

Sense and nonsense about Asia's export dependency and the decoupling thesis

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It has often been argued that East Asia should switch from an export-led growth model to a domestic-demand-led growth model so as to reduce its vulnerability to a sharp slowdown in the US economy. This paper shows that in the foreseeable future, East Asia's business cycle is unlikely to decouple from that of the US; and the switch-of-growth-model argument is problematic because it confuses the effects of external trade on an economy's cyclical developments and its long-term growth potential.

The paper concludes that the desirable way to reduce external vulnerabilities is to diversify export markets and strengthen domestic institutions and policies to reduce the impact of temporary shocks, not by reducing the degree of openness or the share of exports in GDP. It is expected that the rising size of domestic demand in Mainland China will, over time, help the rest of the region diversify its export markets away from the major industrialised countries.

The meaning of trade dependency

A common argument is that East Asia has been too dependent on exports and needs to adopt a domestic-demand-led growth model. This argument reflects a number of observations or concerns: first, East Asia's growth was significantly affected by the bursting of the information technology (IT) bubble that led to a sharp slowdown in US growth in 2001. Similarly, the region may be vulnerable today to a possible sharp slowdown in US growth led by a potential housing market crash. Secondly, rapid export growth in Mainland China has been viewed as an expression of the region's mercantilist habits that reflect chronic weaknesses in domestic demand; and, thirdly, East Asia has been accumulating large trade surpluses in recent years, which are also taken as a sign of trade dependency.

However, this line of argument is problematic because it mixes up the effects of external trade on an economy's cyclical developments and its long-term growth potential. From a longer-term perspective, it is technological progress and not demand that creates growth. When a country is open to international trade and its exports compete on world markets, it is forced to adopt the most recent production and management techniques. Such openness is likely to support technical progress. Indeed, it is this supply-side consideration of the benefits of trade that is behind the Export-Led Growth Hypothesis (ELGH), which sees export expansion as one of the main determinants of growth through technological spillovers and other positive externalities. This hypothesis predicts that export growth should lead to economy-wide productivity gains. On the other hand, inward-looking

development strategies are likely to fail as demonstrated in many countries, especially in Latin America. Also, an export-oriented growth strategy is not one that will hurt other countries. Trade is a positive sum game, where it is possible for everyone to pursue export-oriented growth strategies. This is the essence of the export-led growth model, which has been regarded as the fundamental reason for the Asian growth “miracle”. However, the export-led growth model does not necessarily imply the existence of either a trade surplus or a trade deficit, and certainly does not promote trade surpluses. In fact, it does not have anything to say about the structure of the demand side of the economy.

In contrast, the concept of a domestic-demand-led growth model is not well defined. From a cyclical or demand-side perspective, the contribution of various expenditure components of GDP to its growth, at best summarises short-run economic conditions. It can vary greatly from quarter to quarter and from year to year. Such variation does not have any

predictable relationship with the structure of an economy because the conventional measure of the contribution to growth is purely an accounting relationship, suggesting no causal relationships or theoretical underpinning.¹ Based on such a decomposition, net exports may well be the main contributor to GDP growth for a large and relatively closed economy like the US in a particular quarter, while domestic demand is the main contributor in a small and open economy like Hong Kong. As shown in Charts 1 and 2, the relative contribution of domestic demand and external demand to GDP growth in the selected East Asian and European economies varies greatly from year to year, with no particular relationship to the size or openness of the economies. There is also no necessary relationship between surpluses in the balance of trade and the contribution of exports to economic growth. It is the change in net exports that contributes to an economy's growth, not its size or whether it is positive or negative.²

¹ From the national income identity we can write $\frac{\Delta y}{y} = \frac{\Delta(c+i+g)}{y} + \frac{\Delta(ex-im)}{y}$ where y refers to real GDP, Δy to the change in real GDP, $\Delta(c+i+g)$ to the change in domestic demand, and $\Delta(ex-im)$ to the change in net exports. The contribution of domestic demand is the first term on the right hand side of the above equality, while the contribution of net exports is given by the second term.

² The 1998 data for Hong Kong offer a telling example why the contribution of net exports to growth must be interpreted with care. During that year, net exports in Hong Kong contributed a particularly large share to growth even though (gross) exports declined substantially relative to the previous year. The reason for the positive contribution of net exports to growth was the collapse in imports which led to an improvement in the balance of trade.

