Cutting the Umbilical Cord: Can Asia Decouple?

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Summary

- Why Asia was considered having the potential for decoupling?
- Why Asia did not decouple, but weathered the storm relatively well.
- In an increasingly globalised and interdependent world economy, can Asia decouple?
- Should Asia decouple?

What do we mean with “decoupling”?

- Decoupling: Separating or diverging from and existing connection
- Asia decoupling: “the emergence of a business-cycle dynamic that is relatively independent of global demand trends and that is driven mainly by autonomous changes in internal demand (ADB, 2007)
- Total decoupling from a global shock is impossible in a globalised world economy
- Partial decoupling

Some decoupling examples (both successful and unsuccessful)

- During the Asian financial crisis of 1997-1998: China
- When the contagion of the Asian financial crisis spread to the rest of the world: economies of the euro area with “weak” currencies
- After the burst of the US financial and technological bubble: euro area

Factors supporting the possibility of an Asian decoupling

- Soundness of the region's banking systems
- More flexible exchange rate systems (if compared to those in place at the time of the Asian financial crisis), backed by high levels of reserves
- Significant increase in intra-regional trade
- Room for expansionary policies

Assessment of financial vulnerabilities

	Inflation (latest available)		Fiscal Balance/ GDP (2008)[1]	Current Acct./GDP (latest available)		External Debt/ GDP[2] (4Q08)	Short-Term External Debt/ Reserves (4Q08)[3]	Govt. Debt/ GDP (2008)[4]	Foreign Reserves (number of months of imports)[5]		Foreign Liabilities/ Foreign Assets[6] (latest available)		Loans/ Deposits of Banks[7] (latest available)	
Brunei Darussalam	2.3	(Apr 09)	29.1	45.6	(2006)	7.9	62.4	—	3.4	(Dec 08)	3.6	(Jan 09)	0.73	(Jan 09)
Cambodia	−3.9	(Apr 09)	−1.7	−6.6	(4Q07)	16.1	5.8	26.8	8.8	(Feb 09)	98.8	(Mar 09)	0.97	(Mar 09)
China, People's Rep. of	−1.4	(May 09)	−0.4	9.7	(2H08)	4.0	5.4	—	22.4	(Mar 09)	22.5	(Apr 09)	0.71	(Apr 09)
Hong Kong, China	0.1	(May 09)	0.1	10.7	(1Q09)	173.9	57.7	1.3	6.4	(Apr 09)	63.0	(Mar 09)	0.44	(Mar 09)
Indonesia	3.7	(Jun 09)	0.0	1.6	(1Q09)	20.7	57.5	31.2	7.1	(Apr 09)	53.3	(Apr 09)	0.77	(Apr 09)
Korea, Republic of	2.0	(Jun 09)	1.2	5.1	(1Q09)	26.4	59.6	29.1	6.6	(Apr 09)	185.2	(Feb 09)	1.35	(Feb 09)
Lao PDR	3.2	(Dec 08)	−1.7	2.6	(2007)	46.5	30.3	53.3	3.4	(May 08)	31.6	(Apr 08)	0.35	(Apr 08)
Malaysia	2.4	(May 09)	−4.8	20.2	(1Q09)	27.0	29.1	41.4	7.6	(Apr 09)	124.2	(Apr 09)	0.92	(Apr 09)
Myanmar	12.7	(Feb 09)	—	5.5	(2006)	9.3	55.0	—	4.6	(Jun 07)	—		0.43	(Dec 08)
Philippines	1.5	(Jun 09)	−0.9	5.9	(1Q09)	36.0	28.1	63.6	8.4	(Apr 09)	54.6	(Apr 09)	0.81	(May 09)
Singapore	−0.3	(May 09)	6.5	10.2	(1Q09)	276.2	68.8	99.2	6.8	(Mar 09)	86.7	(Apr 09)	0.81	(Mar 09)
Taipei,China	−2.0	(Jun 09)	−1.4	14.6	(1Q09)	16.2	9.5	31.6	20.4	(Jun 09)	54.4	(Apr 09)	0.69	(May 09)
Thailand	−4.0	(Jun 09)	−0.3	14.8	(1Q09)	11.9	10.3	38.1	9.3	(May 09)	51.3	(Apr 09)	0.94	(Apr 09)
Viet Nam	3.9	(Jun 09)	−4.5	−19.2	(4Q07)	31.4	20.2	44.4	3.8	(Feb 09)	75.6	(Feb 09)	0.98	(Feb 09)

