



**SENSE AND NONSENSE ON ASIA'S EXPORT DEPENDENCY
AND THE DECOUPLING THESIS**

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Abstract

It has often been argued that East Asia needs to 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 argues that, indeed, in the foreseeable future, East Asia's business cycle is unlikely to decouple with that of the US, but the switch-of-growth-model argument is problematic because it mixes up the effects of external trade on an economy's cyclical developments and its long-term growth potential. The paper argues that the desirable way to reduce external vulnerabilities is to diversify export markets and to further strengthen domestic institutions and policies in order to reduce the impact of temporary shocks, not by reducing the degree of openness or the share of exports in GDP. The paper further argues that the rising size of domestic demand in Mainland China will overtime help the rest of the region to diversify its export markets away from the major industrialized countries.

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Executive Summary:

- *There are concerns that East Asia has been too export dependent so that growth may be vulnerable to a possible sharp housing-led slowdown in the US, and therefore the region needs to switch from an export-led growth model to a domestic-demand-led growth model. This paper argues that in the foreseeable future, East Asia's business cycle is unlikely to decouple from that of the US. However, this is not an argument for a switch of the growth model.*
- *The switch-of-growth-model argument is problematic because it mixes up the effects of external trade on an economy's cyclical developments and its long-term growth potential. The export-led growth model that has been regarded as the fundamental reason for Asia's growth "miracle" focuses on the beneficial impact of trade openness on technological progress. In contrast, domestic-demand-led growth is not a well defined concept. From a cyclical or demand side perspective, the contribution of various expenditure components of GDP to its growth does not have any predictable relationship with the structure of an economy. In fact, if an economy's domestic demand consistently grows faster than its GDP, then the economy would be on an unsustainable path of exploding trade deficits. On the other hand, to argue against a domestic-demand-led growth model is not to argue against the need to strengthen domestic-demand from a cyclical perspective. Strengthening domestic demand through structural reforms does not require abandoning the export-led growth strategy.*
- *Openness to foreign trade does increase the vulnerabilities of individual economies to cyclical shocks emanating from the external environment. But the desirable way to reduce such vulnerabilities is to diversify export markets and to further strengthen domestic institutions and policies in order to reduce the impact of temporary shocks, not by reducing the degree of openness or the share of exports in GDP. Indeed, with strengthened fiscal positions and enhanced financial sector soundness, economic fundamentals have improved greatly in East Asia since the 1997-98 financial crisis.*
- *In terms of diversification of export markets, East Asia still has a long way to go. We expect the cyclical outlook in the region to be noticeably affected by any significant change in the growth prospects in the major developed economies, particularly the US, because the export markets of East Asian economies are not sufficiently more diversified than before. Domestic demand in Mainland China still lacks the scale to drive demand growth in the region. Secondly, with the US being the major source of capital flows in Asia, and as the de facto currency regimes of many Asian economies are still closely linked to the US dollar, the region's monetary policy stance and, hence, its business cycle are still very much tied to that of the US.*

Finally, increased globalisation has led to synchronised movements of global as well as Asian financial markets with those of the US.

- *That said, East Asia does have the potential to decouple from the US in the long term. Japan's experience suggests that the Mainland could become Asia's future engine of growth not only through its role as the region's centre of demand but also as a major exporter of capital. The emergence of Mainland China, with rapidly growing domestic demand, would be capable of providing a sufficiently strong alternative source of demand for the rest of the region over time. At the same time, with the Mainland becoming a major overseas investment power, its monetary policy is expected to exert increasing influence on the region's monetary and financial conditions.*

I. THE MEANING OF TRADE DEPENDENCY

A common argument is that East Asia has been too export dependent and needs to adopt a domestic-demand led growth model (Felipe and Lim, 2005). This argument reflects a number of observations or concerns: first, East Asia's growth was significantly affected by the IT bust that led to a sharp slowdown in US growth in 2001. The region may thus be vulnerable again this time to a possible sharp slowdown in US growth led by a potential housing market bust. Secondly, rapid export growth in Mainland China has been regarded as an expression of the region's mercantilist habits that reflect chronic weaknesses of domestic demand in the region; 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 competes on world markets with its exports, it is forced to adopt the most recent production and management techniques, and therefore such openness is likely to support technical progress. In fact, 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.² Inward-looking development strategies on the other hand are likely to fail as demonstrated in many countries, especially in Latin America.³

Moreover, an export oriented growth strategy is not one that will hurt other countries. Dated back to Adam Smith (1776) in "The Wealth of Nations", the theory of absolute advantage suggests that free trade could be beneficial to all parties with a relative cost advantage in the production of certain

² An extensive literature has been devoted to test the ELGH empirically, using both cross-sectional analysis and time-series country case studies. The results appear to be inconclusive, depending on the theoretical approach assumed and econometric methodology employed. While earlier studies with cross-sectional analysis often found evidence of a positive effect of exports on growth, and hence lending support to the ELGH, results from recent time series analysis involving Granger causality and cointegration techniques are mixed and appear to be sensitive to the countries analysed, periods covered, variables included, and methods used. In addition, the debate regarding export-led growth or growth-driven exports continues. See Balassa (1978) for an earlier study, Emilio (2001) for a review and Yang (2006) for recent development in this literature.

