Can Developing Asia Hold its Ground?*

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The recent and ongoing capital flight from Asian markets comes in the wake of a longer pattern of sell-off that has been evident for nearly two years now. And this in turn reflects a deeper unease about the pattern of growth in this hitherto very dynamic region, and the receding prospects of such growth being sustained for much longer.

Of course, it is true that the current instability in global financial markets is obviously a reflection of major political upheavals in the North and their likely economic impact. In particular, the election of Donald Trump has made it all but sure that monetary policy will be tightened in the United States in the coming months (despite the protestations of independence by the US Federal Reserve Chairperson Janet Yellen). If this is combined – as is widely anticipated – by aggressively expansionary fiscal policy based on increased military and infrastructure spending and lower taxes on the rich and on companies, then the US fiscal deficit is also likely to increase. This combination will inevitably attract footloose global capital back into the US, causing currency and asset market havoc in many emerging economies.

Indeed, this prospect is probably already being priced in by many investors and fund managers, which is why currencies of developing countries across the world have depreciated in the weeks since the US election. But it is also true that internal forces and processes have played a role in encouraging capital flight from several of the more important emerging markets, especially in the Asian region.

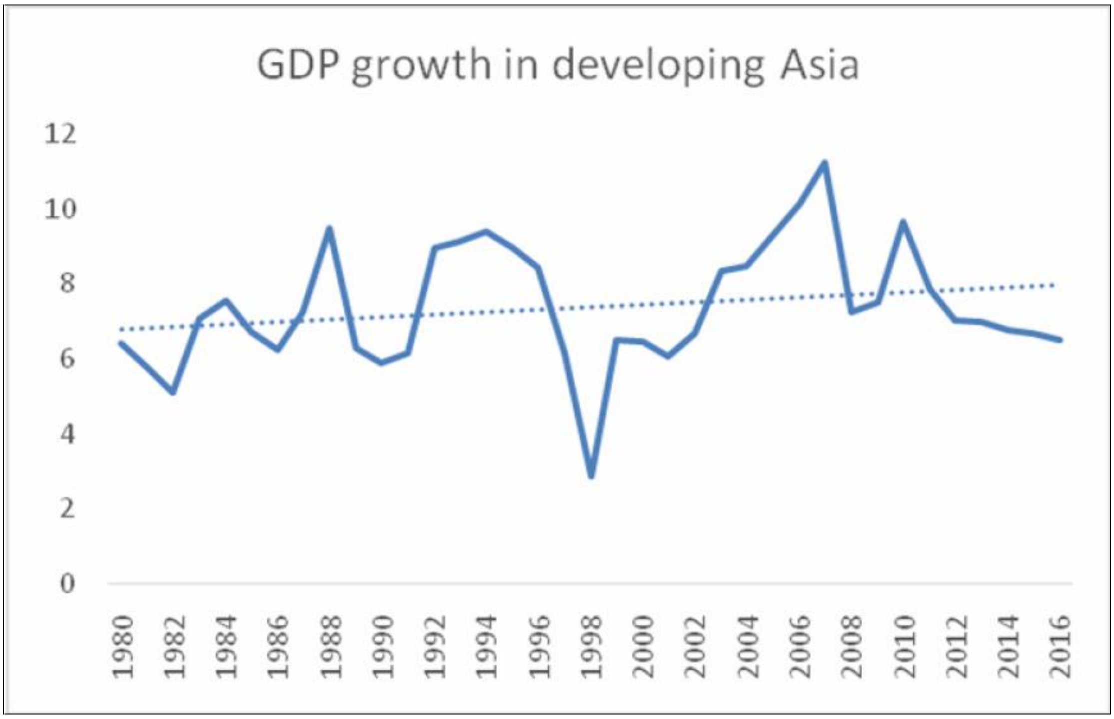
Curiously, in several of them, the domestic forces creating instability are linked in one way or another with issues around corruption. In China, privately held capital has fled in the face of the ongoing anti-corruption campaign that makes local asset holding much less secure. In the Republic of Korea, political uncertainty has contributed to the currency instability, as the President has found herself embroiled in an ever-widening scandal centred on her close associate who used proximity to power for extortion and personal gain. As massive street protests add democratic pressure to the judicial processes already under way, the power vacuum is reflected in capital flight.

And in India, the bizarre, ham-handed and completely mismanaged move to demonetise “high value” currency notes on grounds of eliminating “black money” acquired through illegal or unrecorded activities and curbing counterfeit currency is largely responsible for the sell-off. Since these notes accounted for 86 per cent of the value of money in circulation, their removal has led to massive currency shortages, enormous distress among the population at large and possible medium term destruction of the informal sector, which still accounts for around half of GDP and more than 85 per cent of India’s workers. While this will do relatively little to reduce illicit wealth (the bulk of which is not held in cash) or stem the process of generating it, it has done much wider economic damage. The resulting chaos has also been reflected in other asset markets, with gold prices shooting up and “black market” (or hawala) exchange rates going through the roof, along with some depreciation in the official foreign exchange market.

Despite these proximate more political factors in the region’s largest economies, there are other real economic tendencies that provide some insight into the waning appetite for these currencies among both local and global investors. Foremost among these is the idea gaining ground that the much-vaunted export-led boom in developing Asia is now over, and will not generate the kind of rapid growth witnessed in the past two decades.

Chart 1 shows that while it lasted, the countries of developing Asia on average did indeed benefit greatly in terms of aggregate real income growth (even if that did not always translate into greater material well-being of significant sections of the population). The entire period since 1980 shows a healthy rate of growth for the region as a whole (at a trend rate of 6.75 per cent per annum) and there was a significant acceleration in growth rates in the period 2002-2012. Since then, growth has decelerated, but it still remains by far the most economically dynamic region in the world. This is true despite the much-vaunted US recovery, which increased growth rates there to the most rapid of the developing world, but still less than half the rate of economies like that of China.

