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Will Asia Shape or Shake the World Economy?[1]

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These are testing and indeed unpredictable times for Europe, as we know in our bones, but however things turn out, Europe will doubtless need to deepen its economic ties to Asia. By way of anecdote, I recently spoke at a major conference on the luxury goods sector, where Europe's major brands were ebullient about the significance of the region, which, for many, now provides between 30-40% of their total revenues.

In the more mundane world of macro statistics, EU27 exports to Asia now amount to over €330 billion, or 22% of total of external exports, and imports from Asia are over 30% of external imports of €530 billion. If we take out the US and other advanced nations, Asia represents almost 40% of imports and 30% of exports. On average, China is roughly half of total trade with Asian countries, with EU exports to that country doubling in the last 7 years.

Asia, with China at its heart, is home to the world's busiest trade routes and manufacturing hubs, and some 3.5 billion people. The next billion consumers in the global economy will be based largely in Asia, an Asian middle class will quintuple its size and spending in the next 20 years, and more global companies headquartered in Asia

SUMMARY

Asia's economic rise has changed the world economy – and will continue to do so in the future as well. So no one should doubt that Asia now is part of shaping the world trade, capital markets, commodities and consumer markets. But there may also be a considerable amount of shaking involved. The past four years have demonstrated that many countries in the West relied on flawed economic models. Yet it is also increasingly clear that many countries in Asia need to change economic policy – and the model for economic development – if they should remain growing at elevated levels.

This is true also for China. China's growth in the future needs to be less dependent on growth in fixed capital formation and more anchored in growth in consumption and local entrepreneurship. It will take time to achieve such reforms – and they will prove politically challenging as they equally concern basic institutions. In the short term, China may be tempted to cushion negative effects from the crisis in the Eurozone by expanding credit, a counter-cyclical measure China has often used. But the economic return from that model is shrinking.

Beyond China, Asia countries in general need to reform political, economic and regulatory institutions in order to maintain growth. Some of them are at risk of getting stuck in the middle-income trap. A surprisingly few number of those countries that were middle-income countries in the 1960s have now grown to become high-income countries. That should serve as a warning to those who extrapolate China's future growth on the trend in the past decades.

will make their way into the Fortune 500. What's there not to like? But even as we salivate about the prospects for trade and business with Asia, why should we nevertheless try to keep our optimism in check?

FLAWED ECONOMIC MODELS

I HAVE TRIED to answer this in my book Uprising, which carries a subtitle: will emerging markets shape or shake the world economy? The shaping is pretty self-explanatory, and goes beyond what already has been mentioned. If money is power, then China's and Asia's influence over world trade, but also over capital and commodity markets, and global economic and political institutions should surely increase significantly further. I say 'should', because although this is what most people believe, the shaping that comes with rising levels of wealth and human development is also likely to be accompanied by a considerable amount of shaking as well, for two reasons.

First, there's no guarantee at all that the shift in global power from the West to the East will be accommodated in a largely benign way by either side. On the one hand, it is an unequivocal positive that the major powers in the global system do not have serious ideological divisions: we have all embraced some form of market-based economic models, and therefore, strong mutual economic interests and dependencies.

On the other hand, this is a stressful time for international relations. The Western financial crisis has crippled our banking systems and economies. America's modest economic growth is weakening again, with the prospect of large automatic tax increases and spending cuts looming after the November elections. And in Europe we are in a so-far mild depression, as we struggle in different ways with the unwinding of over-indebtedness and the deleveraging of balance sheets. This is only year 4 of the aftermath of the crisis - we may be 30-40% through it, if we are lucky - and it is small wonder that Western thinking has become more inward-looking and often nationalistic.

Unfortunately, the same is true in Asia. To many, especially to some policymakers in China, the Western crisis is proof of a flawed economic model, and an opportunity to take on the West and set new, more self-interested agendas in everything from economic and financial policy, commerce and innovation, to global security.