CHART 1

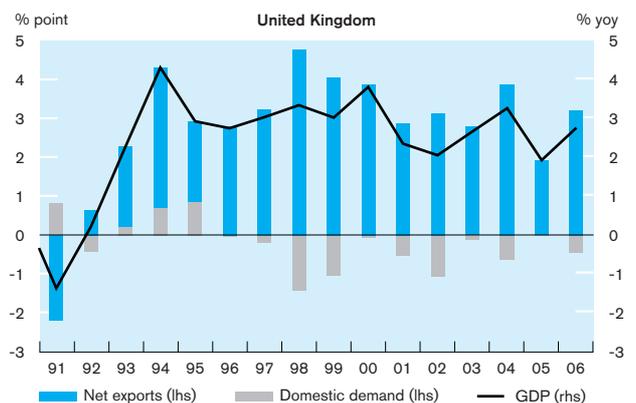
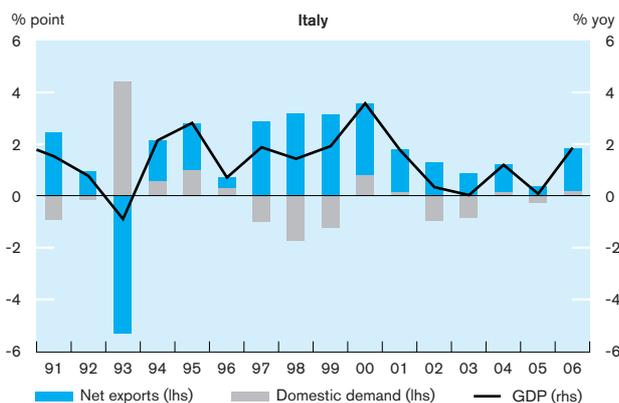
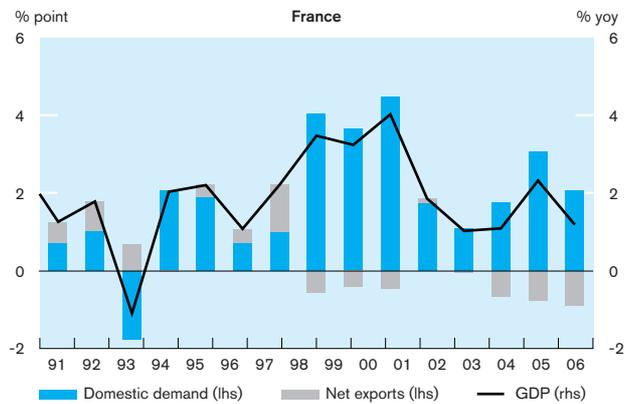
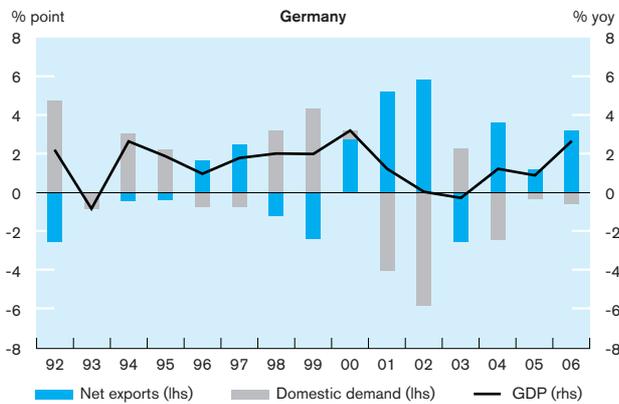
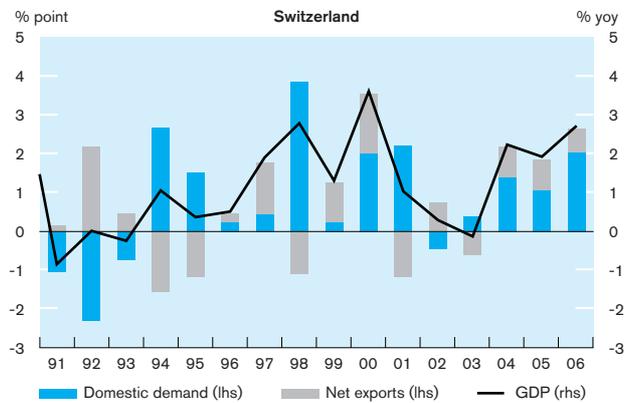
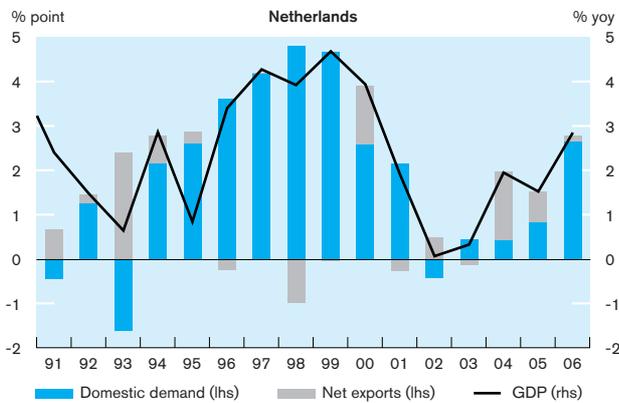
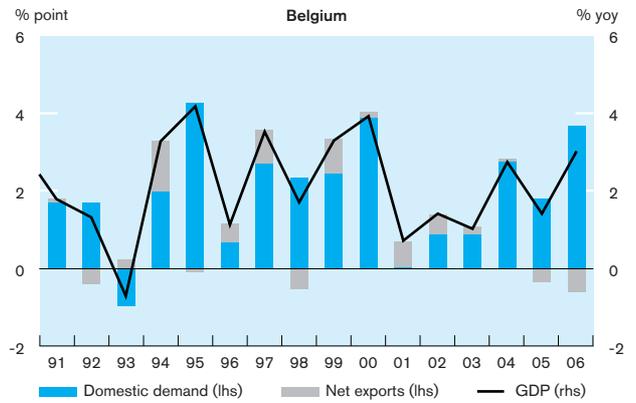
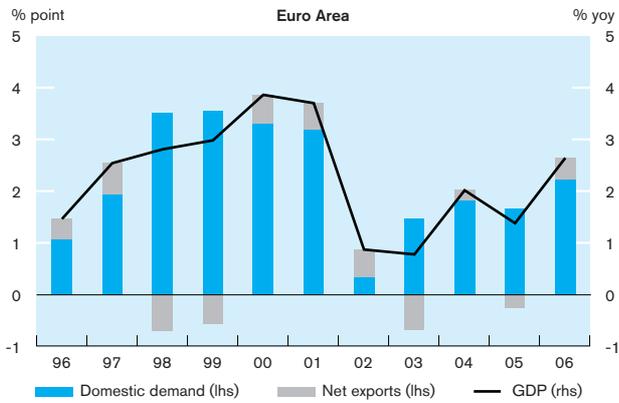
Contribution to growth by domestic demand and net exports in selected East Asian economies



Source: CEIC

CHART 2

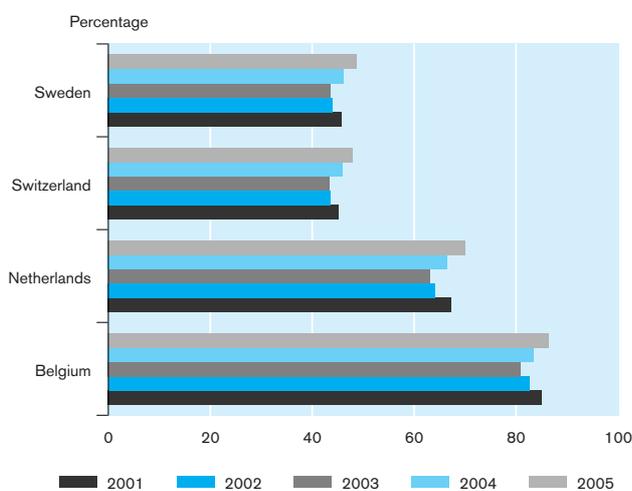
Contribution to growth by domestic demand and net exports in selected European economies



Sources: Eurostat and CEIC.