Source: ADB

Soundness of the Asia banking system

Bank Nonperforming Loans to Total Loans, 2003–2009

	2003	2004	2005	2006	2007	2008	2009	Latest
Asia								
Bangladesh	22.1	17.5	13.2	12.8	14.5	11.2	. . .	June
China[25]	20.4	13.2	8.6	7.1	6.2	2.4	1.8	June
Hong Kong SAR[26]	3.9	2.3	1.4	1.1	0.8	0.9	. . .	June
India[27]	8.8	7.2	5.2	3.3	2.5	2.3	. . .	March
Indonesia[28]	6.8	4.5	7.6	6.1	4.1	3.2	4.1	April
Korea[29]	2.6	1.9	1.2	0.8	0.7	1.1	1.5	March
Malaysia	13.9	11.7	9.6	8.5	6.5	4.8	4.6	April
Philippines[30]	16.1	14.4	10.3	7.5	5.8	4.5	4.7	March
Singapore	6.7	5.0	3.8	2.8	1.5	1.4	. . .	September
Thailand	13.5	11.9	9.1	8.4	7.9	5.7	. . .	December

Source: IMF

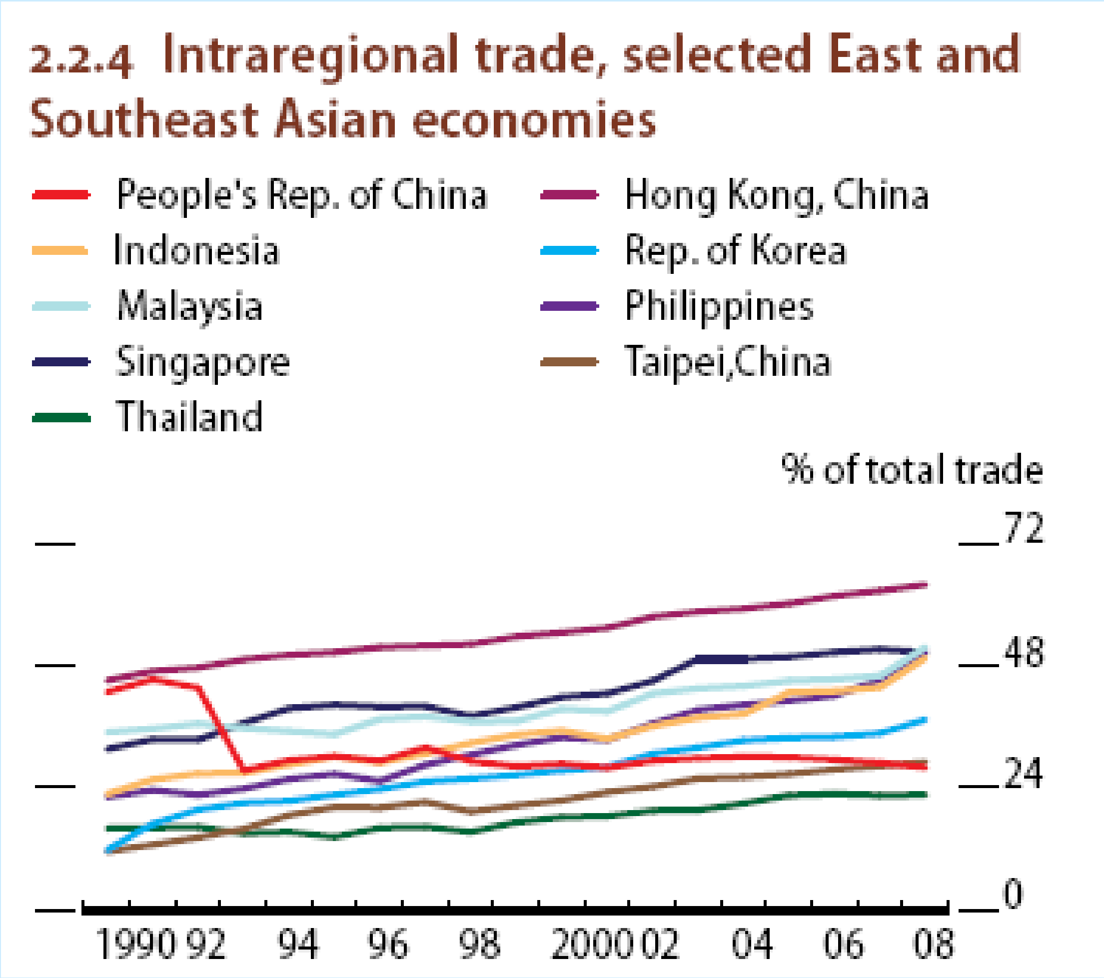
More flexible exchange rate regimes

ASEM Countries De Facto Classification of Exchange Rate Regimes, 2008

	Exchange Rate Arrangement			**Exchange Rate Anchor**			
	Managed Float	Fixed Peg	Floating	Currency Board	US dollar	Composite	Inflation Targeting
Brunei				X			
Cambodia	X				X		
Indonesia	X						X
Lao PDR	X				X		
Malaysia	X						
Myanmar	X				X		
Philippines			X				X
Singapore	X					X	
Thailand	X						X
Vietnam		X					
China					X		
Japan			X				
Korea			X				X
India	X						
Mongolia		X			X		
Pakistan	X				X		

