Can Asia Keep Growing in the Midst of Global Economic Turmoil?

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Getting the right fix on the interaction between macroeconomic policy and structural reforms is crucial to navigating the world's economic woes in the years immediately ahead. The turmoil in industrial Europe and North America today is centrally about plummeting confidence in the ability of political leadership to establish the right balance between stimulating their flagging economies and dealing with the structural problem of future debt. As private sector demand fails to recover quickly because of serious balance sheet effects, it has been difficult for governments to maintain financial market confidence in their ability to deal with spending that is currently needed and future public debt. Fractious politics hamstrings forging majorities for packages designed to lift confidence and get recovery on track. Corrosion of the authority of political leadership feeds back into weak demand for labor and confidence in investing, and deepens the gloom. Restoring confidence will be a slow and painful process in a period of economic and political turmoil.

Europe has its own mess to deal with. The International Monetary Fund meetings in Washington in September and the political follow up that is now playing out across Europe have done something to staunch the financial bleeding, but the European economy is still in emergency triage. The European experiment is at risk. Over the last decade, unit labor costs in Greece grew by about 30 percent more than in Germany. This implies a 30 percent effective appreciation of Greece's real exchange rate. The validation of a real appreciation of that magnitude required a lot of government spending. That fiscal stance was bound to prove unsustainable. Greece is not the only European country in this pickle. Whether the Greek and European body politic can now wear the fiscal burdens of an adjustment without breaking the euro currency system remains to be seen. Deep down the worry is that the writing is on the wall for the euro itself. There is no doubt at all that, despite all the emergency measures to prop up Greece and keep it in the fold, there is serious risk of a eurozone collapse. Greece is not the only eurozone member trapped in the euro straightjacket. The core problem for southern Europe is its chronic inability to match German productivity growth.

In Asia, in which Australia's economic fortunes are crucially enmeshed, the question is whether there is any chance that strong growth will be knocked off course by the continuing weakness in the developed world. Success in avoiding that depends on whether extensive structural reform is put in place to shape the expansion of the investment so that it continues to roll out in ways that ensure it is productive and that economic growth does not run into the sand. In China, worries about inflation now dominate worries about maintaining employment growth, although growth of 8 percent or so would still continue to propel demand for key materials and a range of industrial inputs and imports.

Based on evidence from the last two years, emerging market economies in Asia and elsewhere might have had some reason to think that there was "decoupling" between their growth rates and those in the old G-7 economies; events of the last few months have significantly dispelled that illusion as interdependence through expectations and market sentiment, as well as more directly through trade and finance, has ensured that problems in the industrial economies wreak their havoc around the rest of the world. The political fragilities that were

exposed for all to see in stitching a fiscal deal between the White House and the U.S. Congress and in trying to arrive at a doable deal in the European Union have taken their toll on world markets everywhere. The antics of the Congressional leadership and the cynical, half-baked nature of the deal they put in place, downgraded U.S. economic and political assets around the world.

Decoupling clearly has its limits but the Asian emerging market economies are still in a stronger position with demographic dividends still to reap, much lower debt ratios, and economies that enjoy the benefit of powerful "catch-up" to the industrial country frontier.[1] The potential rate of growth in emerging economies remains high because the "convergence gap," the gap between productivity levels in industrial countries and developing economies, remains large even for economies like China and India. This has not changed because the world has fallen into recession. Dani Rodrik is right that catch-up growth through closing the convergence gap should not be regarded as an automatic mechanism of guaranteeing rapid growth;[2] successful catch-up growth depends on getting policies and institutions right to absorb ideas and knowledge from the technology frontier. But that does not qualify the scope for rapid catch-up growth and the likelihood that it will dominate China and India's economic performance two to three to decades out, given their track record of policy commitment and economic performance thus far. In this context, it is instructive to reflect on the history of Japan's experience in the interwar period, when despite the massive hit that the Japanese economy took through trade and investment shocks as well as policy discrimination, it hardly missed a beat. Japan's economy still recorded in excess of 4 percent real growth (exceptional growth by the standards of that time) through the worst years of the Great Depression.

With these assets, what is to stop emerging economies powering the global economy from its industrial country malaise?

The long-term trajectory that foresaw the emergence of these new economic powers has been both elevated and truncated. Catapulted forward by their economic resilience during the global financial crisis, the BRICS (Brazil, Russia, India, China and South Africa) already have a more prominent place and role in the global system. The prediction less than a decade ago was that they would account for less than 10 percent of global output at the end of the first decade of the 21st century. They already hold twice that share and now global consumption growth in the years ahead is predicated on their continued and rapid growth, with the lackluster outlook for most of the G-7.

The perverse reality is that, even at a time of deficient global demand, the savings of emerging economies—most of which are generated in Asia—are being intermediated chiefly in the financial markets of New York and London. These savings are then invested largely outside Asia with a significant part lent to governments of already heavily-indebted developed (usually western) economies to finance their fiscal deficits. This money can certainly be put to better use. [3]

The "self-imposed crises in the U.S. and the EU have destroyed the capacity of industrial countries to contribute to global growth in the short term".[4] G-20 leaders—understandably consumed by the anxieties in Europe and North America—should not miss a crucial opportunity when they meet in Cannes next month. With Europe and the United States in the mire, this opportunity for medium-term growth is investment in developing economies. That does not mean just another big fiscal stimulus in China—there are risks with that which the Chinese government is justifiably cautious about assuming. But, it means putting the emerging economies of the BRICS at the leading edge of the global recovery strategy.