³ See Taylor (2001).

goods. In the early 19th century, a rather counter-intuitive idea was formulated and proved by David Ricardo — even if some countries have an absolute disadvantage in the production of all goods, all countries could still benefit from trade — that is, the principal of comparative advantage. Therefore, trade is a positive sum game, where it is possible for everyone to pursue export-oriented growth strategies. This is, in fact, the essence of the export-led growth model that has been regarded as the fundamental reason for the Asian growth “miracle”. Trade openness is therefore good for long-term growth.⁴ This is true for small economies like Hong Kong, for large economies like Mainland China, and also for industrialised countries like the US.⁵ Note, however, that the export-led growth model does not imply necessarily the existence of either a trade surplus or a trade deficit. It 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 summarises at best short-run economic conditions. It can vary greatly from quarter to quarter and from year to year, and such variation does not have any predictable relationship with the structure of an economy. The reason for this is that the conventional measure of the contribution to growth is purely an accounting relationship, suggesting no causal relationships or theoretical underpinning.⁶ Hence, based on such 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 at the same time 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 varied greatly from year to year, bearing no particular relationship to the size or openness of the economies. Note also that there is no

⁴ See Krueger (1997).

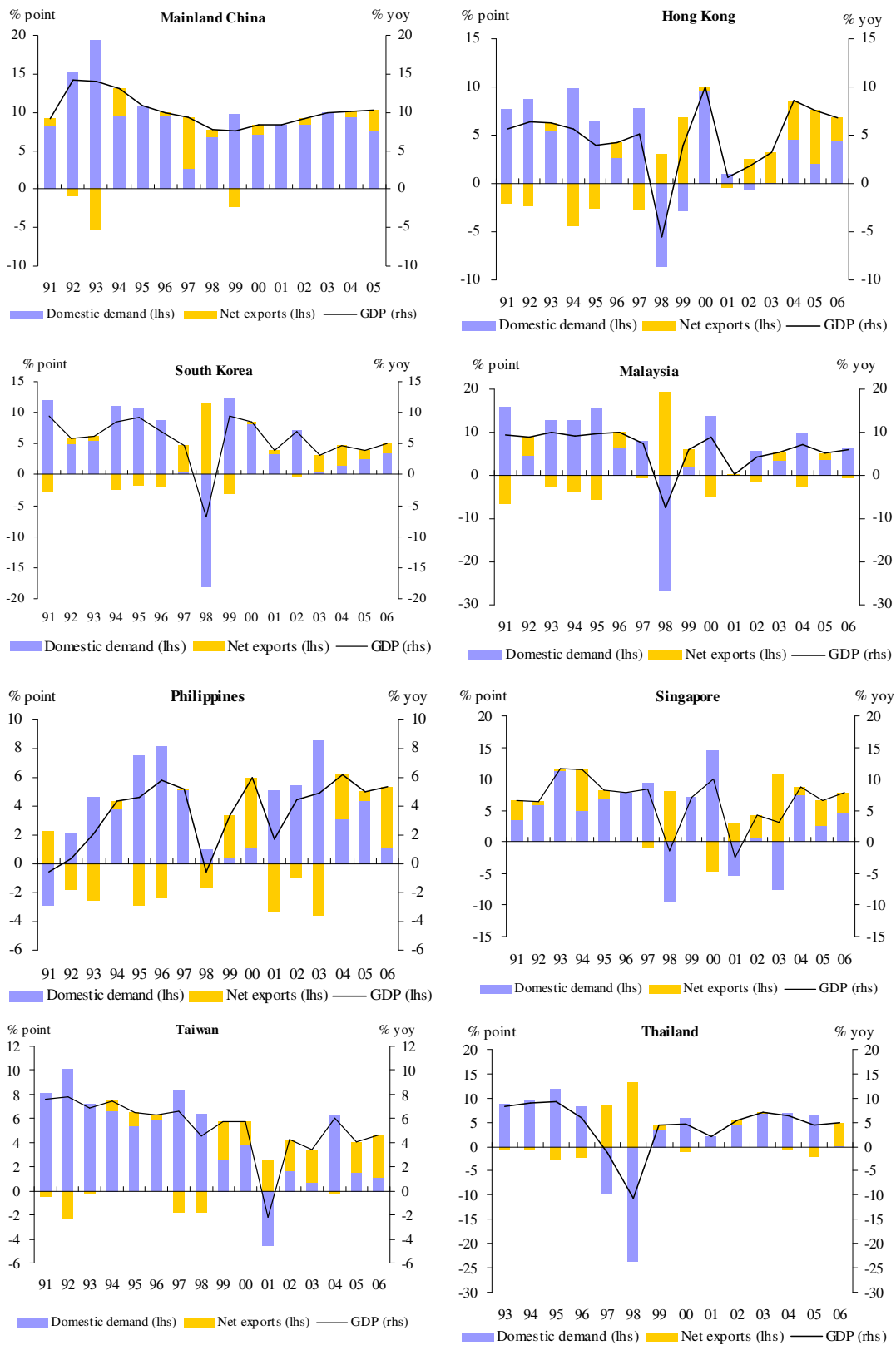
⁵ Marin (1992) found that the hypothesis of export-led growth cannot be rejected for the US, Japan, UK and Germany, and “outward looking” regime seems to favour productivity performance of developed market economies as well.

⁶ 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.