Source: De Facto Classification of Exchange Rate Regimes and Monetary Policy Frameworks, as of April 13, 2008. Washington, DC, April 2009.

Significant increases in intra-regional trade



Source: ADB

Room for expansionary policies

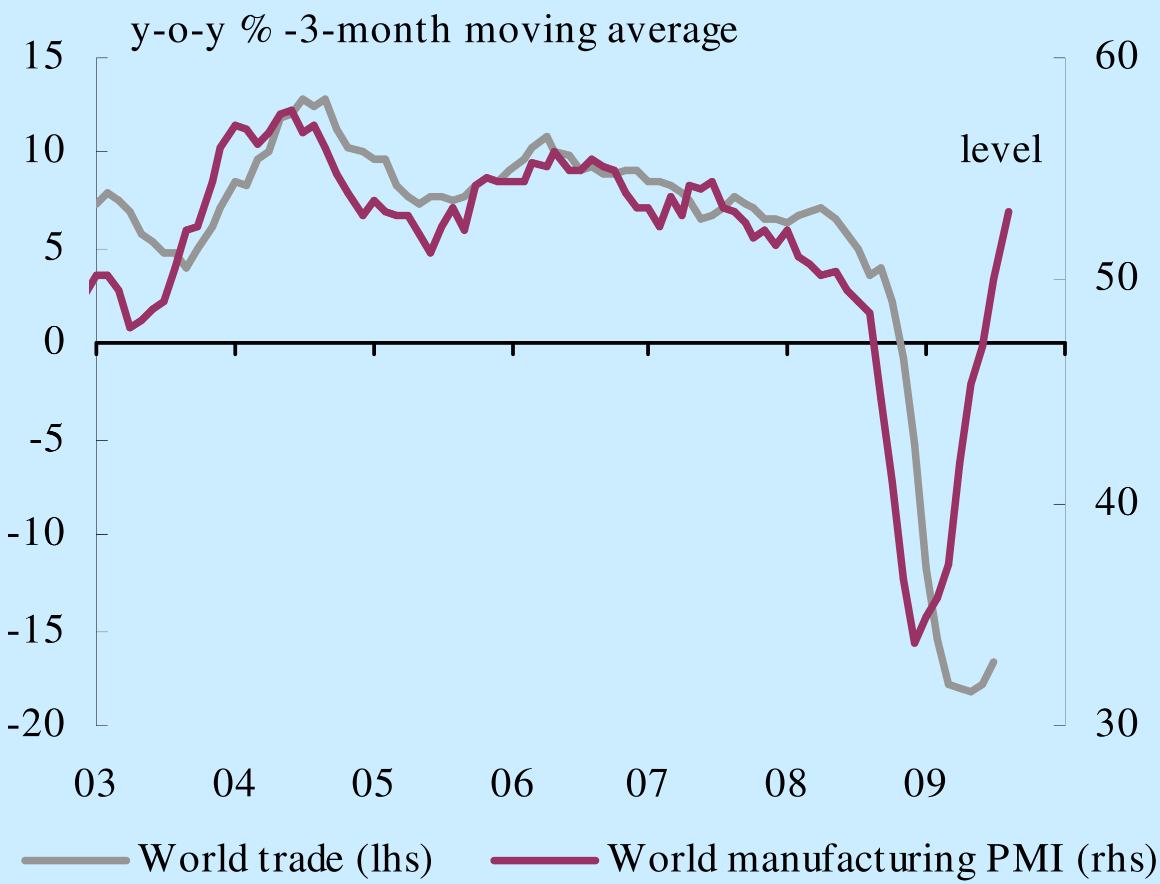
Table 4: Fiscal Balance of Central Government (% of GDP)