As growth in the G-7 economies stagnates, the average growth rate in emerging market economies has remained strong at around 6.2 percent. Over the next few decades, the economies of Brazil, China, India, Russia and South Africa can play an even more important global role along with other emerging economies like those of Indonesia, South

Korea, Taiwan and Singapore.[5] Stronger economic growth in these countries will also secure greater bargaining power, creating stronger leverage in international trade and diplomatic negotiations. BRICS should have a bigger say in world financial matters but they should also seek to define a key role in the strategies for a global recovery as they reform global governance.[6]

The potential for productive investment in infrastructure in the emerging economies is enormous.[7] The Organization for Economic Cooperation and Development estimates global infrastructure requirements to 2030 to be in the order of $50 trillion.[8] Much of this demand is in Asia, which is also the primary source of the savings that are currently sloshing around the global economy. There is almost a trillion dollars worth of infrastructural investments in the region that have been given the once-over by the Asian Development Bank. China's economy may be facing a temporary problem of over-heating, but its stock of capital relative to population and income is low. India and Indonesia offer vast scope for investment infrastructure. The U.S. also needs to make large investments to rehabilitate or extend its economic infrastructure. More generally, global investment is at a historically low share of global output. [9]

An atavistic G-7 mindset has the G-20 focused on a development agenda that largely misses this main point. G-20 leaders have appointed a High-Level Panel on Infrastructure to advise them on improving the institutional and enabling environment for infrastructure investment and ideas for financing infrastructure projects with significant but delayed returns to investors. Yet the panel's brief focuses only on infrastructure in the world's most difficult investment environments, in particular sub-Saharan Africa. This focus is too narrow. The issues of institutional capacity, innovative financing and risk management need attention everywhere. At their next summit in Cannes, G-20 leaders need to grab the panel's terms of reference and widen them, challenging their officials, financial sector managers and international financial institutions to use their expertise to find ways to intermediate more savings into commercially viable investment in infrastructure wherever it is needed, but especially in the BRICS.

The Asian six in the G-20 can take a lead here. On a visit to Jakarta at the end of September, Japanese Economic, Trade and Industry Minister Yukio Edano announced that Japan would support the reconstruction of Jakarta's ramshackle port capacity, including a new airport, and help build a long overdue urban railway system.[10] This is the kind of infrastructure investment that will both boost Indonesian productivity and lift Japan and the G-7's recovery and growth prospects.

It is time for G-20 leaders to look beyond the G-7 funk and focus on the opportunity for sustaining global growth through a development agenda, driven by robust investment and growth in the BRICS.

This strategy for global recovery can succeed only if it is complemented by vigorous structural reform in the emerging economies that must drive it. There cannot be sustained growth through ramping up infrastructure investment if that investment is not productively and efficiently deployed.

Structural reform includes measures that improve institutions, incentivize efficient and sustainable production, investment and employment, and facilitate fundamental, productivity-increasing changes in economic structure. This is a complex task to which the Asian members of G-20 bring a particular and important perspective because of their experience with rapid economic transformation and reform. Structural problems ultimately have to be dealt with by national governments but they will be made more tractable through international cooperation and understanding of what is at stake.

The Asian economies have been growth success stories in the past because of the pro-market, export-oriented reforms that they have undertaken. Openness at the border has delivered high catch-up growth based on the export sector and stimulated by very high rates of investment. This growth

path is unsustainable because market reforms that have encouraged it are incomplete. Goods markets have been liberalized but other markets are still heavily distorted, including those for the services that infrastructure investment is designed to deliver.[11]

A central step in achieving this will be through the liberalization of the factor and service markets: markets for labor, capital, land, energy, the environment, and physical and social infrastructure. This requires market institutions to appropriate to settings in national economies that will ensure the efficient and equitable operation of these markets as well as the markets for goods.

Some of the distortions, such as state control of energy prices or monopolies in telecoms, transportation and other services, are the result of deliberate policy decisions. Others, such as restrictions on capital markets and on the movement of labor, result from transitions in the process of reform. But they all share common features. They generally depress factor prices and lower production costs, subsidizing producers in the tradable goods sector. This model has been successful in the past, judging from the rapid rates of economic growth. The producer subsidy equivalents have increased industrial profits, raised investment returns and improved international competitiveness, artificially lifting these economies to income levels that would otherwise not be possible.

But the pre-crisis growth model has not been without costs and it is not sustainable for much longer. The most obvious problems are the structural imbalances, resulting from the overdependence of the economy on exports and the high rates of investment and resource consumption. More fundamentally, expansion of investment without structural reform will lead to waste, diminishing capacity to grow and mounting debt. This model of economic growth cannot be sustained in the longer term because consumption in advanced country markets has to fall. There will not be the same capacity to absorb exports from emerging markets as there was in the past. Industrial countries have to cut their deficits and rely less heavily in the future on external borrowing.

Growth in Asian and other emerging economies against the global tide is not sustainable in the pre-crisis growth model. But the room to grow is there and that presents an opportunity which the world cannot afford to forego.

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Endnotes

[1] Subramanian (2011).
[2] Rodrik (2011).
[3] Saft (2011).
[4] Elek (2011).
[5] Gupta (2011).
[6] Wihardja (2011).
[7] Elek (2011).
[8] OECD International Futures Programme (2011).
[9] Ibid.
[10] Samboh (2011).
[11] Drysdale and Young (2010).