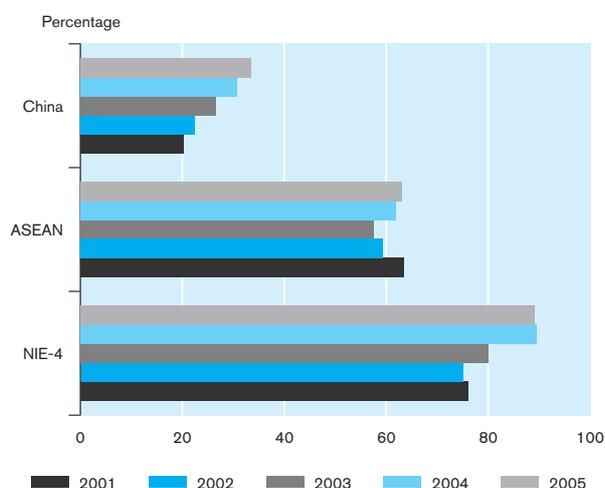
Cross-region comparison of growth experiences also indicates that there is no particular relationship between an economy's exposure to external demand and the level of development. In other words, as economies grow and become richer, they do not necessarily reduce or increase their reliance on external demand. Experience in Europe suggests continued dependence on exports and hence on the world's largest market even as the economies mature. This is particularly true for small open economies, such as Switzerland, Belgium, the Netherlands and Sweden. Chart 3 shows that the share of exports in GDP in these small European economies actually increased over time and has remained high at around 50% to 80%, compared with an average of 80% in East Asia (excluding China) (Chart 4).

CHART 3
Share of exports in GDP in small European economies



Sources: CEIC and Bloomberg.

CHART 4
Share of exports in GDP in East Asian economies*



* Figures for China are based on merchandise exports only. Sources: CEIC.

A domestic-demand-led growth model is sometimes taken to imply that domestic demand grows faster than GDP. While this is feasible, or even beneficial for some economies at certain cyclical junctures, such a growth pattern would be problematic in a longer-term perspective. If an economy's domestic demand consistently grows faster than its GDP, that economy faces an unsustainable path of expanding trade deficits. This was clearly demonstrated in the growth patterns of Korea, the Philippines and Thailand in the 1990s, which over-emphasised expansionary tendencies in domestic demand in the private sector at the expense of net exports³. The resulting decline in the growth of their productive capacity after the financial crisis was a harmful consequence of their strategy, which reversed the healthy balance and the desirable progression of both domestic demand and the tradeable sectors achieved in the second half of the 1980s.

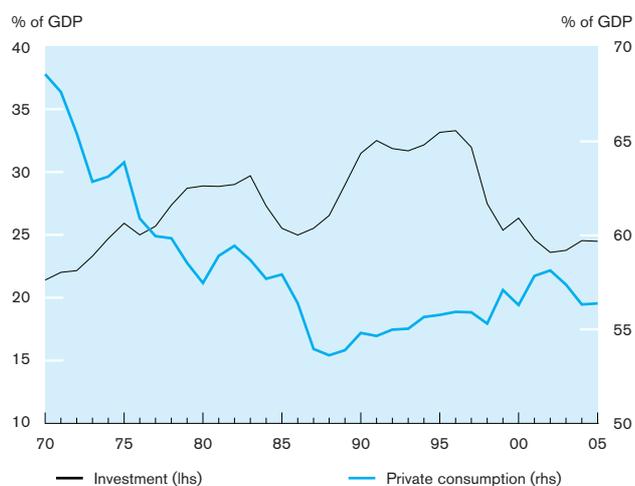
However, to argue against a domestic-demand-led growth model is not to argue against the need to strengthen domestic demand from a cyclical perspective. The region's share of private consumption as a percentage of GDP has been

³ Asian Development Bank (2005), 'Export or Domestic Demand-Led Growth in Developing Asia?', *Asian Development Outlook 2005*, pp. 40-62.

declining since the 1970s, while the share of investment in GDP (excluding Mainland China) has also fallen considerably following the 1997-98 crisis (Chart 5). Continued sound macroeconomic policies, along with microeconomic policies aimed at addressing structural sources of risk are needed to help improve the investment environment and support capital spending. Strengthening domestic demand can be achieved at the same time as an economy succeeds in developing and improving its export sector, and growth in both sectors can be complementary and mutually reinforcing particularly with advances in technology. As such, the region's export-oriented growth model does not conflict with its efforts to strengthen domestic demand. Therefore, strengthening domestic demand does not require abandoning the export-led growth strategy.

CHART 5

Asia's private consumption and investment shares in GDP



Sources: World Bank World Development Indicators 2006, IMF World Economic Outlook database and CEIC.

Cyclical implications of trade dependency

Although competing in international markets allows countries to benefit from economies of scale and facilitates technical progress, a large share of exports in aggregate demand does make them susceptible to cyclical fluctuations in the external environment. Substantial exposure to external demand and strong trade relationships affect cross-country synchronisation of business cycles. Recent empirical work supports the view that developments in the US economy have a strong influence on Asian economies, and Mainland China has been a less important source of external shocks than is commonly thought.⁴ An earlier study by the HKMA also suggests that over the medium to long term, about 60% and 45% of variations in output and prices in Hong Kong can be attributable to US shocks. Any business cycle co-movements between Hong Kong and the Mainland are largely due to the common influence of economic conditions in the US and possibly their US dollar pegged exchange rate systems.⁵

Table 1 shows that not only are Asian business cycles highly synchronised with those in the US, but this is also the case with Europe, particularly for small economies like Switzerland and Belgium. The close correlation of business cycles of advanced economies with the US might reflect both their trade linkages and financial linkages, as economies have become more integrated with globalisation.

⁴ Genberg, Hans (2005), 'External shocks, transmission mechanisms and deflation in Asia,' *HKIMR Working Paper* No. 6/2005, April.

⁵ Genberg, Hans, Li-gang Liu and Xiangrong Jin (2006), 'Hong Kong Economic Integration and Business Cycle Synchronisation with Mainland China and the US,' *Research Memorandum* 11/2006.