	2000–2004 Average	2004	2005	2006	2007	2008	2009[6]
Cambodia[1]	-5.3	-4.5	-2.5	-2.7	-2.9	-1.7	-3.2
China, People's Rep. of[1]	-2.2	-1.3	-1.2	-0.8	0.6	-0.4	-3.0
Hong Kong, China[4]	-2.4	1.6	1.0	3.9	7.5	0.1	-3.9
Indonesia	-1.2	-1.1	-0.2	-0.9	-1.2	0.0	-2.5
Korea, Rep. of[5]	1.5	0.7	0.4	0.4	3.8	1.2	-2.2
Malaysia[2]	-5.0	-4.1	-3.6	-3.3	-3.2	-4.8	-7.6
Philippines	-4.4	-3.8	-2.7	-1.1	-0.2	-0.9	-3.2
Singapore[1,4]	7.0	6.9	9.0	8.3	13.9	6.5	-3.5
Taipei,China[1]	-3.3	-2.4	-1.6	-0.7	-0.4	-1.4	-3.6
Thailand[4]	-0.4	0.3	0.2	0.1	-1.1	-0.3	-3.5
Viet Nam[3]	-4.5	-4.9	-4.9	-5.0	-4.9	-4.5	-4.8

Source: ADB

Why Asia did not decouple

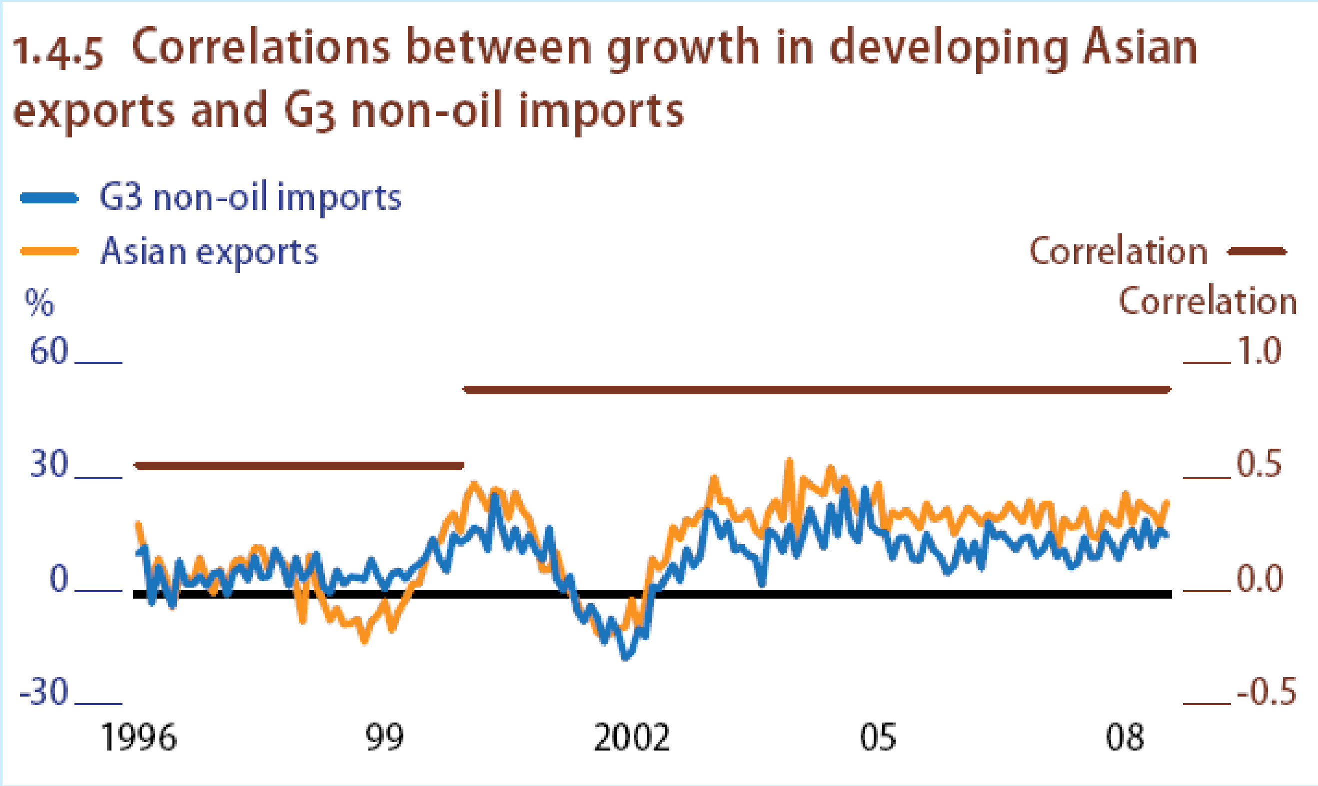
Main reason: collapse in world trade



Source: Commission services

Why Asia did not decouple

In addition, a large-part of intra-Asian trade reflects intra-Asian production fragmentation…and as much as 60% of East Asia's exports are ultimately destined for advanced economies