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 nor whether it is positive or negative.⁷

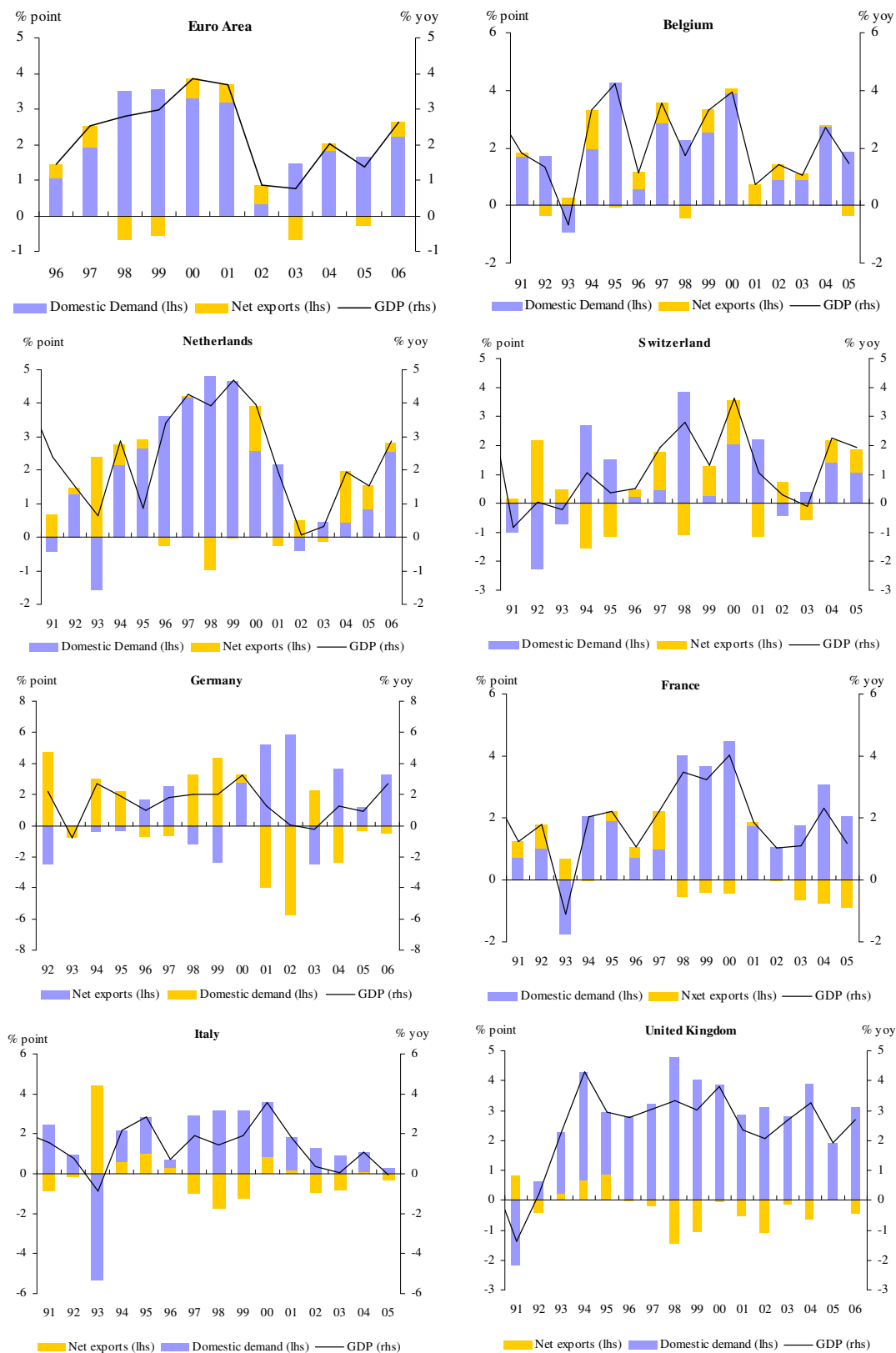
⁷ The 1998 data for Hong Kong offer a particularly telling example why the contribution of net exports to growth must be interpreted with care. During that year, net exports in Hong Kong contributed a particularly large share to growth even though (gross) exports declined substantially relative to the previous year. The reason for the positive contribution of net exports to growth was the collapse in imports which lead 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

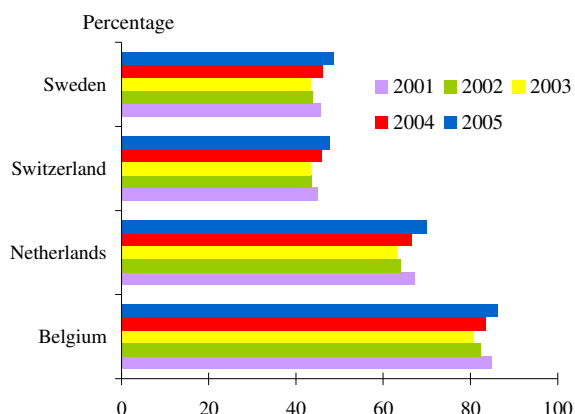
Chart 2: Contribution to growth by domestic demand and net exports in selected European economies



Sources: Eurostat and CEIC.

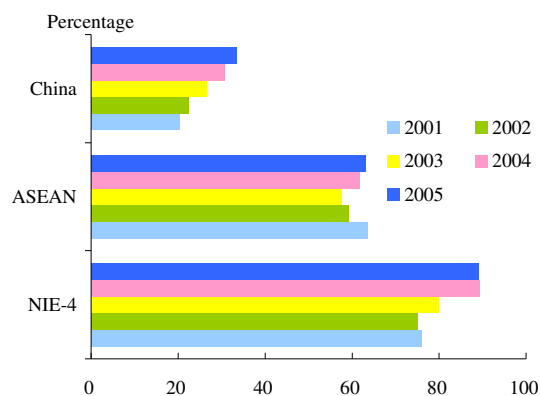
Cross-region comparison of growth experiences also indicates that there is no particular relationship between an economy's exposure to external demand and the level of development. In other words, as economies grow and become richer, they do not necessarily reduce or increase their reliance on external 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, 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 Asia (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.
Source: CEIC.