TABLE 1

Business cycle synchronisation of Asia and Europe with the US¹

	Correlation of real GDP growth ²		Correlation of the cyclical component of real GDP ³			
			Hodrik-Prescott filtered		Band-Pass filtered	
	1991-96	2000-05	1991-96	2000-05	1991-96	2000-03
China	0.52	0.60	0.44	0.75	0.74	0.93
Hong Kong	0.03	0.88	0.40	0.89	0.30	0.95
Malaysia	-0.28	0.87	-0.38	0.84	-0.69	0.95
The Philippines	0.59	0.77	-0.30	0.60	-0.28	0.85
Singapore	0.23	0.83	-0.04	0.87	0.21	0.93
Taiwan	-0.08	0.80	0.50	0.82	0.67	0.88
EU12 ⁴	0.31	0.48	n.a.	0.59	n.a.	0.81
Germany	0.35	0.49	-0.02	0.49	0.15	0.75
Belgium	-0.02	0.65	-0.56	0.83	-0.56	0.93
Netherlands	-0.02	0.44	-0.63	0.64	-0.61	0.81
Switzerland	0.45	0.70	-0.31	0.74	-0.32	0.85

¹ All data used are in quarterly frequency.

² Year-on-year growth rates.

³ The B-P filter removes low-frequency trend variation and smooths high-frequency irregular variation, while retaining the major features of business cycles. On the other hand, the H-P filter removes the trend variation.

⁴ Data start from 1995.

Sources: CEIC, Bloomberg and staff estimates.

However, the desirable way to reduce vulnerabilities to external shocks is to diversify export markets, strengthen domestic institutions and implement sound macroeconomic policies, not by reducing the degree of openness. Improved fundamentals provide Asian economies with more scope for policy adjustments, which should make them less

vulnerable to external shocks than before (Table 2). With lower fiscal deficits, and sounder and more developed financial systems, Asian governments will have more room for policy manoeuvring to support domestic demand in response to a slowdown in growth.

TABLE 2

Improved fundamentals of the Asian economies¹

	Real GDP growth	Fiscal balance ²	Current account balance	Short-term external debt Q3 06 (% of foreign reserves)	Foreign reserves Q3 06 (US\$ bn)	Banking sector NPLs Q4 06 (% of total loans)	Credit rating (S&P)
	% yoy	(% of GDP)	(% of GDP)				
Hong Kong	6.8	1.0	11.5	n.a.	133.2	1.1	AA
Korea	5.0	0.4	0.7	47.0	228.2	0.7	A
Singapore	7.9	0.6	27.5	n.a.	128.9	3.9	AAA
Taiwan	4.6	-1.2	7.1	17.1	261.6	2.2	AA-
Indonesia	5.5	-0.5	2.6	47.9	42.6	8.1	BB-
Malaysia	5.9	-3.5	17.1	28.9	79.5	4.8	A-
Philippines	5.4	-1.0	4.3	54.2	21.6	6.1	BB-
Thailand	5.0	3.2	1.5	25.6	61.6	4.2	BBB+

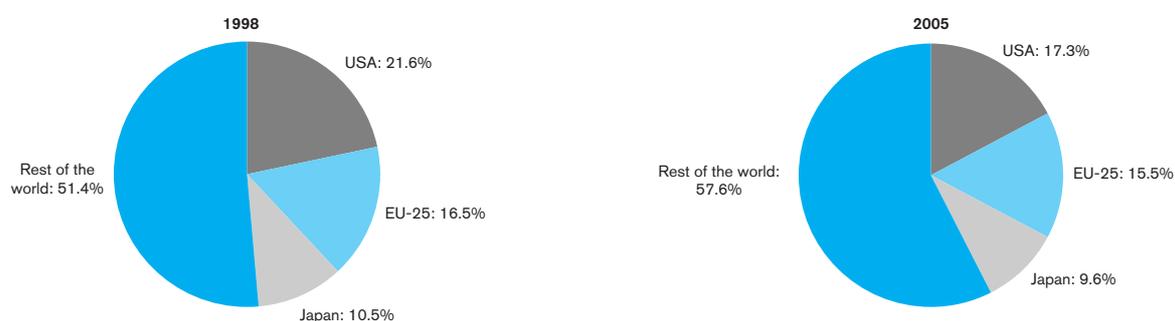
¹ All data are for 2006 or the latest estimates except otherwise stated.

² Year 2005 data for Hong Kong and Indonesia.

Sources: Bloomberg, CEIC and staff estimates.

CHART 6

Share of Asian exports by market



Sources: Direction of Trade Statistics and CEIC.

Nevertheless, policy adjustments are likely to provide only temporary respite to shocks from the US. An enduring offset to the underlying correlation of business cycles in the region with those in the US will require a significant change in the underlying economic structure. Because of this, the next section examines the likelihood of this decoupling thesis by focusing on the underlying correlation between growth in Asia and the US.

Does Asia fulfil the conditions for decoupling?

For the East Asian economies to decouple structurally from the US, they must satisfy three conditions. First, they need to have export markets that are sufficiently more diversified than before. Secondly, they must have policy autonomy, that is, the ability to establish independent settings for monetary policy. Finally, their financial markets have to be sufficiently uncorrelated with those in the US.

Are Asian exporters diversifying sufficiently?

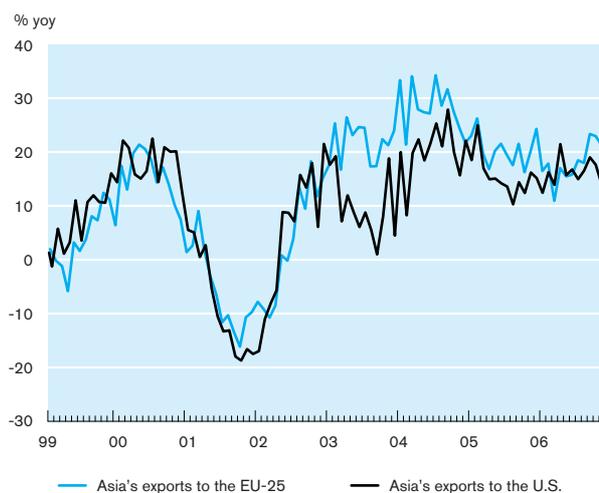
Trade links are important transmission channels for shocks from the US to the rest of the world. Asian economies can be affected directly by a slowdown in US demand through lower exports to the US. However, Asian exports to the US, as a share of total exports, have fallen, and the European Union (EU) and Japan are now becoming more important relative

to the US in supporting the demand for the region's exports (Chart 6).

