East Asia’s Limited Ability to Influence the U.S. Business Cycle

By Michael Ivanovitch, PhD

East Asia will continue to be the fastest-growing segment of the world economy, led by China’s relentless drive to expand, modernize, and lift 200 million people from utter poverty. So it’s not surprising that we are labeling the countries of this region as the new engines of global economic growth, particularly as the United States and Europe—which account for half of the world’s output—struggle with high unemployment and sluggish spending in the aftermath of a huge financial crisis.

Home to more than half of humanity, and with most of its economies in early stages of industrial development, East Asian countries deserve the attention they have been getting. But the ability of these economies to influence the global business cycle will remain limited for a number of reasons.

First, although their combined gross domestic product (GDP) roughly equals that of the United States, these economies are developing according to the export-driven growth model, i.e., with subdued household consumption and relatively high savings. Second, with a current account surplus of $560 billion, East Asian economies are a drag on global economic growth. More than half the U.S. trade deficit in 2009 was accounted for by the economies of that region. Third, to serve as an engine of world economic activity, the structure and the composition of East Asian economic growth would have to change: They would have to consume and invest more and save (export) less. As we shall see below, some East Asian countries may well succeed in achieving such a structural change as they seek to base their growth on domestic demand rather than exports. Fourth, the United States cannot expect East Asia to contribute significantly to U.S. economic growth because East Asia consumes less than one-quarter of U.S. exports.

Understanding East Asian economic policies and growth strategies is key to seeing how, and to what extent, the U.S. economy can make the most of this expansion.

China’s Growth Strategy Offers an Expanding Market for U.S. Exports

Of all the East Asian economies, China has the clearest policy intentions: Beijing wants to get away from export-led growth and anchor its economy with domestic demand. This policy shift is being reinforced with a $585-billion fiscal stimulus package—implemented through an avalanche of cheap credit—to keep the Chinese economy on a 9–10 percent growth path.

Beijing has moved to this new strategy for two key reasons. First, the Chinese realized that if they continued with export-led growth, China would lose control of its economy, because exports depend on external demand and world prices. (The Japanese never understood this.) Second, by de-emphasizing exports and cutting trade surpluses, Beijing hopes to minimize trade friction with the United States and the European Union.

China, therefore, is set to change the composition of its aggregate demand. This will take time because its entire manufacturing sector was set up to produce cheap exports based on cheap labor and tax incentives. Foreign companies played a key part: An estimated three-quarters of Chinese exports are generated by joint-venture operations with foreign manufacturers.

Washington should be supporting Beijing’s push to generate growth through domestic demand, but it’s not. The United States instead is wrongly focusing on the dollar-yuan exchange rate. U.S. policy makers don’t understand that trade balances result from savings rates, not exchange rates. If exchange rates had anything to do with trade flows, the United States would be running a huge trade surplus and Japan and Germany would be piling on trade deficits and net foreign debt. In reality it is just the opposite: Japanese and German savings rates have been several times higher than the U.S. savings rate. China’s savings rate of about 50 percent of GDP means that China will remain a surplus country for some time.

In addition to encouraging the Chinese to spend more and save less, Washington also should make sure that U.S. companies have as much access as possible to the Chinese market. The United States has the bargaining clout to achieve this access.

U.S. trade interests would be greatly enhanced, however, if U.S. diplomats were to clear the suspicion and recrimination prevalent in relations with China. Washington should define with greater clarity its posture toward Beijing. What exactly does it mean to brand China as a “strategic competitor”? Creative ambiguity (i.e., “keep them guessing”) won’t do. The United States must develop a mutually agreeable modus
India’s Markets Must Open to U.S. Goods and Services

In spite of significant progress in U.S. trade with India over the past five years, the United States’ exports to India are one half of its exports to the Netherlands, where GDP is about three-quarters that of India. China and the United Arab Emirates are ahead of the United States as India’s trading partners. The United States should be doing more business than that with India, which is aiming for 10–11 percent annual growth and has an infrastructure modernization program worth more than $500 billion.

Opening India’s markets won’t be easy, but access is not the only issue. Those who think India is catching up to China’s booming economy should think again. China’s high savings rate means that it can easily finance a rapid economic expansion with internal sources. India cannot. Its trade deficits require India to import foreign savings to sustain economic growth. To make matters worse, India’s public-sector deficit (about 10 percent of GDP) takes most of the country’s domestic savings and leaves very little to finance investment. This is unlikely to change because of India’s commitments to a broad and expanding range of politically sensitive spending programs. Government’s role in stabilizing the economy is essential in a country where 80 percent of people are farmers and/or live on less than $2 a day. The growth potentials, and growth prospects, of China and India are very different; China has a significant edge.

