# ISAS Brief

**No. 101 – Date: 13 April 2009**

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

## Asia's Economic Revival: Seeking Solutions beyond the Fiscal Stimulus

M. Shahidul Islam[1]

As the recession in the United States (US) deepens, it is apparent that America's traditional role as the world's 'consumer of last resort' is now at stake. Consumer confidence in the US has plunged, owing to the 'wealth effect' following the burst of the assets bubble. The McKinsey Quarterly reports that the two forces which until recently turbocharged the US consumer spending – growing household debt and a falling savings rate – are now following a reversal trend.[2] American consumers have accounted for more than three-quarters of its gross domestic product (GDP) growth since 2000 and for over one-third of global growth in private consumption since 1990.[3]

The rise in US savings and the fall in its debt (and vice-versa for Asia) are indeed badly needed to correct the global imbalances, a financial mismatch between the US and Asia which is believed to be the epicentre of the current crisis. Now there is a consensus among economists that unless there is a significant correction in the global imbalances, the US' twin deficits are not sustainable. Thus, sooner or later, this adjustment has to take place.

The crisis has clearly shown that Asia has not decoupled from the US growth. The region is, thus, also bound to absorb the cost of adjustment. The drop in Asia's exports to the US is expected to continue. China and some other Asian countries risk the grind-down of their reserves which are invested in US treasury and other American assets.

Considering these scenarios, the key question is – where does Asia stand in terms of its growth potentials? Though 2008 (and 2009 too?) has been an *annus horribilis* for growth forecasters such as the International Monetary Fund (IMF) and the Asian Development Bank, it is widely viewed that Asia's growth prospects are not that bleak owing to several positive signs. These include fewer mismatches in external debt, lower imbalances within the government, better corporate and banking sector balance sheets, and ample foreign exchange reserves, *inter alia*.

---

1 Mr M. Shahidul Islam is a Research Associate at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He can be contact at isasmsi@nus.edu.sg.

2 The Economic Impact of Increased US Savings, *The McKinsey Quarterly*, March 2009, McKinsey & Company.

3 Ibid.

Although the fundamentals of emerging Asia's banks and financial sectors are much better than those in the West, banks in the Asian region have stopped lending to riskier borrowers. Regional equity markets have plunged and Asia's access to external finance faces severe challenges. All these factors are affecting bank lending as well as consumers' and investors' confidence adversely. Consequently, fiscal policies are in the spotlight more than monetary measures – a general phenomenon during an economic downturn.

**Is a Fiscal Stimulus Adequate for Asia?**

In line with the Keynesian prescriptions, one of the major policy responses that several key Asian countries have adopted are fiscal stimulus plans aimed at stimulating their aggregate demand. The question, however, is whether a fiscal stimulus is enough to rebound Asia's growth. There is also a debate on the degree of effectiveness of the fiscal multiplier.

The old Keynesian multiplier which captures the impact of government spending is estimated to be in the range of 1.5 to 2. However, recent research, particularly following the publication of the *Smets-Wouters* model in the *American Economic Review*,[4] suggests that the impact of government spending is much less in the new Keynesian multiplier which is more forward-looking. The reason is that the effect on the GDP diminishes as non-government components (consumption and private investment, in particular) are crowded out by government spending.

However, one should be more cautious in explaining the impact of the fiscal multiplier as one-size-does-not-fit-all. The impact of the fiscal stimulus depends on leakages into savings and imports, and the responses of the monetary policy to the fiscal actions, among others. According to a recent IMF Staff Position Note,[5] for a relatively closed economy with few or no financing constraints for the government such as the US, it is plausible that the fiscal multiplier would exceed 1, especially when combined with an accommodative monetary policy, whereas the size of the multiplier would be smaller for a small open economy that is usually prone to higher leakages into imports. Moreover, such economies are more susceptible to financial market constraints (owing to upward pressure on real interest rate) or could be subject to a monetary policy that offsets the fiscal stimulus.

However, compared to the current US fiscal measures, the Asian economies have some leverage in terms of their effectiveness. About half of the Washington package consists of transfer payments, as opposed to a permanent increase in government spending. However, in most Asian economies, in the absence of programmes such as unemployment benefits, money can be spent directly on infrastructure or in other similar sectors instead of transfer payments. Nevertheless, the effectiveness of government expenditures on infrastructure projects, particularly in terms of employment generation, depends on whether the concerning projects favour capital or labour.