Nevertheless, the US has remained the largest single export market for Asia. And, as previously discussed, Europe's business cycle is still highly correlated with that in the US, as indicated in Table 1. In fact, Europe also went into a slump when the US IT downturn hit in 2001, with the result that Asian exports to Europe fell as fast as those to the US (Chart 7).

CHART 7

Growth in Asian exports to the US and EU



Sources: Direction of Trade Statistics and CEIC.

At the same time, Japan's recovery is by no means complete. Much of the upturn in corporate earnings

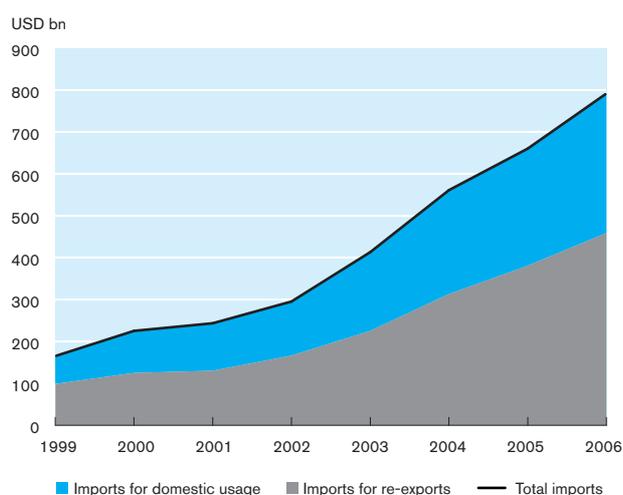
and fixed capital investment is concentrated in export-oriented manufacturing industries, while the domestic property market has still to revive in full. More importantly, Japan's ageing population and shrinking labour force mean that real growth rates will remain relatively modest over the medium term. Therefore, the recovery in Japan is not likely to offset a significant slowdown in the US anytime soon.

The major focus of the decoupling thesis is that Mainland China is the new centre of demand in Asia that would enable the region's growth to decouple from the US. The emergence of China has reshaped the pattern of regional trade flows, with manufacturing increasingly moving to the Mainland from elsewhere in the region. As a result, Mainland China has overtaken Japan as Asia's main regional export partner.

However, while total imports from the region to the Mainland have been growing strongly in the past few years, much of these imports are in processing-related goods that are exported through the Mainland to the rest of the world. These imports have been taking as important a share in the Mainland's total imports as those for domestic usage⁶ (Chart 8).

CHART 8

Mainland's imports by usage



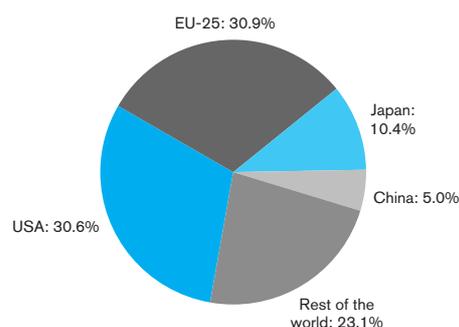
Source: CEIC.

⁶ Imports for domestic usage are proxied by the ordinary trade component of the imports statistics (by definition, this excludes imports that are processed and re-exported) and imports for re-exports are the residual of total imports minus ordinary imports.

The Mainland's domestic demand still lacks the scale to take the driver's seat of demand growth in the region as a whole. Although Mainland China has become the fourth largest economy at current exchange rates, it accounted for only about 5% of world demand in 2005 (Chart 9). Over the past five years, consumption in the Mainland grew at an average annual rate of around 7% in real terms. This represents much faster growth than the major economies, but it has not kept pace with the Mainland's GDP growth. Reflecting this, total consumption fell to 52% of GDP in 2005, from 62% in 1990 (Chart 10) – well below the consumption shares of 70-85% in major economies.⁷

CHART 9

Mainland's share in world demand



Sources: World Bank, Global Economic Prospects 2007 and CEIC.

CHART 10

Mainland's consumption share in GDP

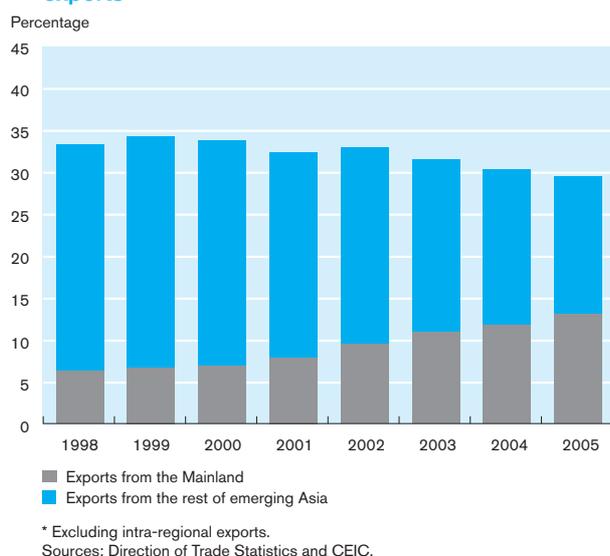


Source: China Statistical Yearbook 2005.

⁷ Even if consumption in the Mainland were to increase to 70% of GDP, the Mainland's share of world demand would only increase to 6%.

The Asian economies' growing processing trade with the Mainland also means the region can be affected indirectly through lower exports via the Mainland to the US. While intra-regional trade currently accounts for as much as half of the region's total exports, it is highly dependent on the end-market demand in the US. Asian economies typically ship raw materials and intermediate goods to the Mainland, where they are assembled before being exported to the US. In Mainland China, shipments to the US currently account for around 26% of total exports (allowing for re-exports through Hong Kong). In fact, the share of exports from the Mainland to the US in emerging

CHART 11
Share of exports to the US in emerging Asia's total exports*



Asia's total exports have been increasing, although the share of exports from the rest of emerging Asia has declined (Chart 11).⁸ As a result, the US' share in the region's total exports has remained rather stable at close to 30%, albeit at a slightly lower level than formerly. Therefore, the impact of any decline in US demand for Asian-made goods will remain significant to the region.