Source: ADB

Why Asia did not decouple

Therefore Asia's exposure to the economic cycle in the EU and US remains large

Foreign Income, Financial Indicator and World Trade Elasticities of Asian Economies

Country or Grouping	Global Regions	Foreign Income Elasticity		Commodity Terms of Trade		Foreign (US-EU) Import Demand		Asian Private Capital Flows	
		Short-Term	Long-Term	Short-Term	Long-Term	Short-Term	Long-Term	Short-Term	Long-Term
ASEAN	US plus EU	0.40	1.00	0.11	0.28	0.39	0.63	0.40	1.25
China	US plus EU	0.18	1.41	0.15	0.83	-	-	0.01	0.05
Other ASEM	US plus EU	0.12	1.00	0.09	0.33	0.16	0.17	0.01	0.08

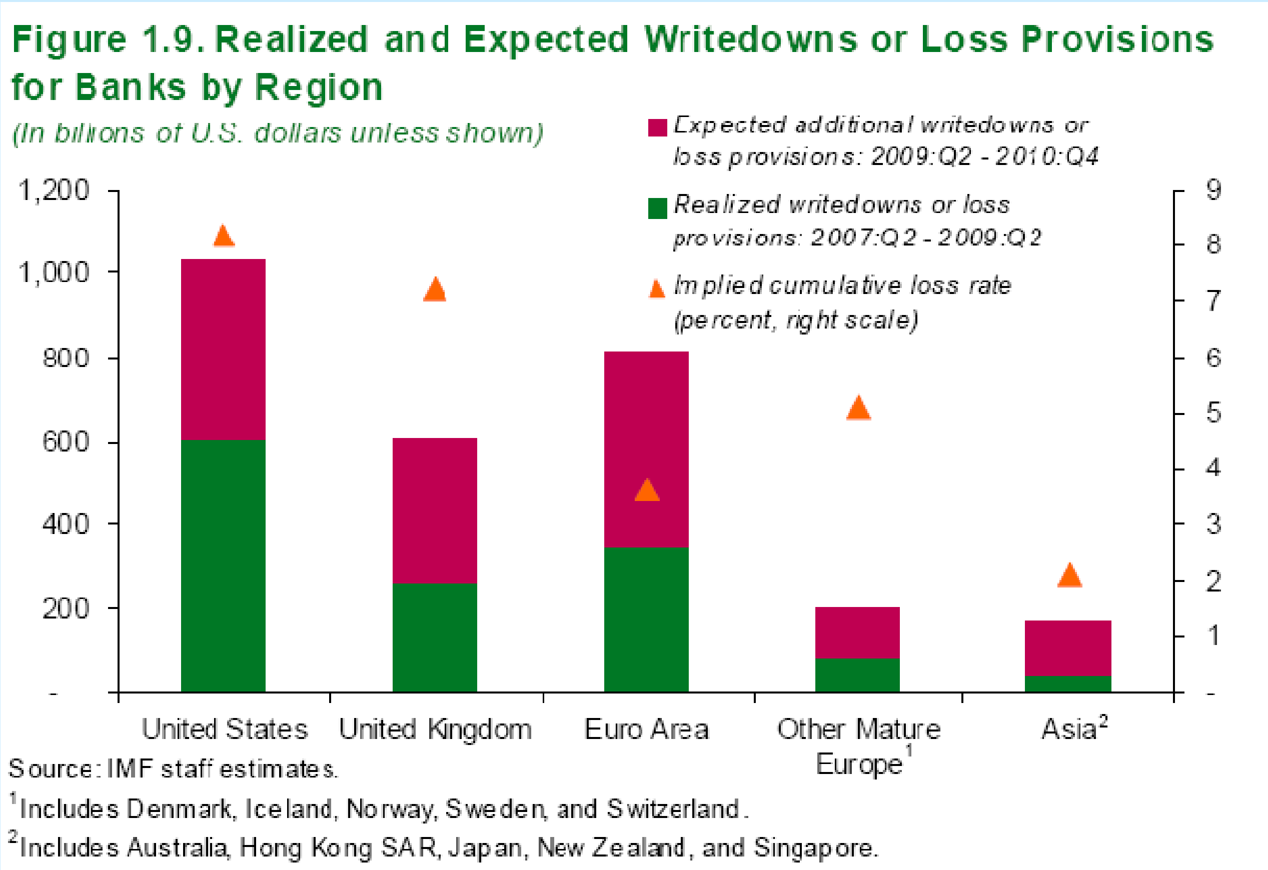
Notes:

1. Foreign Income Elasticity: Measures the percentage change in real GDP of each country or grouping brought about by a 1 percent change in the real GDP growth of the United States and the European Union.
2. Commodity Terms of Trade: Measures the percentage change in brought about by a 1 percent change in the relative prices of non-fuel commodities to manufactures.
3. Foreign Import Demand Elasticity: Measures the percentage change in real GDP of each country or grouping brought about by a 1 percent change in the volume of imports of the United States and the European Union.
4. Asia Private Capital Flows Elasticity: Measures the percentage change in real GDP of each country or grouping brought about by a 1 percent change in the net private capital flows of the developing Asian economies. Net private capital flows comprise net direct investment, net portfolio flows, and other long- and short-term net investment flows including official and private borrowing.