Moreover, Asia is home to the largest number of hand-to-mouth households which generally consume all their current income. This is yet another good sign that the money will be spent on consumption rather than savings even if some fiscal stimulus comes as transfer payments.

---

4 Smets, Frank and Raf Wouters (2007), "Shocks and Frictions in US Business Cycles: A Bayesian DSGE Approach." *American Economic Review*, 97, 3: 506–606.

5 The Case for Global Fiscal Stimulus, *IMF Staff Position Note*, International Monetary Fund, 6 March 2009.

The IMF Staff Position Note[6] shows that the size of the fiscal stimulus packages announced for 2009 by the US, Euro zone, Japan and emerging Asia is equivalent to 1.9, 0.9, 1.4 and 1.5 percent respectively of their economies' GDP, albeit the US' fiscal package for 2010 is much bigger than the other regions. It also reveals that, of the two major types of stimulus plans, namely, tax cuts and infrastructure, emerging Asia is banking much more on the latter. Generally, the multipliers for tax cuts are much smaller, ranging from 0.5 to 1. The study projects that the growth effects of a fiscal stimulus could result in 2.1 percent growth in Asia, followed by the US (1.5 percent), Japan (1.1 percent) and the Euro area (0.9 percent) in 2009.

Using its global macro model, the simulation run by the *Oxford Economics* has also found that fiscal packages could drive Asian growth from as low as 0.5 percent for India to as high as 6.5 percent for Thailand, depending on the size of their packages as a share of GDP, among others.[7]

Of all major Asian economies, India does not have much fiscal space, owing to its current high fiscal deficits. India's consolidated fiscal deficit is estimated to be between 11 and 12 percent of its GDP for the current year. Singapore's fiscal plans that accounts for 5.9 percent of its GDP is expected to generate a 3.6 percent growth rate in 2009. Being an open economy, much of the city-state's government expenditure could leak to other economies.[8]

Although the ultimate effects of government expenditures vary from country to country, the broad picture is that Asia can bank on fiscal packages in 2009 and perhaps in 2010 too. However, the governments' fiscal imbalances cannot be sustained for an indefinite period. If the current recession is no different than the previous ones, then one can expect Asia and the rest of the world to rebound following the adjustments of a traditional boom and bust of business cycle. However, if there are some outliers with low predictability and high impact, then this recession could be very different from the previous ones. Unfortunately, we do not know that just yet. Nevertheless, despite massive quantitative easing (historic lowest interest rates and other easy monetary measures) and record fiscal packages, markets from the Atlantic to the Pacific show no sign of rebound; rather one notices a continuous deterioration of growth scenarios around the world.

If the rest of the world does not recover by 2010, particularly if the US and Europe go into a prolonged recession, then Asia's decades-long high growth may come to a halt. The simple reason is the region's excessive dependence on external demand for growth, India being an exemption to some extent. To avert such a gloomy scenario, Asia requires another plan.

**Asia Needs to Think of 'Plan B'**

Asia's 'Plan B' would be the creation of a sustaining consumer class, which is a lengthy process. Here, economies such as China and India have an edge as both the countries have witnessed the growth of a huge middle class population in the recent past. For these countries, the challenge is to sustain this population by investing in education, agriculture, infrastructure, technology and small-medium enterprises, *inter alia*. In this regard, China is in a better position than India, thanks to its financial strength. Economies such as Singapore need to engage with them as much as possible and share their capital, expertise and

---

6 Ibid.
7 *Asian Development Outlook 2009*, Asian Development Bank.
8 Ibid.

technology, owing to their own limited internal markets. Asia's largest economy, Japan, too faces limitations to grow its banking merely on its internal demand.

The Asian countries should look more closely in their backyards in pursuit of growth. The economic complementarities between the highly developed Asian regions and the least developed ones have to be explored. Asia needs to create more growth zones such as the Mekong-Ganga cooperation. The successes of the South China growth zone could also be emulated in other parts of Asia. Cross-border infrastructure projects like the Asian highway needs to be beefed up.

The European Union's success in integrating its relatively least developed eastern region with the highly developed western part is worth noting in this context. The economic crisis will possibly pay off China's Africa mission not just strategically, but economically as well.

Asia has much room to bank beyond the fiscal stimulus to rebound by primarily employing its economic fundamentals. Waiting for the US to recover as in the past could be a costly mistake for the region. As the Black Swan logic says, the history of a process over a thousand days tells us nothing about what is to happen next. The best example is a turkey before and after Thanksgiving.

oooOOOooo