4 Rebalancing in East Asia

Linda Y.C. Lim
University of Michigan

This chapter considers Asia's contribution to the global imbalances and the financial crisis as well as the sources of the region's imbalances. It suggests that its imbalances were caused by the combined effect of demographics, precautionary savings, high costs of residential property, underdeveloped financial sectors, widening income inequality, and high corporate savings. But still, the solution will require multilateral collective action as well as national rebalancing.

Asia's contribution to global macroeconomic imbalances and the financial crisis

After recovering from the Asian Financial Crisis of 1997-98, East Asian countries as a whole began running consistently large current account surpluses. The accumulated foreign exchange reserves served as a buffer against potential speculative attacks on their now-floating currencies, and as a means to manage those currencies in order to reduce volatility and maintain the international competitiveness of their heavily export-oriented economies.

Because the US was the largest final destination market for their exports—including intermediate exports routed through a regional manufacturing supply-chain vertically integrated across national borders—as well as home of the world's reserve currency, a large proportion of these Asian reserves were invested in US dollar assets. These included particularly US Treasuries, but also, via Asia's sovereign wealth funds, corporate assets.

The resultant capital inflow into the US and global markets, together with the US Fed's easy money policy, kept US and world interest rates low, funding ever-increasing US and some European government budget deficits and household debt. Cheap money also fuelled "financial innovations" such as subprime mortgages and other risky assets aimed at securing higher returns for investors and their financial intermediaries, which subsequently led to crisis.

The capital flow from Asia (and other e.g. commodity-exporting economies) also propped up the dollar and depressed Asian currencies, maintaining Asian export competitiveness, current account surpluses and reserve accumulations, while expanding US current account deficits and national indebtedness.

Sources of the Asian imbalances: Why do Asians save so much?

The serving US Fed chairman Ben Bernanke identified a "global savings glut" as the cause of these global macroeconomic imbalances. With only a few exceptions (most significantly, Singapore), excess public sector savings in the form of persistent government budget surpluses are not the source of the high savings in East Asia which lead to the observed current account surpluses. Japan notably runs large government budget deficits and has a huge national debt but still exports more than it imports from abroad, due to high savings in the private sector. The basic question is: Why do East Asians save so much, particularly at low levels of income?

Demographic profile is a major reason. Half a century of rapid economic growth at least initially predicated on female-labour-intensive export manufacturing resulted in sharp declines in fertility. With the bulk of the population in the prime working-age years, and high rates of female labour force participation, dependency ratios have been relatively low, leading to high household savings and correspondingly low shares of consumption in GDP.

With few descendants to support them in retirement (and high life expectancy in many Asian countries), as well as weak or non-existent social safety nets, there is a *high rate of precautionary savings* not only for retirement, but also for health care and children's education. Some economies—Singapore, Malaysia, Hong Kong—have forced-saving schemes or national "provident funds" with high rates of mandatory contributions out of earned income.

Some researchers (e.g. Abeysinghe and Choy 2004 for Singapore) have also identified the *high cost of residential property*—as measured by ratios of housing prices to years of annual income much higher than international norms at given per capita income levels—as a contributing factor to high savings and low current consumption rates. This is particularly exaggerated in China due to the extreme gender ratio imbalance resulting from its one-child policy, leading to what Wei and Zhang (2009) call "competitive savings" (among households with sons seeking scarce female spouses) which push up property prices for society as a whole.

Underdeveloped and inefficient (e.g. monopolistic) financial sectors in many Asian countries also ensure low returns for savers, necessitating a larger quantum of savings to yield the income required for retirement support and precautionary reasons. *Widening income inequality*, with China, Hong Kong, and Singapore now at the US levels of Gini coefficient (e.g. Lim and Lim 2010), also concentrates income among high-income earners who tend to be high savers.

Finally, *high corporate savings* are a major contributor to high aggregate national savings. In Asia these result from a number of structural features of the corporate sector. Large low-income China and small high-income Singapore represent the two extreme cases, with the lowest shares of labour (wages) in national income, and consumption ratios at or below only 40% of GDP (versus the Asian average of 55%). Moreover, in each case these shares have steadily declined over the past two decades. Malaysia ranks a close third.

Both China and Singapore are correspondingly characterised by high and rising shares in GDP of state-owned enterprises or government-linked corporations, and of multinational corporations—none of which have built-in incentives to distribute corporate income where it is produced, preferring reinvestment for growth. Multinationals are often beneficiaries of host country tax breaks or other investment incentives that reduce local income distribution, and are obligated to remit income overseas to their predominantly home-country shareholders.

In particular, in single- or dominant-party corporatist states like China, Singapore, and Malaysia, there is also little political pressure on state-owned enterprises and government-linked corporations to distribute their income to boost domestic consumption, or to privatise their holdings to local entrepreneurs who might present a challenge to continued state power. Elsewhere, the private sector is often dominated by closely-held public companies or family-owned conglomerates, both of which have little shareholder pressure or motivation to distribute rather than accumulate and reinvest corporate income for growth and expanded market share.

Policy solutions and their limitations

Most of the causes of high Asian household and corporate savings are structural rather than policy-driven, and thus cannot be easily or quickly unwound by government policy. Demographics obviously take a long time to change but have an impact when they do. As a population ages and large cohorts retire, they dissave, while gender imbalances narrow and disappear as affluence and education levels increase.