Source: Lord (2009)

Why Asia did not decouple

Even if the conservative strategy of Asian banks has sheltered the region from the worst of the financial contagion



Source: IMF

Why Asia did not decouple

Asian financial market integration is still at an early stage. US and, to a lesser extent, EU markets have a leading impact

Table 3.6: Asia, US and EU Stock Market Developments, 2000 to mid-2009

	United States	Europe	Asia		
	S&P500	FTSE 100	Hang Seng	NIKKEI	KLSE
Correlation with S&P 500	1.00	0.95	0.72	0.91	0.58
Average Monthly Change (+ or -)	5.1%	9.5%	8.4%	3.2%	13.5%
Volatility Index	16.4%	15.0%	23.7%	20.9%	18.0%

Note: The Black-Scholes index of volatility is calculated as the standard deviation of the natural log of price changes, adjusted by the square root of the number of months in the sample.

Source: Lord (2009)

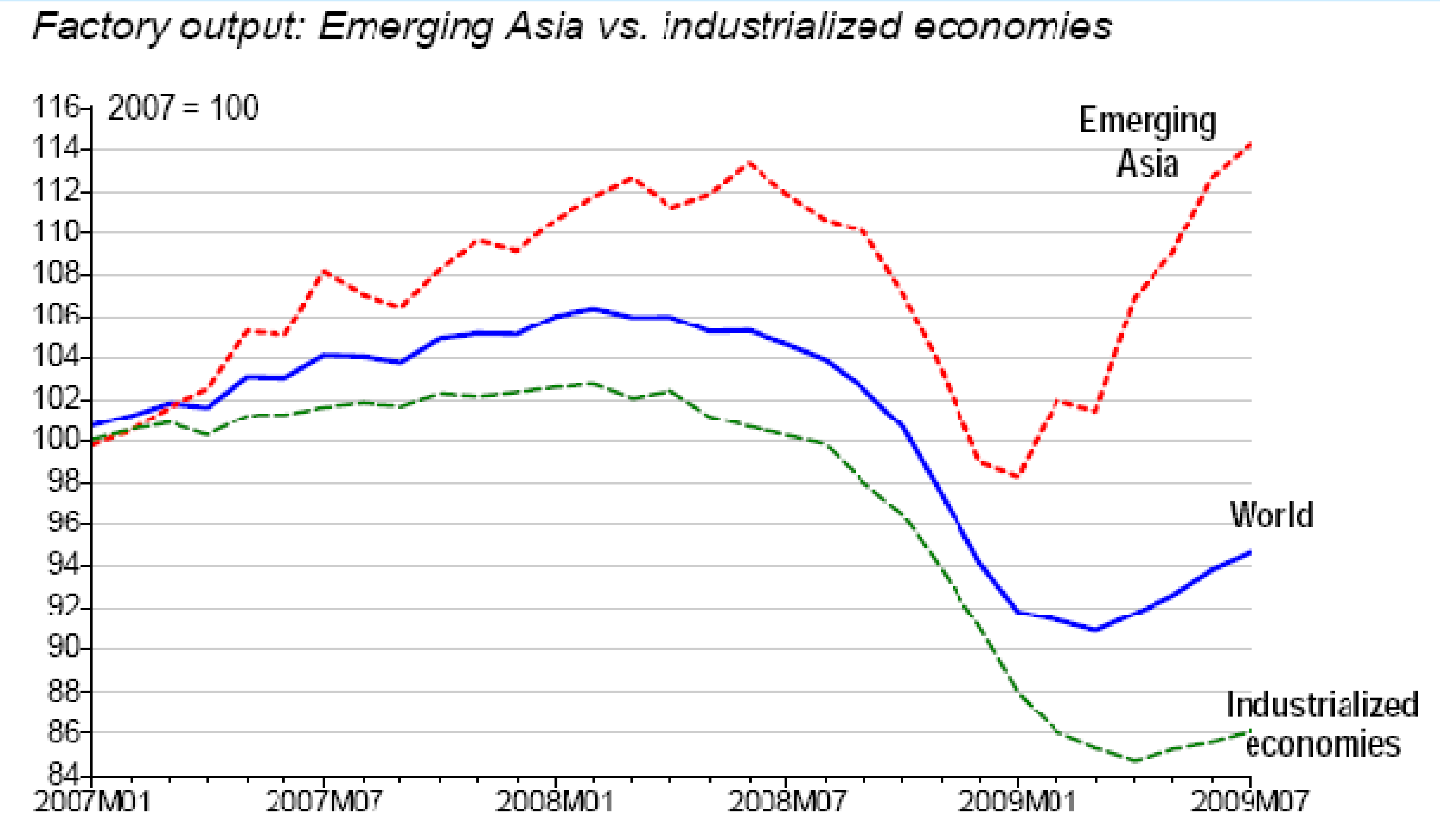
In the end, Asia did not decouple; nevertheless it weathered the storm relatively well

