Is the worst over for East Asia?

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Empirical evidence indicates that economic contractions tend to be sharper and last longer if the real sector contraction is preceded by a crisis in the financial sector, rather than when the financial sector remains intact.

In the United States, this time around, the financial sector began to feel the pinch in mid-2007 when sub-prime woes started to unfold. The real sector of the US economy registered negative growth in the third quarter of 2008. The US crisis has subsequently spread to the rest of the world through financial and trade channels.

In Europe, too, the turmoil was first felt in the financial sector, due mainly to the European Union's huge financial exposure to the US. But the financial meltdown in the EU pales in comparison with that of the US, thanks arguably to better regulations.

However, despite the EU's trade dependence on the US being small, the real sector of the EU has contracted severely due primarily to Europe's tough anti-inflationary macroeconomic measures.

The situation in East Asia differs somewhat, although there are significant inter-country variations. Economies that are exposed to the US both financially and commercially seem more vulnerable than those that are largely export-dependent on the US market.

But it is important to make a distinction between central banks' exposure to the US via foreign exchange reserves and private-sector exposure to the US via financial instruments.

Since the private-sector exposure has been relatively small, the financial sector in East Asia has remained somewhat insulated, quite unlike that of the EU. There is no financial crisis in East Asia, now that there is a lot of liquidity in East Asian economies, with domestic savings far exceeding domestic investment, while the balance sheets of commercial banks remain in fairly good shape.

East Asia is postulated to turn the corner sooner than the US or the EU. This is reinforced by the notion that China's seven to eight per cent growth this year will have a positive spillover on the rest of East Asia.

The World Bank has recently upgraded its forecast of China's gross domestic product for this year to 7.2 per cent, although this still falls short of China's official target of eight per cent.

Other considerations point in the opposite direction. East Asia may not be cash-strapped, but the East Asian economies are badly hit by the slump in external demand. This is not to deny that domestic fiscal stimulus packages have boosted domestic consumption in several economies, but no increase in domestic demand can adequately fill the void left by the export slump, especially in small economies where the domestic sector is simply not big enough.

Meanwhile the media is abuzz with reports of early signs of economic recovery dubbed “green shoots”. These signs relate essentially to the increasingly slower pace of contraction in the world economy seen in recent times, which really means that the world economy is still contracting and that it has not hit the bottom.

Even optimists have ruled out a V-shaped recovery - that is, a sharp contraction this year followed by a sharp recovery next year. A U-shaped recovery, after a two-year slump, is now seen as more likely. Pessimists still speak of an L-shaped recovery, meaning doldrums stretching beyond two years.

There is yet another possibility where the so-called recovery falls flat prematurely, with major economies experiencing a relapse before a real recovery, in which case it would be a W-shaped recovery. Rough calculations suggest that there is a 50 per cent chance of this happening to East Asia, for there are indications that the so-called “green shoots” may well be stillborn.

Much would, of course, depend on the effectiveness of the fiscal stimuli, which in turn depends on such factors as the size of the stimulus package, the speed of implementation and the multiplier effect of public expenditure on the economy.

These vary from country to country, admittedly, but leaks may weaken the multiplier effect and cause the impact to be one-off with no continuity, warranting a repeat of this exercise, which may fly in the face of fiscal prudence.

Fiscal stimulus without fiscal discipline is a recipe for disaster. Countries that have been running budget deficits even during good times are particularly constrained, while those with budget surpluses during good times are better equipped to cope with tough times.

Not many countries in East Asia belong to the latter category. Fiscal fatigue is thus likely to dampen the jump-start mechanism.

The recession in East Asia is attributed to the sudden drop in export demand, not liquidity shortage or insolvency at home. External demand cannot be substituted by domestic demand, which suggests that fiscal stimuli can only minimise the pain but not spawn recovery, which can only come with a recovery in external demand.

This goes for not only small economies but also large ones. Even China, with a huge domestic market and an enormous stimulus package, cannot return to the pre-crisis double-digit growth trajectory in the absence of a recovery in the US and Europe - what more for the smaller economies of Singapore or Malaysia?

This underscores the need for a sustainable recovery exactly where the crisis began, namely, the US. The notion that East Asia is largely immune to the crisis in the US, as it has supposedly “decoupled” from the West, has been proven wrong. It is this discredited “decoupling” theory that has now led some observers to postulate that East Asia will recover on its own. They were wrong before and are wrong now.

For such decoupling to take place, intra-East Asian trade will have to go far beyond components and parts, with the final goods still destined largely for extra-regional markets.

In order for East Asia to consume its own exports, the region must first forge closer financial and economic integration, which understandably is a long-drawn process.

For now, economic recovery in East Asia hinges critically on the recovery in North America and Western Europe. A modest three per cent growth in the US will mean a lot more to East Asia than a whopping nine per cent growth in China.

Adapted from "The worst is not yet over for East Asia", New Straits Times, 7 July 2009