But to a greater or lesser degree, this line of thinking represents hubris, and papers over something very important. Which is, that if we in the West face a decade or more of stagnant growth, the more so as we experience the consequences of rapid population ageing, Asia's growth model is also flawed. We economists talk a lot about the decoupling of Asia from the West, but a) empirical evidence doesn't suggest it has happened much at all, and b) where it has, most notably in Chinese fixed asset investment spending, it is the 'wrong kind' of decoupling. In other words, yes, Asia definitely needs to change its development models to focus on more domestically generated growth and intra-Asian trade, but not, for example in China's case, if more and more capital investment creates deeper and more dysfunctional economic imbalances that, in turn, increase the possibility of economic instability and disappointment down the line.

South Korea and Taiwan, of course, have already become successful high income countries, but most of East Asia remains low to average middle income, and South Asia is still poor. Rapid economic growth is, of course, changing prospects and possibilities, but history shows us that rapid economic development is always accompanied by strong pressures for social and political change, to which the ruling elite must respond effectively. The Asian Tigers certainly did so, but you can certainly ask trenchant questions as to whether China can, or India will, for example. And what if they do not?

ASIA IS NOT GOING TO 'EAT OUR ECONOMIC LUNCH'

One can be structurally optimistic about the long-run growth of Asian consumer markets, without necessarily conceding that Asia is going to eat our economic lunch, so to speak. There are a few of the reasons why I think it's the case. And it's quite an important point for Europeans negotiating economic and commercial interactions with Asian nations.

First, though there are countless mathematical predictions about when China's GDP will overtake the US, or India's that of Europe, and so on, the implications aren't quite as powerful as many people, often self-servingly, assert.

Even as these phenomena happen, per capita income in China, some of ASEAN, and in India and other Asian countries, will still be a small fraction of that in the US and Europe.

This is important. A country with a big GDP can project political and military power, much as the USSR did and Russia does today, but a country with relatively low income per head is a) still relatively poor, and b) much less able to project the soft power needed to set global agendas, let alone implement them.

Second, the story of China's or Indonesia's GDP to date, and drawn in linear fashion to 2020 or 2040, doesn't tell you anything about **how** they grew to where they are today, and whether the model that produced that growth can carry on. I've already alluded to this, but it's worth repeating that Asia's growth model, predicated on some combination of trade surpluses, and the export supply chains ending up in vibrant Western economies is now rather frail.

Structural changes to that model will take time. So, the immediate challenge in Asia is to keep the growth hit from Europe to a minimum, and to try to avoid financial instability and destabilising capital in- and out-flows. There has been, and there may yet be more, criticism, for example, of the effects of Western quantitative easing in driving up exchange rates and money supply and credit, but now from China down to Singapore, the flows seem to be going the other way, partly reflecting lowered expectations about local growth and currency appreciation.

Growth in China is slowing down, paced partly by exports but, importantly, by the downswing in fixed investment, especially in property. Growth has become positively disappointing in India, and compromised by both its twin deficits, and government policy inertia. Growth in Korea and Taiwan, already pedestrian as befits higher income nations, is now threatened from the export side, while in much of the rest of Asia, the call on GDP is in effect a call on exports too. With export volumes in 2012 so far flat or down on what they were last year, it's no surprise that Asian growth 'ain't' what it used to be.

And Asian governments must be careful not to substitute credit expansion for structural reforms. In the 8 years before the Asia crisis, bank credit to GDP surged from 65% to a peak of 96%. The crisis gave way to several years of deleveraging, but in the last decade, it has grown sharply again to 106%, much of the rise occurring since 2008. Loan to deposit ratios in Asian banking systems are rising significantly again, and re-leveraging is all the rage. You'll be gratified that in no country is leverage as acute as it was in 1997, but you should also be clear that things are going the wrong way, in particular in China.

ADAPT TO THE NEW NORMAL

Asia's medium-term challenge is to adapt to its own 'new normal', to coin a phrase. As already has been mentioned, this means looking more and more to domestic, especially household, demand as the leader in economic development, and changing export structures to embrace emerging markets in Latin America and Africa. But it also means at least three other major priorities.

First, economic development and Asia's own rapid urbanisation and population developments underscore the urgency of paying more attention to the social and environmental consequences of rapid growth, and distributing the benefits wisely to correct deficiencies in public health, educational attainment levels, the position of women in the economy and society, infrastructure, and innovation.