GDP growth, IMF forecast October

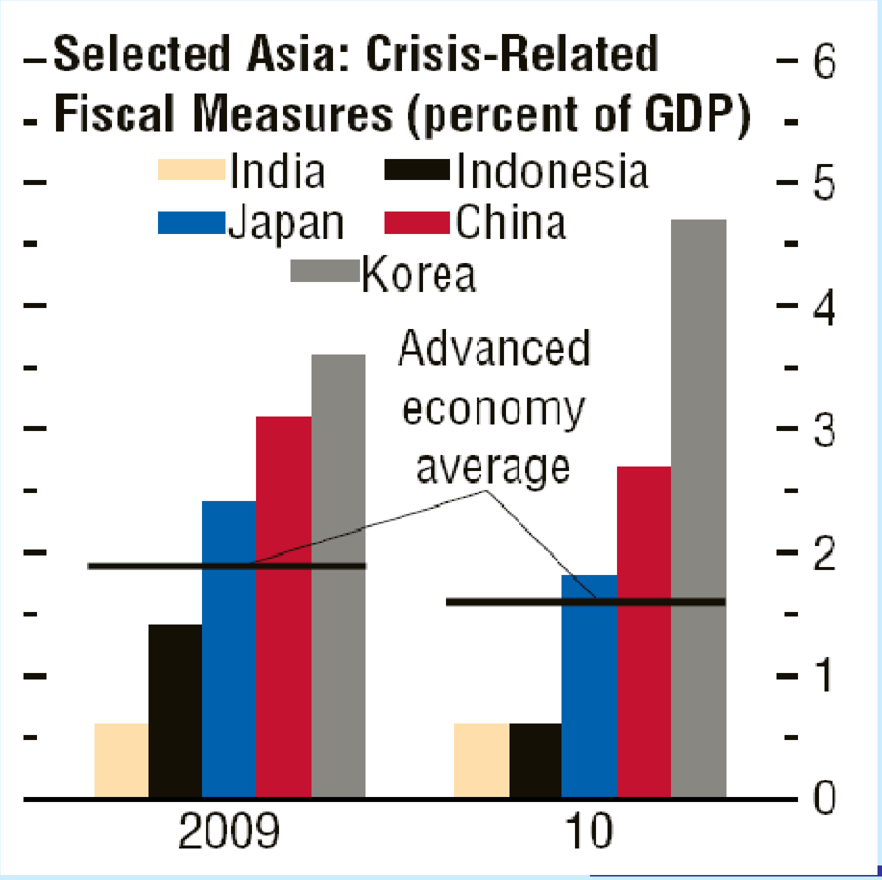
	2008	*2009*	*2010*
United States	0.4	-2.7	1.5
Euro Area	0.7	-4.2	0.3
Japan	-0.7	-5.4	1.7
China	9.0	8.5	9.0
ASEAN-5	4.8	0.7	4.0
Korea	2.2	-1.0	3.6
India	7.3	5.4	6.4

Source: IMF

In fact, industrial production is above pre-crisis levels



Policy response was strong, timely and effective to counter the cyclical downturn



Source: IMF

Can Asia decouple?