Some simple calculations of the direct and indirect trade effects of major Asian economies are provided in Table 3. While growing intra-regional trade has reduced the direct trade exposure of Asian economies to the US over the past few years, the impact of indirect effects has remained significant. The indirect trade effect is defined as the fall in overall Asian exports due to lower exports to other countries affected by lower US imports. It is estimated here by assuming that a 10% fall in US imports would lead to a proportionate decline in its trading partners' exports, which in turn, will reduce proportionately that country's demand for imports from other countries. Our estimates suggest that for most Asian economies, excluding Mainland China, the indirect effects of lower US imports could be comparable to the direct trade effects. For NIEs, the indirect trade exposure to the US was even larger than the direct effect in 2005. Given the important role played by Mainland producers in shaping the supply side of the world economy, together with the equally dominant role the US consumer has played in driving the demand side, it appears decoupling will not be easy.

TABLE 3

Direct and indirect trade exposure to the US⁹

(% decline in total exports due to a 10% decline in US imports)	Direct effect		Indirect effect		Total	
	2005	2001	2005	2001	2005	2001
Japan	2.3	3.0	1.5	1.6	3.8	4.6
China	2.1	2.0	1.5	1.9	3.6	3.9
NIE-4	1.4	2.0	1.5	1.5	2.9	3.5
ASEAN	1.6	2.0	1.3	1.7	3.0	3.7

Sources: Direction of Trade Statistics, CEIC and staff calculations.

⁸ This is based on total exports of Asia excluding intra-regional exports.

⁹ The direct effect for country i ($\delta_{i,us}$) is calculated by multiplying the share of country i 's exports to the US in total exports ($EX_{i,us}/EX_i$) by the percentage decline in US imports from the

country, which is assumed to be 10%. The indirect effect for country i through country j is the direct effect of a decline in US imports on country j ($\delta_{j,us}$) multiplied by the share of country j 's exports in country i 's total exports (EX_{ij}/EX_i). The total indirect effect on country i is the sum of the indirect effects through all of country i 's trading partners.

Does Asia have independence in setting monetary policy?

Some claim that central banks in Asia now have more scope in easing monetary policy to support domestic demand. They point to the accumulation of foreign-exchange reserves and lower dependence on external financing giving Asian economies the flexibility to decouple their interest rates from those of the US, as the effects of higher interest rates raising the borrowing cost and debt-service burdens of the government and the public sector becomes less of a concern. Indeed, Asia's central banks have not raised interest rates in lock-step with the US Federal Reserve over the past two years as they did in previous cycles.

Although their exchange rates are becoming more flexible, the de facto currency regimes of many Asian economies, such as Indonesia, Korea, Malaysia, the Philippines and Thailand, are still closely linked to the US dollar and this ties the Asian economies' monetary policy stance and hence their business cycles to that of the US. Table 4 shows that while the

volatility of most East Asian currencies' exchange rates against the dollar has increased from the pre-Asian financial crisis level, it has remained low compared with that of major currencies, such as the Euro and Japanese yen.

With the US being the major source of capital, the region has little scope for setting independent monetary policy, given the limited flexibility in the exchange rates. By the end of 2005, the US accounted for 43% of the inward portfolio investment in Asian economies (Chart 12).¹⁰ A loosening of monetary policy by the Fed, for example, will act as a push factor to the financial markets in these economies and lead to an easing of monetary and financial conditions. This will act as a constraint on Asian economies to tighten monetary policy, particularly if they are concerned about the effect of an appreciation of their currencies on export competitiveness. Such dependence on US monetary policy will reinforce the highly correlated business cycles between Asia and the US. Without an independent monetary policy setting, any decoupling of the Asian business cycles from those in the US appears unlikely in the near term.

TABLE 4

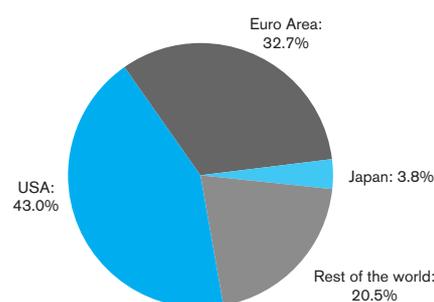
Standard deviation of daily exchange rate fluctuations vis-à-vis the US dollar

	pre-crisis (Feb 94-May 97)	2002-06 (Jan 02-Dec 06)
Renminbi	0.05	0.06
Hong Kong Dollar	0.03	0.03
Indonesian Rupiah	0.14	0.54
Korean Won	0.28	0.44
Malaysian Ringgit	0.21	0.11
Philippine Peso	0.32	0.27
Singapore Dollar	0.20	0.28
New Taiwan Dollar	0.20	0.26
Thai Baht	0.23	0.31
Japanese Yen	0.69	0.58
Euro	n.a	0.58

Sources: CEIC and staff estimates.

CHART 12

Inward portfolio investment to Asia by country



Sources: IMF Coordinated Portfolio Investment Survey database and staff estimates.

¹⁰ Based on preliminary data for 2005.

Can Asian financial markets be sufficiently delinked from those in the US?

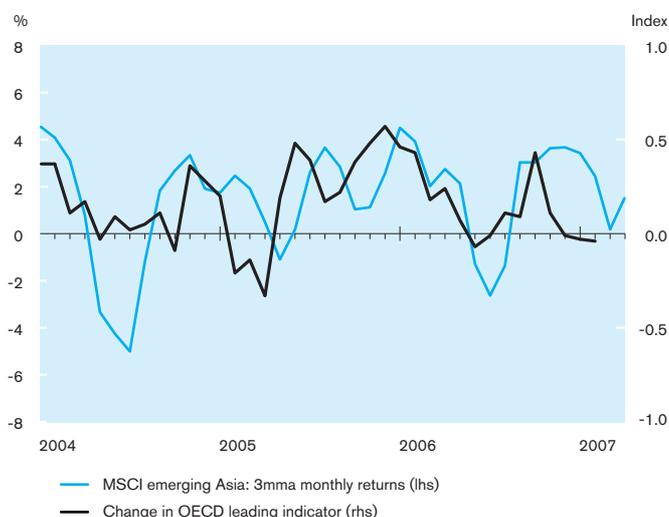
The close correlation of Asian financial markets with the US economic cycle and financial markets also makes any decoupling in economic growth difficult. A significant US slowdown will have negative effects on growth as well as financial markets in Asian economies that, until recently, have widely benefited from high global growth, and a continuation and expectation of easy global financing conditions.

Financial asset prices could fall more generally as a consequence of rising risk premia. Given emerging Asia's intensive trade and financial links with the global economy, regional equity markets have been strongly correlated with the global economic cycle (Chart 13). Lower global growth and reduced global liquidity will have negative effects on the financial markets as well as the real economies of emerging Asia.