A domestic-demand led growth model is sometimes taken to imply that domestic demand grows faster than GDP. While this is certainly feasible or even beneficial for some economies at certain cyclical junctures, such a growth pattern would be problematic from a longer-term perspective. Indeed, if an economy's domestic demand consistently grows faster than its GDP, then the economy would be on an unsustainable path of exploding trade deficits. A particularly telling example is the growth patterns of Korea, Philippines, and Thailand in the 1990s which over-emphasized expansionary tendencies in domestic demand in the private-sector at the expense of net exports (ADB, 2005).⁸ The resulting decline in the growth of productive capacity in these economies

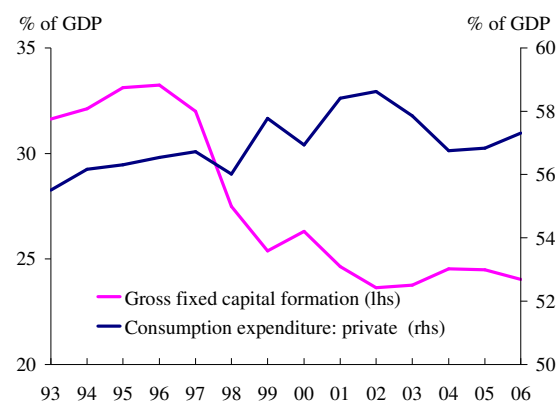
⁸ This is reflected in the frequently discussed roots of the Asian crisis — currency overvaluation as well as over-lending or over-borrowing syndrome that were spurred by inflows of short-term speculative capital. These brought high growth to the domestic and nontradeable sectors, and deterioration in the net export positions.

after the financial crisis is a harmful consequence of the strategy they followed, which reversed the healthy balance and the desirable progression of both domestic demand and the tradable sectors achieved during 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. In fact, 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 could be complementary and mutually reinforcing in terms of technology deepening. As such, the region's export-oriented growth model does not conflict with its effort to strengthen domestic demand. In other words, strengthening domestic demand does not require abandoning the export-led growth strategy.

Although real consumption growth in East Asia is high by international standards, the region's share of private consumption as a percentage of GDP has been declining—consumption shares in East Asia fell from around 70% of GDP in 1970 to less than 60% in 2005 (Chart 5).⁹ While the long-term declining trend reflects the need to mobilise domestic savings for domestic capital formation given the rapid pace of economic development, the decline in recent years appeared to have been due to increased precautionary savings in response to the perceived greater uncertainties in the wake of the 1997-98 financial crisis, relatively less developed capital markets compared to the industrial countries, and demographic influences in relation to a relatively young population (IMF, September 2006).

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.

At the same time, investment as a percentage of GDP in East Asia (excluding Mainland China) has declined considerably after the 1997-98 crisis,

⁹ See IMF, *Regional Economic Outlook: Asia and Pacific*, September 2006. According to the study, with the exception of Mainland China, there is little evidence that suggests private consumption in emerging Asia is too low to be consistent with what economic fundamentals would suggest.

falling from the recent peak of 33% in 1995 to around 25% in 2005 (Chart 5).¹⁰ While a comparison with the pre-crisis level which was associated with over-investment might not be appropriate, the decline seems to be sharper-than-expected according to empirical models based on macroeconomic fundamentals (Chinn and Ito, 2005, and IMF, September 2005). This, to a large extent, is likely to reflect responses of corporations to increased risks of higher macroeconomic volatility (such as rising exports and output volatility due to a shift in production towards the electronics markets) and the perceived greater microeconomic uncertainty (such as riskier governance indicators) in the wake of the crisis (IMF, May 2006). While such hypothesis of greater risks seems counterintuitive, this might reflect the fact that investor perceptions may have become more realistic than they were prior to the financial crisis, and that investors might now be subject to more risks given the withdrawal of government guarantees and explicit cross-guarantees. Continued sound macroeconomic policies, along with microeconomic policies aimed at addressing structural sources of risk could help to improve the investment environment and support capital spending.

II. CYCLICAL IMPLICATIONS OF TRADE DEPENDENCY

Although competing in international markets allows countries to benefit from the 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. Large exposure to external demand and the strong trade relationships affect the cross-country synchronisation of business cycles. Recent empirical work supports the view that developments in the US economy have very strong influences on the Asian economies, and Mainland China has been a less important source of external shocks than is commonly thought (Genberg, 2005). An earlier study by the HKMA also suggests that over the medium to long run, 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 system (Genberg, Liu and Jin, 2006).

¹⁰ Nevertheless, the investment rate remained above those in other regions.

Table 1 shows that not only are Asian business cycles highly synchronised with that in the US, but also Europe's business cycle is still highly correlated with that in the US, particularly for the small economies such as Switzerland and Belgium. The close correlation of business cycles of the advanced economies with the US might reflect not only their trade linkages but also financial linkages, as economies have become even more integrated along with globalisation.

