are then exported to America as finished products. On top of this, if a sinking American economy pulled the dollar down with it, this would further squeeze Asian exporters.

A recent report by Peter Morgan at HSBC estimates that slower American growth will hurt China, India and Japan much less than it will the smaller Asian economies, such as Singapore, Taiwan and Hong Kong, that are more dependent on foreign demand. China, India and Japan account for three-quarters of Asia's GDP and so, given the deeper regional trade links, they should help to support demand in the whole region. If America's GDP growth slows next year to 1.9%, from 3.5% in 2006, as HSBC expects, then Asia's growth is tipped to slow from just above 7% this year to just below 6% in 2007. Weaker exports will badly hurt some industries, but overall, the region will continue to grow at a reasonable pace.

Could Asia withstand a sharper American slowdown? Hong Liang at Goldman Sachs estimates that if America's GDP growth drops to zero by the end of 2007 then China's annual export growth could plummet from 26% in early 2006 to a decline of 2% by late 2007. That sounds dire. Yet after taking account of the impact of slower export growth on imports and domestic demand (ie, slower growth in investment), Ms Liang estimates that China's GDP would still expand by a respectable 8%. That is significantly down from this year's growth rate of over 10%, which is still too fast to be sustained. China is today tightening policy so as to slow down its runaway economy: weaker external demand could be partly offset by reversing these measures.

In sum, if America suffers a slump, the economies of China and the rest of Asia would slow, but they are unlikely to be derailed. However, a slowdown in America could affect Asia indirectly through other channels. Most important and least certain of all would be the impact of an American recession on financial markets. Even if economies can decouple, global financial markets tend to be more tightly linked through the investment strategies of hedge funds and the like. If America's economy hits the buffers, this will surely trigger a rise in risk premiums and a drying up of market liquidity, pushing share prices lower in Asia as well as in America. When America sneezes, the rest of the world's economies may no longer catch a cold; but if Wall Street shivers, global tremors will still be widely felt.

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