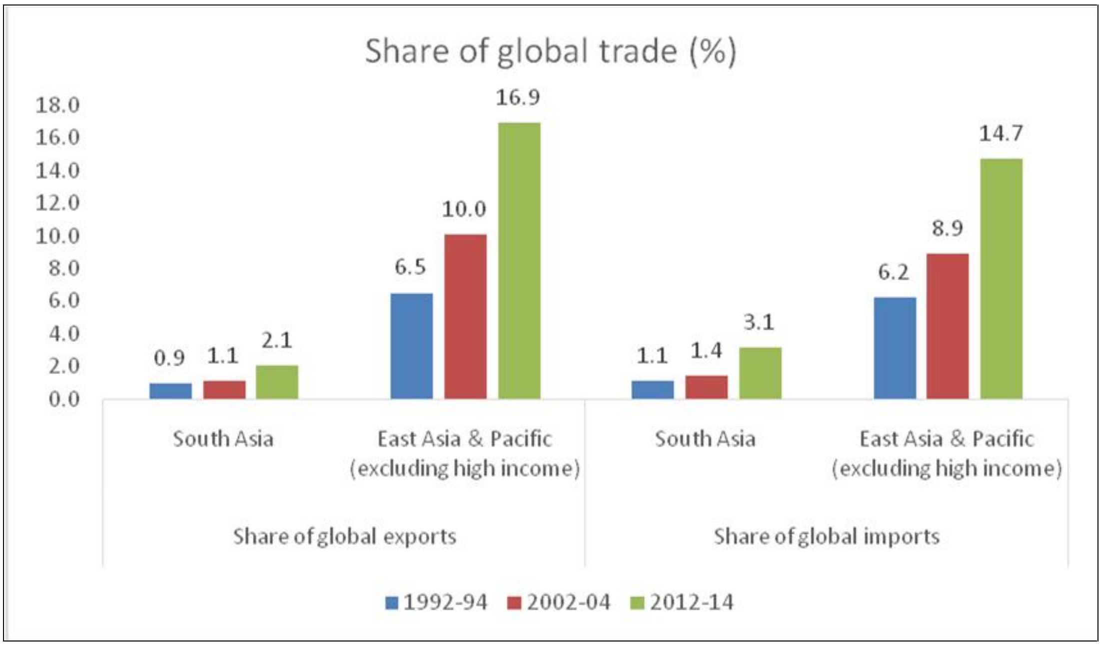
Chart 1: Developing Asia has been the most dynamic region in the world since the 1980s



Source: World Bank World Development Indicators online, accessed on 23 November 2016

It is widely recognised that this was crucially dependent upon global integration, and specifically for many countries in the region, on increasing shares of global trade. Beginning with the East Asian NICs, continuing with the second-tier NICs in Southeast Asia and finally with the roaring expansion of China, this region sharply increased its share of global exports as well as (to a lesser extent) global imports. Chart 2 indicates developing East Asia and the Pacific (including Southeast Asia) nearly tripled its share of global exports in two decades, to around 17 per cent in 2012-14. Its share of global imports also increased, albeit to a lesser extent, leaving this region with significant current account surpluses. South Asia also increased its share of global exports, but from a much lower base and to a lesser degree, so that in 2012-14 it accounted for just above 2 per cent of world exports. However, its share of global imports was higher at more than 3 per cent, pointing to substantial current account deficits in terms of its own national incomes.

Chart 2: And sharply increased its shares of global trade



Source: IMF Direction of Trade Statistics online, access on 23 November 2016

Obviously, since 2002, most of the region’s increasing shares in global trade have been due to China, which has emerged as the largest trading partner for all developing (and indeed developed) regions and for most countries in developing Asia. China became the centre of a global production relocation process that drew in raw material and intermediate goods for final processing and export, with the Northern countries still dominant as the final markets. This led to increasing commodity prices and export bonanzas for primary commodity exporters, as well as dramatically increased manufacturing exports (as part of global value chains) from many countries to China, including especially countries in developing Asia.

But then Northern markets began to slow down and demand for developing country exports also decelerated. This forced the hand of Chinese policy makers to embark on the much-prophesied rebalancing of the Chinese economy away from export-led to domestic demand-led growth, which really began from around 2012. The internal rebalancing is already evident in higher wages and consumption rates and reduced investment rates inside the Chinese economy.

However, this has not been accompanied by commensurate external rebalancing, to reduce the export surpluses. Indeed, in the more recent period, while Chinese exports have decelerated dramatically, even falling in absolute terms over some periods, imports have fallen even more precipitously. As evident from Chart 3, this has been acute with respect to China’s trade with other developing countries, for which China’s trade surpluses have actually been rising through this period of slowing and falling exports.

Chart 3: But China no longer provides a net positive trade stimulus for developing countries

Source: IMF Direction of Trade Statistics online, access on 23 November 2016

The consequences for other developing countries – and especially those in developing Asia – are dire. For these countries, the net stimulus provided by trade with China is now negative, and increasingly so. Furthermore, it is likely to remain this way for some time. This points to real concerns about the future viability of the export-led growth model, which several governments in the region (including in India) continue to espouse.

So the recent adverse movements in financial markets may reflect more than the effects of immediate policies and other problems of some countries. Clearly if there is to be any medium-term revival of growth in the region, and that too on more sustainable and equitable lines, the export-led model that powered previous growth will have to be reconsidered.

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