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, and to strengthen domestic institutions and implement sound macroeconomic policies, not by reducing the degree of openness. Indeed, improved fundamentals do provide the 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, the 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	Current account balance	Short-term external debt	Foreign reserves	Banking sector NPLs	Credit rating
	% yoy	2005 (% of GDP)	2005 (% of GDP)	2005 (% of foreign reserves)	(US\$ bn)	(% of total loans)	(S&P)
Hong Kong	6.8	1.0	13.5	n.a.	132.7	1.2	AA
Korea	4.0	-1.5	0.2	29.8	239.0	0.8	A
Singapore	5.9	-0.3	30.9	n.a.	136.8	3.9	AAA
Taiwan	5.0	-0.9	7.1	14.9	266.1	2.3	AA-
Indonseia	5.5	-0.8	4.3	53.5	42.6	8.7	BB-
Malaysia	5.8	-3.8	18.8	24.1	82.5	4.8	A-
Philippines	4.8	-2.7	3.2	66.5	23.0	7.5	BB-
Thailand	4.7	0.1	2.4	24.5	67.0	4.2	BBB+

1. All data are the latest estimates, except otherwise stated.

Sources: Bloomberg, CEIC and staff estimates.

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 that in the US will require a significant change in the underlying economic structure. In view 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.

III. DOES ASIA FULFILL THE CONDITIONS FOR DECOUPLING?

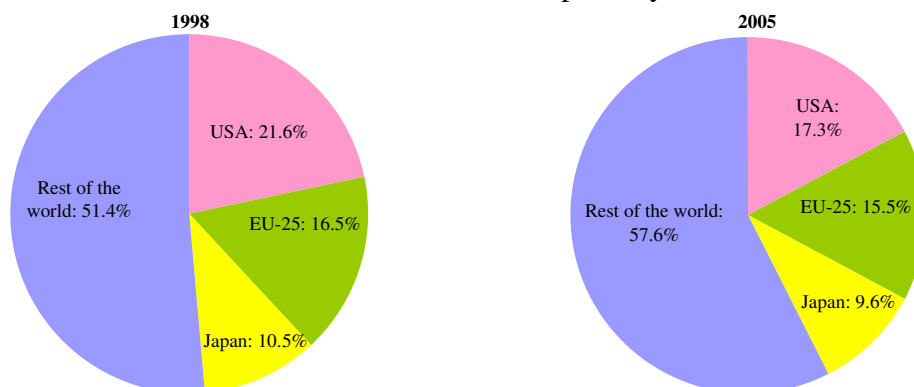
For the East Asian economies to decouple structurally from the US, they must satisfy three conditions. First, they need to have sufficiently more diversified export markets than before. Secondly, they must have policy autonomy, that is, the ability to establish independent settings for monetary policy.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

a. 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. Nevertheless, 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).

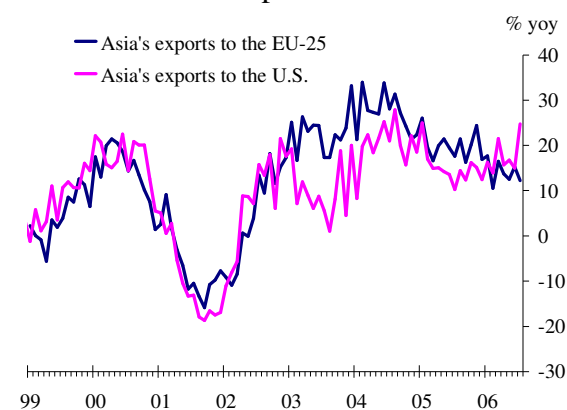
Chart 6: Share of Asian exports by market



Sources: Direction of Trade Statistics and CEIC.

Nevertheless, the US has remained the largest export market of Asia. Furthermore, as previously discussed, Europe's business cycle is still highly correlated with that in the US, as indicated in Table 1. In fact, experience suggests that Europe also went into a slump when the US IT downturn hit in 2001, and as a result 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.

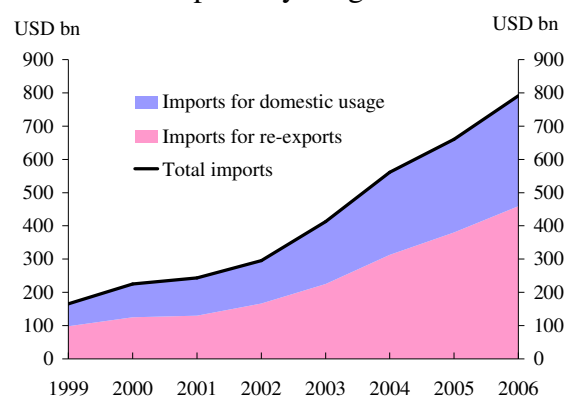
At the same time, Japan's recovery is by no means complete. Much of the upturn in corporate earnings and fixed capital investment is concentrated in export-oriented manufacturing industries, and the domestic property markets are yet to revive in full. More importantly, Japan's aging population and shrinking labour force mean that real growth rates will remain relatively modest over the medium term. In other words, the recovery in Japan is not likely to offset a significant slowdown in the US anytime soon.

In fact, the major focus of the decoupling thesis is that Mainland China is the new centre of demand in Asia, which enables the region's growth to decouple from that in the US. Indeed, the emergence of Mainland China has

reshaped the pattern of regional trade flows, as manufacturing has increasingly moved 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 over the past few years, a large part of these imports are processing-related goods that are exported through the Mainland to the rest of the world. Such imports have been taking equally important shares in the Mainland's total imports as those for domestic usage¹¹ (Chart 8).

Chart 8:
Mainland's imports by usage



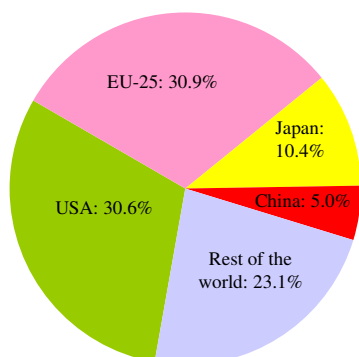
Source: CEIC.