In addition, as the US economy slows, prospects for stock markets in the region could be affected. Chart 14 shows that the high correlation among global equity market indices suggest that such effects might be considerable. The correlation of the US market with European markets is even higher than that with Asian markets. This might reflect the globalisation of financial markets, which are affected by common shocks, such as the tech bubble in 2001, causing major corrections in markets around the world. Such phenomena also lend support to the synchronisation of growth patterns of both the Asian and European economies with those of the US as discussed above. Global financial markets also tend to become more tightly linked through the investment strategies of institutions like hedge funds. The factors that led to systemic risk in previous episodes of financial distress, as in the 1987 stock market crash or the 1998 LTCM near collapse, are still present today.

CHART 13

Equity performance in emerging Asia and OECD leading indicator



Sources: Morgan Stanley Capital International Inc. and Bloomberg.

CHART 14

Global and Asian stock market indices



Sources: Morgan Stanley Capital International Inc. and Bloomberg.

The Mainland could be the future driver of growth

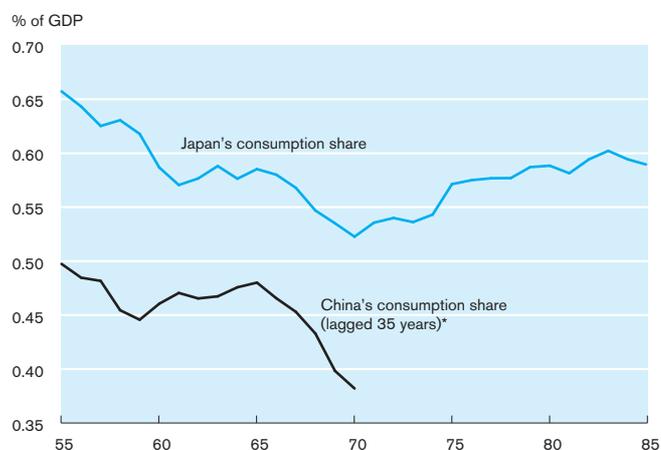
Nevertheless, East Asia has the potential to decouple from the US in the long term, particularly given the size and growth prospect of the Mainland economy. Although its domestic demand lacks the scale to drive regional demand for the time being, the Mainland is having an increasingly positive impact on East Asian economies through its rising demand for the region's exports, as well as its emergence as a major investor in terms of both direct and portfolio investment.

China to create a centre of demand

The current size of the Mainland's consumer base remains small, but it has the potential to create a centre of demand in the long term. And while its current share in GDP remains low, consumption is expected to make a more important contribution to GDP when the Mainland's savings and spending patterns adjust along with a further rise in income levels. As the economy continues to develop, and given an ageing population, the high savings rate is likely to be reduced, and consumption as a share of GDP is expected to rise. Experience in Japan lends support to this trend. Chart 15 shows that private consumption share of GDP in Japan was on a declining trend in the first 15 years of industrialisation as investment grew rapidly to meet the need for capital formation in the early stage of development. Interestingly, the Mainland has also been experiencing similar trends over the past 15 years. Consumption in Japan picked up when the income level reached a certain threshold, with private consumption share in GDP continuing to increase

CHART 15

Private consumption share in GDP in Japan and the Mainland



* The starting year corresponds to the year in which the Mainland and Japan had the same per capita GDP.

Source: CEIC.

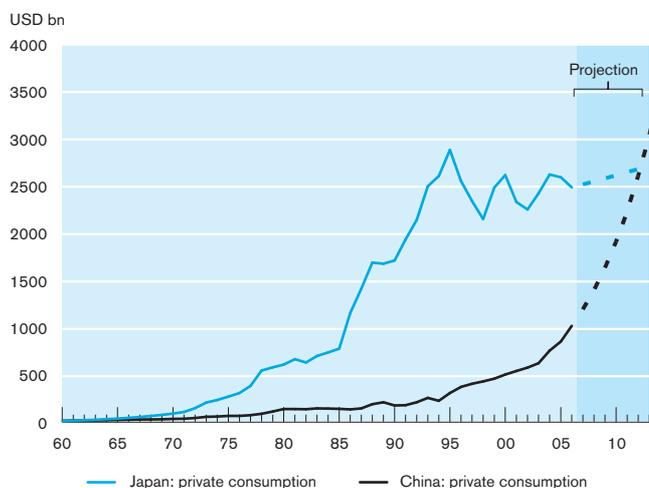
before stabilising at a high level of around 57% as the economy matured. This suggests there is great potential for consumption to play an increasingly more important role in driving aggregate demand in the Mainland as income levels rise.

If the Mainland, with the sheer size of its economy and the rapid pace of growth, follows the same path as Japan, its people will represent a large potential consumer base. At current rates of economic growth, the Mainland will surpass Japan by 2011 to become the second largest economy. By then, Mainland China will have the market scale to sustain the region's consumption demand. Chart 16 shows that if the Mainland manages to increase the share of private consumption in GDP to its pre-industrialisation level of around 50%, the Mainland could surpass Japan in 2013 to become the third largest consumer base in the world.¹¹

¹¹ This is based on the assumption that GDP in China and Japan will continue to grow at the current annual rates of 13.9% and 1.2% respectively. Nevertheless, such increase in consumption demand is likely to be offset by a decline in investment demand as the Mainland moves progressively away from the early stage of industrialisation. This might lead to changes in the composition of demand from the Mainland and hence exports from other economies in the region, possibly resulting in a shift in the share of the region's exports from raw materials and capital goods to consumer goods.

CHART 16

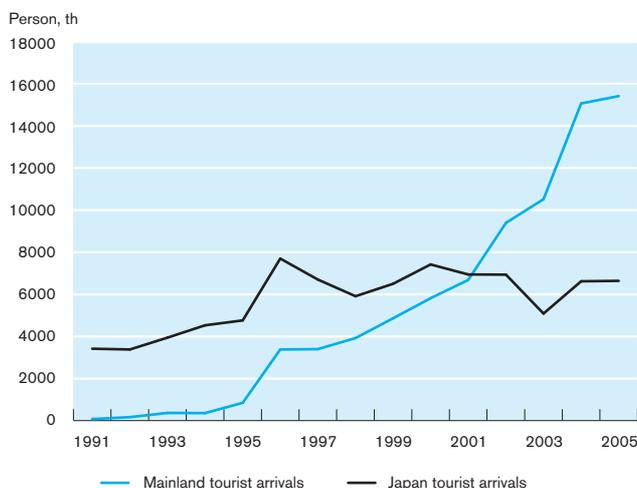
Private consumption in the Mainland to catch up with Japan



Sources: CEIC and staff estimates.