Financial sector reform should help rebalancing by increasing the efficiency and diversity of financial instruments, so that less savings are required to earn a target return for the investor. After the Asian financial crisis, privatisation and liberalisation of this sector was recommended to increase competition and develop capital markets. This did occur in some countries, most notably South Korea. Elsewhere banks remain dominant and became more conservative in their lending practices after the AFC. Furthermore, the experience of the Asian financial crisis made China reluctant to pursue capital account liberalisation.

Still, demographics and financial sector reform are probably responsible for the increased share of private consumption in GDP between 1990 and 2008 in the largely domestic private sector economies of Japan (rising from 53.2% to 57.8%), Taiwan (54.6% to 61.4%), Korea (50.9% to 54.5%) and Hong Kong (57.1% to 60.5%), whose populations aged significantly (and gender imbalances almost disappeared) over this period as their financial markets were liberalised. Consumption also increased (41.6% to 45.2%), but remained low, in Malaysia over this period.

The difference between Hong Kong and Singapore is striking, with private consumption in the latter declining from 46.3% of GDP in 1990 to 38.6% in 2007 (surpassed only by the decline in China from 50.6% to 36.4%). Besides the much higher share of state ownership and the practice of running surplus government budgets in Singapore compared to Hong Kong, the decline in the wage and consumption share is probably due to the large and rising share of foreign labour—which (like multinationals) has an expected higher propensity to save its income for repatriation rather than domestic consumption (Lim and Lee, 2010).

The lack of a social safety net might partly explain high savings in relatively low-income China, but cannot explain continued high savings in high-income Singapore and Japan, where safety nets are adequate and financial markets relatively well-developed. Forced-savings schemes also do not seem to reduce rates of overall or voluntary private savings. In any event, developing a social safety net, especially for a vast and diverse country like China with administrative and perhaps political constraints, will take a long time, as will any attempt at reducing income inequality.

What about currency appreciation? In theory this should reduce the relative share of export to domestic market production, while increasing the share of imports for consumption, thus shrinking current account surpluses and foreign exchange reserve accumulation. However this has not happened despite the near-continuous appreciation of Asian currencies against the dollar over the last three decades, particularly in Japan and Singapore.

Political Constraints

The last two decades in East Asia have seen savings' high share of GDP decline in the "more democratic" countries of Japan, Korea, and Taiwan, but also in non-democratic Hong Kong. This is probably mostly due to demographic reasons largely beyond the control of government policy, with the exception of Singapore's migrant labour policy. But the inevitable acceleration of ageing and retirement will eventually make a major contribution to lower savings and thus to macroeconomic rebalancing away from export production and toward domestic consumption.

Financial sector liberalisation has helped rebalancing, but is still incomplete and likely to continue being retarded by a combination of post-Asian financial crisis and post- Global Crisis risk-aversion and ideological scepticism, nationalist objections, and resistance by domestic financial institutions to increased competition. Witness, for example, Japan's backtracking from the proposed privatisation of its postal savings institution, Korea's legal attacks on foreign transactions in its financial sector, and the continued dominance and even expansion of China's state-owned banks.

There is no evidence from East Asia to date that expanding social safety nets will significantly reduce savings, given that they have not done so in Japan and Singapore. There may also be governmental hesitation to do so, given ageing populations and the recent negative demonstration effect of fiscally unsustainable safety nets in Europe.

But it is the corporate restructuring necessary to reduce high corporate savings rates that is likely to prove most politically intractable, requiring authoritarian and semi-authoritarian governments to relinquish state control of economic resources and activity on which their political power is partly based. At the same time there are risks that rapid privatisation especially in developing economies may simply give rise to private monopolies with a similar lack of incentive to distribute rather than save their earnings (e.g. as in the Gulf States and Russia).

On the other hand, the experience of the Global Crisis and international pressure to rebalance to prevent further crises, provide an external political stimulus and awareness of the necessity of multilateral collective action as well as national rebalancing. Domestic political pressures can also build from the popular criticism in both China and Singapore of the poor performance of sovereign wealth funds in their international investments, which have also raised some concerns in foreign host countries.

References

Abeysinghe, Tilak and Choy Keen Meng, 2004. "The aggregate consumption puzzle in Singapore", *Journal of Asian Economics* Vol. 15, pp. 563-578

Linda Lim and Lee Soo Ann, 2010. "Globalizing State, Disappearing Nation: The Impact of Foreign Participation in the Singapore Economy" in Terence Chong, ed. *The Management of Success Revisited*, Singapore: Institute for Southeast Asian Studies (in press)

Michael Lim Mah Hui and Lim Chin, 2010. *Nowhere to hide: The great financial crisis and challenges for Asia*, Singapore: Institute for Southeast Asian Studies

Shang-Jin Wei and Xiaobo Zhang, 2009. "The competitive saving motive: evidence from rising sex ratios and savings rates in China", NBER Working Paper 15093

About the Author

Linda Y.C. Lim is Professor of Strategy, Ross School of Business, and former Director, Center for Southeast Asian Studies, at the University of Michigan. A specialist on East and Southeast Asian economies and business, she has published extensively on international trade and investment, multinationals, local business and labour in the region, has consulted for United Nations and other international development agencies, and serves as academic editor of the peer-reviewed *Journal of Asian Business*. A Singapore national, she has served and serves on the boards of US public companies with extensive Asian operations, and lectures frequently to executive and public policy audiences on business and economic development in Asia.