Second, financial stability issues are liable to become more pressing, partly because of the credit expansion currently underway, and especially as growth decelerates. For India, with problematic twin deficits, this is of immediate relevance. For China, with growing evidence of investment misallocation, it will become so. And if China were genuinely to want the Yuan to become a global currency, or even a future rival to the US dollar, enormous financial sector reforms would be required that would be both potentially destabilising, not to mention incompatible with its current political economy model.

Third, and perhaps most difficult of all, economic reforms will require extensive reform of political and governance institutions. And you don't have to take my word for it. Premier Wen Jibao recently acknowledged, to the Western media at least, that without political reform, China would be unable to implement economic reform effectively. And the Asian Development Bank has been warning for some time that Asia generally needs to continuously refresh and reboot its legal, social and economic institutions in order to fulfill what we all regard as its potential. This is not just a rant for liberal economic models. It is also about building inclusive and trustworthy institutions, and ensuring that governments provide non-tangible services and arrangements to allow private and family firms to prosper, and an innovative and entrepreneurial culture to flourish.

In a recent excellent report by the World Bank, written in conjunction with Beijing's Development Research Centre[2], the authors emphasise how hard it is for countries that have attained middle-income status to break out of this grouping to become high income. They demonstrate that only 13 of the 101 countries, deemed middle income in 1960, had done so by last year. This is a salutory observation that basically says that without robust legal, government and other institutions, countries that have graduated from low income to middle income, tend to get stuck in a so called middle income trap.

Some countries like Malaysia and Thailand are solid middle income, but the quality of institutions is not close to, for example, Hong Kong and Singapore. Indonesia scores pretty well overall, but is weak in its legal and regulatory institutions. India is still low income with satisfactory legal institutions, but weak governmental, labour market and regulatory institutions. And last but not least, China, which could, on present trends triple its income per head by 2020 to become borderline high income, scores well in terms of government institutions, but poorly in terms of its legal, entrepreneurial and commercial institutions.

What Asia lacks is a sufficient focus on the significance of political and institutional reform, and a strong pan-Asian framework for policy dialogue and co-operation, designed to facilitate economic model change, the correction of infrastructure and power generation deficiencies, financial stability, and the creation of larger and more generous financial safety nets to deal with both rapid population ageing, as in China, and rapid labor force growth as in India and Indonesia.

You will all be conscious of the sometimes tabloid, but essentially very serious developments leading to China's once-a-decade leadership change later this year. This complicated and opaque event is occurring against a backdrop of an economy that is slowing down, partly by design, and that has, by general agreement, become chronically unbalanced, and potentially unstable. Premier Wen's championing of the cause of political reform is important, even though he will step down, but it isn't at all clear what political reform means. My sense is that it is about reform of the Communist Party of China (CPC) and its responsiveness and workings, not about the need for a radical shift towards a liberal market economy. So, we shall see who and what transpires.

But from the point of view of the economy, I'll end with three points. First, comprehensive economic reforms are urgent if high growth - which is the source of the CPC's legitimacy - is to be sustained, and a hard landing avoided in the next two years.

Second, China's biggest economic issue is the investment-centric nature of how it grows. People often say that it is ludicrous to say that a relatively poor country can invest too much. But this is to confuse stocks and flows.

There's no question China's capital stock has exploded in recent years, especially since 2003, and again after 2008, and that at current rates, it will double again in the next 5 years. We could debate at length whether by then it will be appropriate or not for a country with China's population and income levels. More certainly though, the speed with which the flow of investment is increasing, aided and abetted by the lowest real lending rates in a generation and strong vested political interests, is leading to growing misallocation of capital, weakening investment returns, and deteriorating asset and lending quality. This comprises a formidable challenge for China's new leaders.

And third, economic reforms can only be assessed in the context of China's political economy, which means that they are really about whether the CPC is willing and able to allow the redistribution of power away from state-owned enterprises, state banks, family clans, the Party and military apparatus itself, to private firms and small and medium sized firms, households, and disadvantaged citizens in both rural areas and in cities. And ultimately, what if it isn't?

ENDNOTES

1. This brief is based on remarks by the author to the Europe-Asia trade and economic relations conference, organised by ECIPE, Brussels, 5th June 2012
2. World Bank & Development Research Centre of the State Council, P.R.C (2012), China 2030: *Building a Modern, Harmonious, and Creative High-Income Society*. Washington, DC: World Bank

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