CHART 17

East Asia*: Tourist arrivals from the Mainland and Japan



* Excludes Taiwan.

Source: CEIC.

And, the Mainland's development has so far been promising. There is a growing culture of consumption and consumerism in the traditionally frugal Chinese society. Goods and services that were once regarded as luxuries are now seen as necessities by many urban residents. Apart from sales of durable consumption goods, services consumption, such as air travel, are also surging. Mainland tourist arrivals in the rest of Asia are growing. The number of Mainland tourists travelling to East Asia has surpassed the number of Japanese travellers since 2003 (Chart 17). For several ASEAN countries, Mainland China is already the biggest source of tourist arrivals.

China as the major exporter of capital

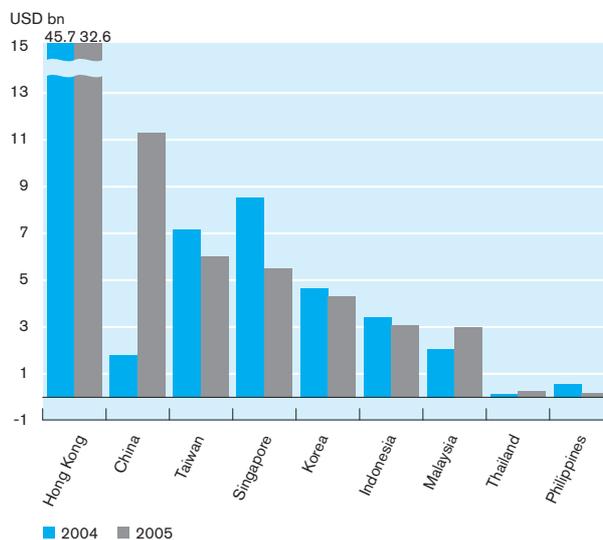
In addition to its potential role as the region's centre of demand, the Mainland is expected to sustain Asia's growth through increasing capital flows to the region. Together with this increased financial integration, the Mainland's monetary policy is expected to have a growing influence on the region's monetary and financial conditions. Again, parallels can be drawn with Japan.

Similar to Japan in the 1980s, Mainland China is emerging as a major investor in Asia. Its foreign

direct investment (FDI) outflows reached US\$11 billion in 2005, driven by some large merger and acquisitions in manufacturing and natural resources. In particular, the Mainland's outward FDI to Asia reached US\$4.4 billion in 2005, a three-fold increase from the level in 2003. Over the past 10 years, the number of approved Mainland enterprises in East and South-East Asia has accounted for around half of its total overseas investment. Chart 18 shows that the Mainland surpassed most economies

CHART 18

FDI outflows in emerging Asia



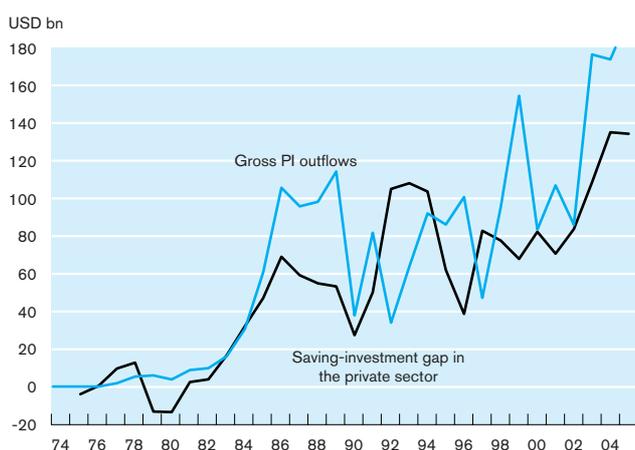
Source: UNCTAD.

in emerging Asia to rank second only after Hong Kong as a major exporter of FDI in 2005. The Mainland has also become a more important investor in many emerging Asian economies, particularly in Hong Kong.

The potential outward portfolio investment from the Mainland represents huge opportunities for the region. Experience in Japan suggests that given the Mainland's high savings rates and limited domestic investment opportunities, the potential for its portfolio investment overseas could be comparable to that in Japan, should restrictions on outward capital flows be relaxed (Chart 19). Indeed, our research study suggests the amount of outward portfolio investment from the Mainland could reach 23% to 54% of GDP, by the time the Mainland's capital account is as liberalised as OECD countries. Hong Kong is set to be the major beneficiary of this increased portfolio capital outflow. In the process, Hong Kong will play a key role in the financial intermediation of the Mainland's domestic savings through greater use of Hong Kong's sophisticated financial services.¹²

CHART 19

Saving-investment gap and gross portfolio investment outflows in Japan



Sources: IMF.

Concluding remarks

This analysis has argued that East Asia's trade openness is beneficial to its long term growth, even if it means the region could be cyclically vulnerable to shocks emanating from other regions, particularly the US. Indeed, with globalisation, any significant slowdown in the world's largest economy will unavoidably affect almost every other economy. The solution to reducing such vulnerabilities is to diversify export markets, strengthen domestic institutions and implement sound macroeconomic policies, not by reducing trade openness.

For the rest of the economies in the region, the emergence of Mainland China, with its rapidly growing domestic demand, will be capable of providing a sufficiently strong alternative source of demand over time. Although the Mainland is still in the early stage of overseas investment, it is likely to become a major investment power resulting in growing synchronised movements between financial markets in the Mainland and the rest of Asia. This could lead to the Mainland's monetary policy having increasingly more significant influence on the region's monetary and financial conditions. Whether this influence will result in more cyclical stability in Asia will depend on the People's Bank of China's ability to conduct successful monetary policies.

¹² Cheung, Lillian, Kevin Chow, Jian Chang and Unias Li (2006), 'Outward Portfolio Investment from Mainland China: How Much Do We Expect and How Large a Share can Hong Kong Expect to Capture?', *HKMA Research Memorandum 13/2006*.