In fact, 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 the Mainland has become the fourth largest economy at current exchange rates, it accounts for only around 5% of world domestic 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. While this represents much faster growth than that in the major economies, 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). This is far below the consumption shares of 70-85% in major economies.¹²

¹¹ 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.

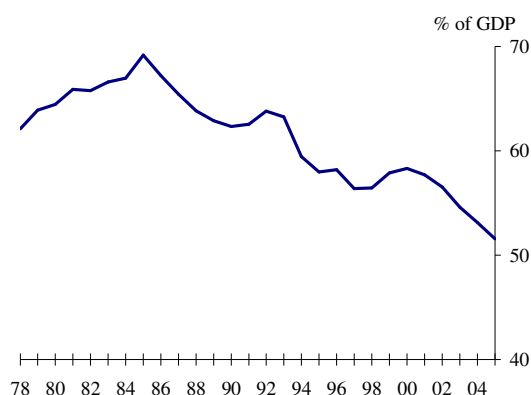
¹² Even if consumption in the Mainland were to increase to 70% of GDP, the Mainland's share of world domestic demand would only increase to 6%.

Chart 9:
Mainland's share in world domestic demand



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

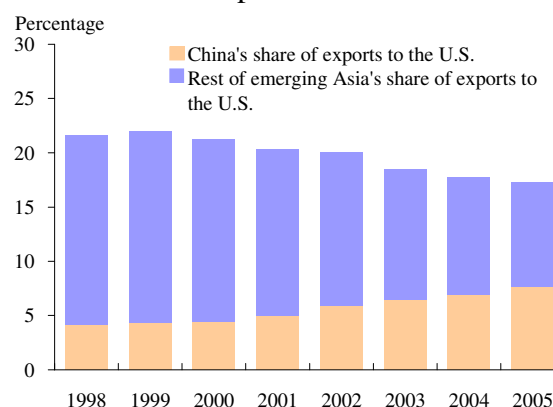
Chart 10:
Mainland's consumption share in GDP



Source: China Statistical Yearbook 2005.

Growing processing trade of the Asian economies with the Mainland also means that the region can be affected indirectly through lower exports via the Mainland to the US. In fact, 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 Mainland's exports to the US has been increasing, although the share of the rest of Asian exports to the US has declined significantly (Chart 11). In consequence, although the region's share of exports to the US has declined as a whole, it has remained substantial at close to 20%. Therefore, the impact of any decline in US demand for Asian-made goods will remain significant to the region.

Chart 11:
Mainland's and the rest of emerging Asia's share of exports to the US



Sources: Direction of Trade Statistics and CEIC.

Some simple calculation of the direct and indirect trade effects of the major Asian economies are provided in Table 3. While growing

intra-regional trade has reduced the direct trade exposure of the Asian economies to the US over the past few years, the impact through 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 the NIEs, the indirect trade exposure to the US was even larger than the direct effect in 2005. It appears that given the important role played by the Mainland producers in shaping the supply side of the world economy, together with the equally dominant role that the US consumer has played in driving the demand side, decoupling would not be easy.

Table 3: Direct and indirect trade exposure to the US¹³

(% 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.

b. Does Asia have independence in setting monetary policy?

Some claim that central banks in Asia have now more scope in easing monetary policy to support domestic demand. It is suggested that the accumulation of foreign-exchange reserves and lower dependence on external financing have given the Asian economies the flexibility to decouple their interest rates from that of the US, as the effect of higher interest rates raising the borrowing cost of and debt-service burdens on the government and the public

¹³ 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 ($EX_{i,j}/EX_i$). The total indirect effect on country i is the sum of the indirect effects through all of country i 's trading partners.

sector becomes less of a concern. It has been pointed out that Asia's central banks have not raised interest rates in lock-step with the US Federal Reserve over the past two years as they had in previous cycles.

Nevertheless, the de facto currency regimes of many Asian economies are still very closely linked to the US dollar, although their exchange rates are becoming more flexible over time, and this ties the Asian economies' monetary policy stance and hence their business cycles to that of the US. Although countries such as Indonesia, Korea, Malaysia, Philippines and Thailand were forced to float their currencies after the financial crisis in 1997, the currencies appear to remain closely linked to the US dollar. Table 4 shows that while the volatility of most East Asian currencies' exchange rates against the dollar has increased from its pre-crisis level, it has remained low compared with that of major currencies such as the Euro and Japanese yen.¹⁴

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

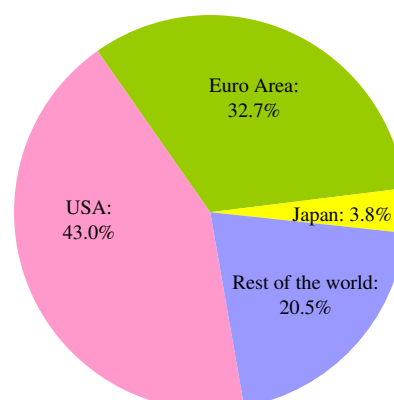
1. Pre-crisis period refers to February 1994 to May 1997.

Sources: CEIC and staff estimates.

¹⁴ In fact, McKinnon (2006) argues that the region is again back on a dollar standard. He argues that trade flows as well as international flows of finance in East Asia are overwhelmingly dollar invoiced, and establishing long-term dollar parities for exchange rates as a "nominal anchor" against fears of currency depreciation and inflation in the smaller East Asian debtor economies are potentially of great mutual advantage. Nevertheless, Ho, Ma and McCauley (2005) question the empirical validity of McKinnon's hypothesis.

