Time for East Asia to rethink its growth strategy

MOHAMED ARIFF

The current global economic crisis has brought East Asia to a crossroads. It now has three options: one, continue as before with no change; two, take a U-turn and look inward; and three, stay outward-looking but with a distinct difference.

One must however acknowledge that the export-led growth strategy has paid handsome dividends for the East Asian economies, enabling them to fly high. No wonder, Japan and South Korea were able to climb the development ladder rapidly through exports, especially to the United States.

This was fuelled by consumption-driven economic growth and liberal trade policies in the developed countries' export markets. Japan and South Korea took advantage of the opportunity by introducing new products and processes that made their exports highly attractive and competitive. Other East Asian economies followed suit, moving into labour-intensive operations, complementing Japan and South Korea, in this export oriented industrialisation mode.

This does not mean that there is any such thing as a single East Asian model, for there are important differences between countries. While Japan and South Korea have relied heavily on conglomerates, Taiwan's industrialisation was driven essentially by small and medium enterprises. Likewise, foreign direct investment has played a pivotal role in Southeast Asia and China, quite unlike Japan or South Korea, where domestic investment has prevailed.

Export orientation has been the common denominator in all these cases. East Asia could produce more than what it was consuming, with sizeable trade and current account surplus, which have translated into hefty external reserves. Since one country's surplus is the deficit of another, it is not difficult to understand why the East Asia's trade surplus is a reflection of the US' trade deficits.

Economics textbooks tell us that such imbalances are unsustainable and that a rebalancing will take place, with rising demand for imports and stronger currency in the surplus country, and the deficit country experiencing the reverse. However, equilibrating forces have failed to correct the US-East Asia trade imbalances, given the US' penchant for conspicuous consumption and the unique status of the US dollar as the global currency for international transactions and as a reserve currency for the central banks.

Contrary to theoretical reasoning, East Asia has enjoyed persistent trade surplus at the expense of the US for decades. This could happen simply because East Asia has been financing the US deficits, so that the US would continue to import from it. All that the US needed to do in this game was to issue dollar-denominated papers, which East Asian central banks would buy and keep.

The US-East Asia trade imbalances are also a reflection of the serious gaps in the equations between production and consumption on the one hand and savings and investment on the other. What all this means is that the US has been consuming too much and saving too little, while East Asia has been good at saving a lot and consuming little.

To correct the trade imbalances, there is a need for East Asia to consume more and save less, and the US to consume less and save more. This in turn calls for price and expenditure adjustments on both sides of the equation, and not just in the US. The status quo cannot last for long, as the US debt is ballooning while East Asia is getting increasingly wary of its dollar-denominated assets.

The global economic crisis is partly an upshot of the dangerous fault lines in the world economy. Interestingly, the current global recession has not done much to redress the trade imbalances, although trade flows have been drastically reduced in absolute terms in the wake of the crisis. East Asia's exports have been declining in recent times due to depressed external demand, but so have its imports.

Most East Asian economies continue to garner trade surpluses, despite declining exports. In other words, countries that have been in the red before the crisis still remain in the red, despite shrinking gross domestic product (GDP).

What does all this mean for East Asia? Apparently, the global economic crisis has revealed the risks associated with external demand. The US is unlikely to revert to the pre-crisis consumption levels after the anticipated recovery.

In any case, a return to the pre-crisis consumption levels is not an option for the US. The chances are the US will consume less and therefore import less, which means that East Asia must generate its own demand for its products in order to grow.

Instead of investing its huge savings in the West via deficit financing, East Asia should invest more within the region, thereby raising employment, income and consumer demand in the region while reducing its dependence on extra-regional markets.

This does not mean that individual East Asian economies must abandon their export-led growth strategy. This only means that they will have to import more from, and export more to, one another. This also means that exports will remain the main driver of growth for the East Asian economies, especially those with a small domestic sector.

The ratio of exports to GDP will, of course, vary from country to country, with smaller economies having higher ratios. In any case, it is important to ensure that there is no policy bias in favour of or against exports, and hence the importance of "neutral" policies that will allow the market forces to determine the optimum level of exports.

Care must be taken to ensure that East Asia will not become an inward-looking entity, turning its back on the rest of the world. Such a reorientation will carry the prospect of East Asia failing to take advantage of the opportunities that exist elsewhere. For the world is too small to be fragmented into autarkies. East Asia must maintain its current outward-looking posture and continue to engage the rest of the world in this positive-sum game, in which all are winners.

The envisaged model entails a deeper regional economic integration, which may well be the end result rather than a precondition. Be that as it may, any new model will have to evolve on its own, albeit in a policy-driven fashion. There is also a need for a deeper regional capital market to funnel regional savings into regional investments.

All this would work only if the East Asian economies can bury the hatchet, close ranks, and let go some sovereignty. What works for East Asia as a whole may not work for individual East Asian economies, were they to go it alone in the pursuit of a new model of their own aimed at reducing their dependence on exports. Exports and imports will therefore remain indispensable, although the contents and the directions of trade flows may change significantly for individual economies.

In the new paradigm, where the bulk of East Asia's trade revolves around East Asia, the greenback will no longer dominate. This means that the US will have a somewhat lower profile in East Asia's trade matrix with bilateral near-balances, so that the question of the need for the East Asian financing of the US current account deficits will no longer arise.

Any new model for East Asia, in the final analysis, must be able to solve the global imbalance problem, to which the "old" model contributed gleefully. Rebalancing warrants simultaneous adjustments on both sides of the divide, namely the US and East Asia. While the US must spend less and save more, East Asia needs to spend more and save less. This also underscores the need for East Asia to export less to, and import more from, the US than previously.

Adapted from "Is East Asia ready for a rebalance?", New Straits Times, 10 September 2009