U.S. access to Indian markets also depends on diplomacy. Delhi views Washington’s growing military involvement in Pakistan and Afghanistan with great suspicion. The new U.S.-India Economic and Financial Partnership, announced by President Obama in November 2009 when he hosted Indian Prime Minister Singh at the administration’s first state dinner, is too narrow a forum given the need for wide-ranging political and strategic cooperation.

Japan Will Remain a Drag on World Economy

With Japanese trade surpluses at 3–4 percent of GDP, exports and external demand will continue to drive Japanese output, demand, and employment. The United States, therefore, cannot expect the world’s third-largest economy to significantly contribute to the U.S. economy. U.S. exports to Japan are about 30 percent less than U.S. exports to China and roughly equal to U.S. exports to the United Kingdom, which has an economy less than half the size of Japan’s.

The Japanese government’s economic forecasts are based on this export economy. Japan is making no credible effort to stimulate private consumption or residential investment. Between 2007 and 2009, Japanese household consumption was stagnant. During the same period, the housing sector was in free-fall, tumbling at an average annual rate of more than 10 percent, while business investment fell at a rate of 5.6 percent. The Japanese economy has been rescued from depression by its net exports, largely thanks to China and the rest of Asia, which take more than half of Japan’s foreign sales.

Japan also has worrisome demographic trends: It has one of the world’s fastest-aging populations; 23 percent of Japan’s 126-million people will be older than 65 in 2010 (compared with 13 percent in the United States); and a median age of 44 makes Japan the world’s oldest society. Japan would do well to encourage family formation and new births, perhaps by helping young couples acquire property, as Australia did when it provided grants for down payments on homes and prompted an economic upswing. Subsidies and tax credits for children stimulate new births, as demonstrated by France and Sweden, which thus overcame declining birthrates. Daycare centers and child education allowances also would help Japan achieve lasting recovery by stimulating domestic demand, allowing it to make a net contribution to world growth and let go of its current policy of export-led stagnation. Tokyo’s belated and inadequate measures to help families with children, and to renew the housing stock, are not addressing the core issues and will lead nowhere.

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The United States Will Continue to Move the Global Business Cycle

East Asia’s growth potential should not be confused with its contribution to the world economy. As long as East Asian countries generate large trade surpluses, they will live off the rest of the world. This situation will change when these countries put more emphasis on domestic demand. So far only China, India, and Indonesia are moving in that direction.

The United States must expand its economic, political, and strategic involvement in East Asia to prompt the structural changes necessary to increase East Asia’s net contribution to global economic growth. A more constructive relationship with China is perhaps the most important policy issue Washington must address. East Asia is a well-functioning segment of the vast dollar currency area, and Washington
should provide support by enhancing the dollar’s role as a key vehicle of global trade and finance. Constant and unnecessary exchange-rate skirmishes do exactly the opposite: They drive China and other countries in the region to ad hoc and suboptimal bilateral trading arrangements in order to avoid dollar-denominated transactions.

Unfair trade barriers to U.S. firms in East Asia must be dismantled. That should be easy to do because the United States is the main export destination for these export-driven economies. East Asian policy makers have a keen interest in open and expanding U.S. markets for their goods and services, especially since the European Union would not allow liberal access to its markets. The use of the United States as the ultimate dumping ground for East Asia’s products and services—without the corresponding access of our firms to their markets—must stop.

The United States also must improve the quality of its monetary management and strengthen the supervision of its financial system. Only a monetary policy focusing on price stability (defined as an inflation rate of 0–2 percent) will set the foundation for a steady and sustainable growth and will reaffirm the role of the dollar as the world’s unrivaled transaction currency and store of value. U.S. financial markets and institutions also must regain the reputation of fair and adequately regulated outlets and intermediaries, with strong and transparent investor protection rules.

If the United States achieves these two objectives, the vitality of the U.S. economy will do the rest. Pessimism about the United States’ ability to grow and create employment is misplaced. With an average growth in the U.S. civilian labor force of about 1.2 percent per year, and an average growth of U.S. nonfarm labor productivity of about 2.4 percent, the potential and noninflationary growth rate of the U.S. economy remains in the area of 3.5 percent. There is no “new normal” here, bandied about by people who don’t understand that the United States still has the world’s most-productive economy. The United States has been set back by an appallingly incompetent monetary policy and an even more incompetent supervision of the financial system, but the U.S. economy is rebounding and will remain the ultimate mover of the global business cycle for the foreseeable future.

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Endnotes


2 “Vast dollar currency area” refers to the fact that the dollar remains the key vehicle of international trade and finance. That is particularly true in East Asia—including Japan and China—where domestic currencies (including the yen and the yuan) play little, if any, role in international transactions.