At the same time, 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 accounts for 43% of the inward portfolio investment to the Asian economies (Chart 12).¹⁵ A loosening of monetary policy by the Fed, for example, will act as a push factor to the financial markets in the Asian economies, leading to easing of monetary and financial conditions in these markets. This will thus act as a constraint on the 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 that in the US thus appears unlikely in the near term.

Chart 12:
Inward portfolio investment to Asia by country



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

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

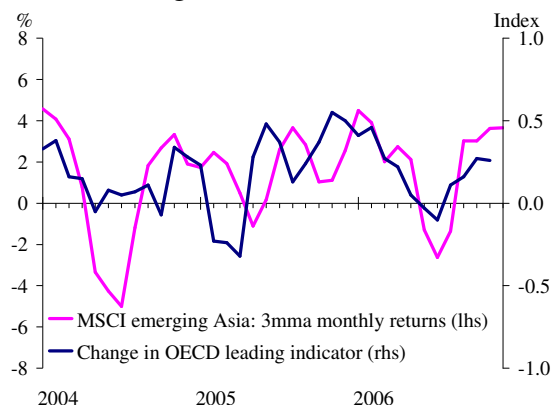
The close correlation of the Asian financial markets with the US economic cycle and financial markets also makes any decoupling in economic growth difficult. A significant US slowdown will have negative effects on growth as well as financial markets in the Asian economies that, until recently, have widely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

¹⁵ Based on preliminary data for 2005.

Financial asset prices could fall more generally as a consequence of rising risk premia. Given emerging Asia's intensive trade and financial linkages 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.

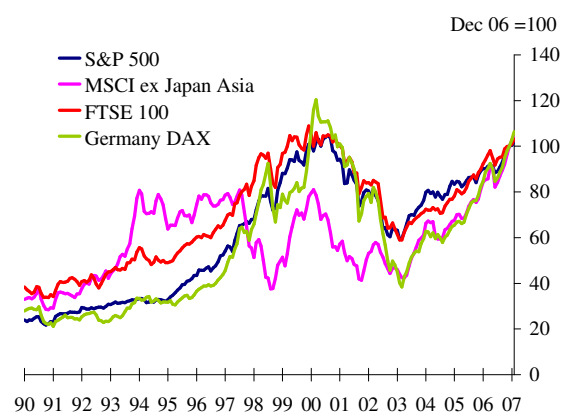
Moreover, as the US economy slows, prospects for stock markets in the region could be affected. Chart 14 shows that the high correlation among global equity market returns suggest that such effects might be considerable. The correlation of the US market with the European markets is even higher than that with the 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 the global financial markets. Such phenomenon also lends support to the synchronisation of growth patterns of both the Asian and European economies with those of the US as discussed above. Furthermore, global financial markets tend to become more tightly linked through the investment strategies of hedge funds and the like. The factors that led to systemic risk in previous episodes of systemic 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 indicators



Sources: Morgan Stanley Capital International Inc. and Bloomberg.

Chart 14:
Global and Asian stock market returns



Sources: Morgan Stanley Capital International Inc. and Bloomberg.

IV. BUT THE MAINLAND COULD BE THE FUTURE DRIVER OF GROWTH OVER TIME

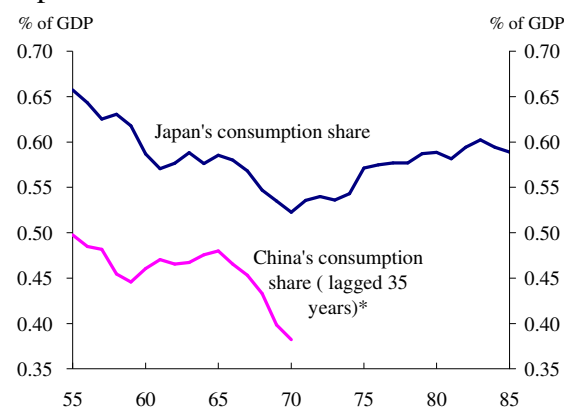
That said, East Asia does have the potential to decouple from the US in the long term, particularly given the size and growth prospect of the Mainland economy. Although its domestic demand lacks the scale to drive regional demand for the time being, the Mainland is having a growing positive impact on the economies in the region 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.

a. China to create a centre of demand

While the current size of the Mainland's consumer base remains small, it has the potential to create a centre of demand in the long term. Although its current share in GDP remains low, consumption is expected to make an increasingly more important contribution to GDP when the Mainland's savings and spending patterns adjust along with further rise in income levels. As the economy continues to develop, and given an aging 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 at the early stage of development. Interestingly, the Mainland has also been experiencing similar trends over the past 15 years. Nevertheless, consumption in Japan picked up when the income level reached a certain threshold, with private consumption share in GDP continuing to increase before stabilising at a high level of around 57% as the economy matured. This suggests that there is great potential for consumption to play an increasingly more important role in driving aggregate demand in the Mainland as the income level rises to a higher level.

Chart 15:
Private consumption share in GDP in Japan and the Mainland

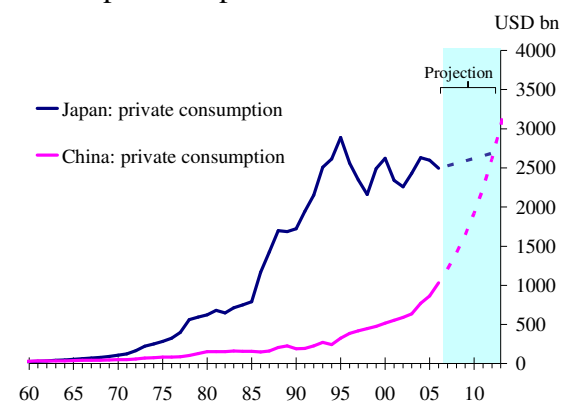


* The starting year corresponds to the year in which the Mainland and Japan had the same per capita GDP.