Pre-requisites:

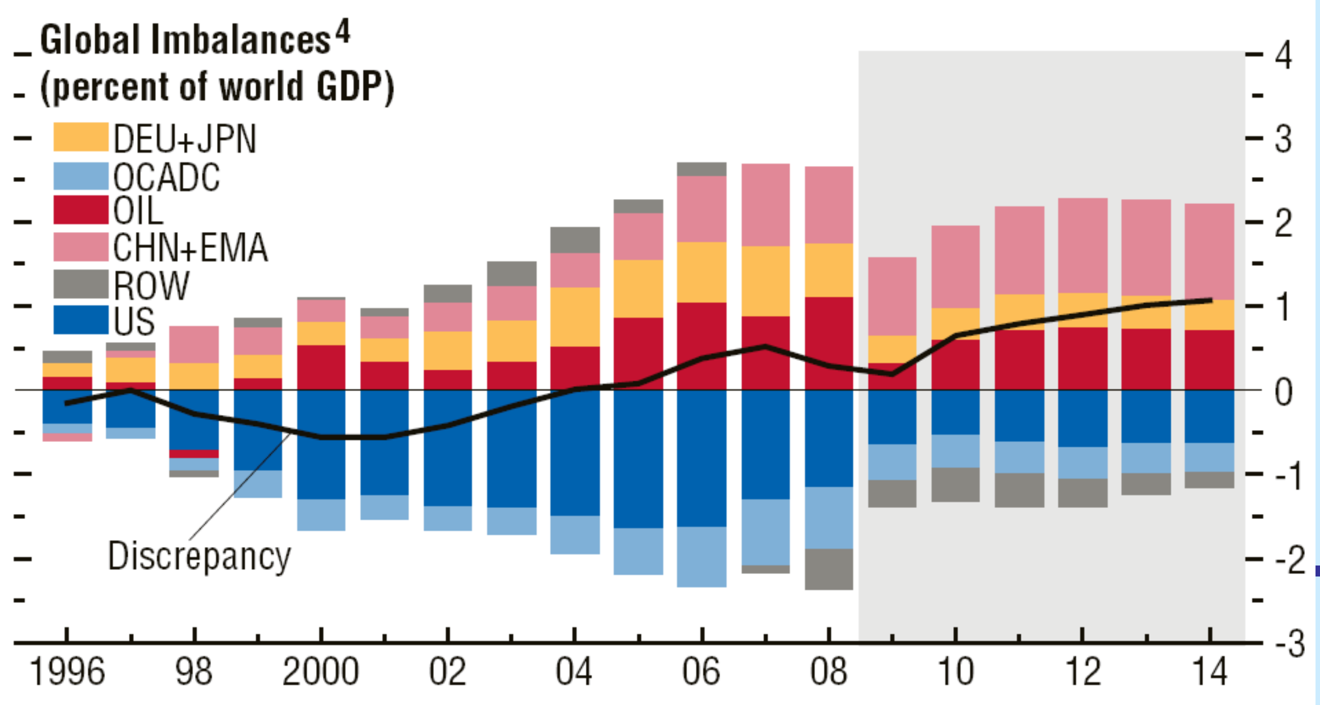
- Intra-regional trade should not be driven mainly by the Asian supply chain
- Intra-regional barriers to trade should be removed
- Move to more domestic-demand led growth regimes
- Allow for exchange rate adjustments, in particular for countries with large current account surpluses
- In parallel with financial globalisation, proceed with the integration of regional financial markets. Need for Asian "leading markets"
- Last but not least, establish mechanisms for surveillance, peer review and coordinated interventions (e.g. expanding and deepening of Chiang Mai)

Should Asia decouple?

- Should Asian countries' policies aim at making the region less dependent on the rest of the world?
- Not necessarily, but…
- … a global growth model based on large imbalances between the largest economies is not viable
- No need to have the largest regional blocs with their external position balanced …
- … but they should not carry permanently large surpluses or deficits
- This means that the Asian growth model should become more domestic demand oriented (as a region), and rely less on export to the EU and the US. Exchange rate adjustments are needed.

Should Asia decouple?

- Conservative banking strategies helped Asian countries to avoid the worst of the financial contagion, but the *status quo* will not strengthen the resilience of the Asian economies in the future. Need of leading regional (or even global) market leaders.
- If nothing changes new large external imbalances risk to undermine the recovery under way



Source: IMF

Conclusions

- For Asia, decoupling should not be an end in itself, but it could become, depending on the nature of the shock, one of the outcomes of a growth rebalancing process
- Rebalancing is needed to make Asian economies sounder and more resilient and to contribute to world economic stability
- In a post-growth crisis Asian countries will be called to play a key role in the management of the global economy. The rise of the G20 as the premier forum for international economic cooperation well reflects this radical change

Conclusions

- The adjustment will require major policy changes, including with regard to exchange rate regimes
- Structural reforms to boost consumption, reduce excessive precautionary savings, cut excessive capacity creation in the manufacturing sector and boost the still underdeveloped service sector will be key to a successful rebalancing of growth
- As the European experience shows, stronger coordination of economic policies at regional level may make this task easier