Source: CEIC.

Should the Mainland follow the footsteps of Japan, given the sheer size of the economy and the rapid pace of growth, Mainland consumers would represent a large potential consumer base. At current rates of economic growth, by 2011, the Mainland will surpass Japan to be the second largest economy. By then, the Mainland 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.¹⁶

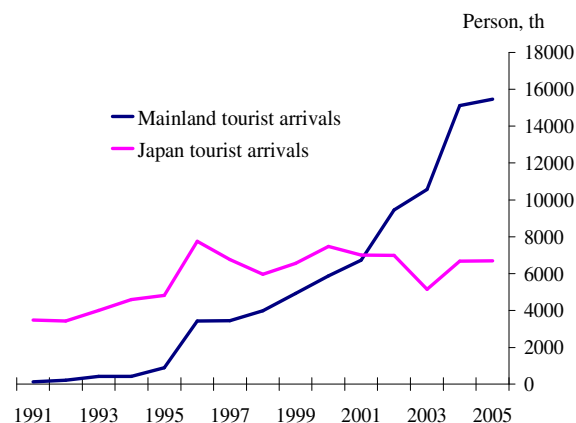
Chart 16:
Private consumption in the Mainland to catch up with Japan



Sources: CEIC and staff estimates.

In fact, the development in the Mainland so far has been promising. There is a growing culture of consumption and consumerism in the traditionally frugal Chinese society. Goods and services that had been 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 already surpassed the number of Japanese travellers since 2003

Chart 17:
East Asia*: Tourist arrivals from the Mainland and Japan



* Excludes Taiwan.

Source: CEIC.

¹⁶ 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 17). For several ASEAN countries, Mainland China is already the biggest source of tourist arrivals.

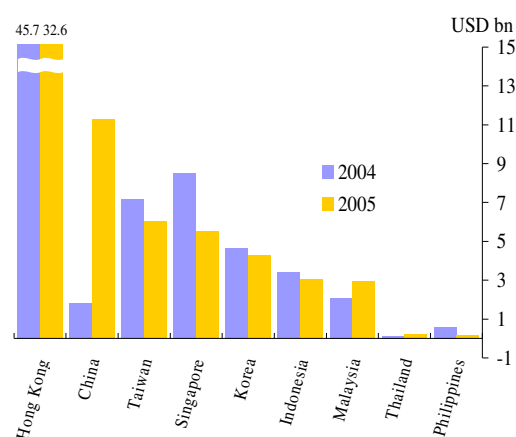
b. China as the major exporter of capital

Apart from 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. Along with this increased financial integration, the Mainland's monetary policy is expected to have increasingly more significant influence on the region's monetary and financial conditions. Again, one could draw inference from the case of Japan.

Similar to Japan in the 1980s, the Mainland is emerging as a major investor in Asia. The Mainland's 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 China's enterprises

in East and South-East Asia accounts for around half of its total overseas investment. Chart 18 shows that the Mainland surpassed most economies in emerging Asia to rank the second only after Hong Kong as a major exporter of FDI in 2005. The Mainland has also become an increasingly more important investor in many emerging Asian economies, particularly in Hong Kong.

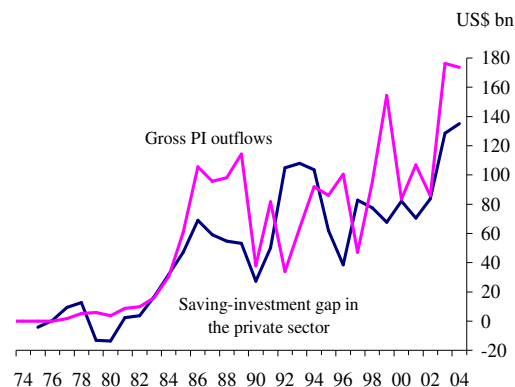
Chart 18:
FDI outflows in emerging Asia



Source: UNCTAD.

In addition, the potential outward portfolio investment from the Mainland also represents huge opportunities to the region. Experience in Japan suggests that given the high savings rates and limited domestic investment opportunities in the Mainland, the potential of 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 that 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 in the OECD countries. In particular, Hong Kong is set to be the major beneficiary of increased portfolio capital outflows from the Mainland. In the process of the Mainland's capital account liberalisation, Hong Kong will play a key role in the financial intermediation of Mainland's domestic savings through greater use of Hong Kong's sophisticated financial services (Cheung et al, 2006).

Chart 19:
Saving-investment gap and gross
portfolio investment outflows in Japan



Source: IMF.

V. CONCLUDING REMARKS

This note has argued that East Asia's trade openness is beneficial to its long term growth, even if it means that the region could be cyclically vulnerable to shocks emanating from other regions, particularly the US. Indeed, in a globalised world, 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, and to 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 rapidly growing domestic demand, would be capable of providing a sufficiently strong alternative source of demand over time. At the same time, Mainland China, though still at its early stage of overseas

investment, is likely to become a major overseas investment power. This is expected to result in growing synchronised movements between financial markets in the Mainland and the rest of Asia, which will mean that the Mainland's monetary policy could have increasingly more significant influence on the region's monetary and financial conditions. Whether this influence will lead to more cyclical stability in the region will of course depend on the People's Bank of China's ability to conduct successful monetary policies.

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