The Insight Bureau

From the Desk of...

Pam Woodall

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Even if America drops, the world economy will continue to shop, says Pam Woodall, Asia Economics Editor of The Economist

According to conventional wisdom, the American economic locomotive has single-handedly pulled the world economy along for the past decade. Meanwhile, frugal Europeans and Asians have preferred to save, not spend. Alarming signs that America's boom may be fading is therefore cause for concern all around the globe. Previous American downturns have usually dragged the rest of the world down, too. This time, however, stronger demand in Asia and Europe should keep the global economy chugging.

The risks of a sharp downturn or even a recession in America during the next year or so are mounting. By virtually every measure, America’s housing market is in big trouble. Home sales and residential construction are tumbling, the overhang of unsold homes has soared and house prices are falling. The problems with sub-prime mortgages will cause the market to weaken further. So far, the housing bust has mainly hit construction, but if home prices continue to slide, even the most spendthrift Americans will keep a tighter grip on their wallets, causing a sharp slowdown in consumer spending. The annual rate of growth of America's real domestic demand has already dropped to only 1.4% in the second half of last year from 4.4% in 2004. Weaker demand means that it will import less from the rest of the world.

But in contrast to the past, as the American engine has lost steam, many other economies have put on a spurt. GDP growth in both Japan and the euro area has perked up strongly, thanks to more robust domestic demand. Even more important, domestic spending is also booming in emerging economies, especially in Asia. One big difference from previous American downturns is that this one will stem from a domestic housing bust rather than from global forces such as higher oil prices or a worldwide collapse of stock markets, which in the past dragged down all economies simultaneously.

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The popular idea that the world economy was being pushed along in a huge American supermarket trolley was always an exaggeration: the $500 billion increase in America's current-account deficit over the past five years may seem huge, but it is equivalent to an annual increase of only 0.2% of global GDP. Asia, not America, has been the main driver of global demand. During the past five years America has accounted for only 13% of global real GDP growth, using purchasing-power parity (PPP) weights. Asia has accounted for over half of the world's growth. Even in current dollar terms, rather than PPP, Asia's contribution to the increase in world GDP has exceeded America's.

The world is experiencing one of the biggest revolutions in history as economic power shifts from the developed world to China and other newly emerging giants. This is shaking up the world economy in many ways, powering it through its fastest five-year period of growth since the early 1970s and causing big changes in relative prices and incomes. But one important consequence of the greater vigour of emerging economies is that global growth is less dependent on the United States than it used to be.

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China and other emerging economies are not just producing much more, they are also buying more. As their incomes rise, so does their spending.

It is a myth that China's consumer spending is feeble: retail sales are rising at an annual rate of over 12% in real terms – the fastest in the world and much faster than in America. There is also good reason to believe that official figures understate consumer spending in China because of their inadequate coverage of services.

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More generally, the common belief that Asia's growth is mainly export-led – and hence dependent on the American consumer – is flawed. The bulk of Asia's growth has in fact been domestically driven, especially in China, India, and Japan. Even without the boost from net exports, China's GDP growth would still have been an impressive 8.5% last year.

Slower growth in the United States will of course mean that it buys fewer goods from the rest of the world. But its share of world imports has fallen from 21% to 16% over the past five years – further proof that demand is strong elsewhere. China's exports to America have fallen from 34% of its total exports in 1999 to 25% now. China now exports as much to the European Union as to the United States. If America imports less, this will cause the Asian economies to slow, but they are unlikely to be derailed. A slump in America will hurt China, India and Japan much less than it will the smaller Asian economies, such as Singapore, Taiwan and Hong Kong, which are much more dependent on foreign demand. And China, India and Japan account for three-quarters of Asia's GDP, so, given the deeper regional trade links, they should help to support demand in the whole region.

Another reason for believing that Asian economies can decouple from an American downturn is that most of them (with the glaring exception of Japan) have small budget deficits or even surpluses. This means they have plenty of scope to ease policy to support domestic demand so as to offset any fall in exports. China is currently tightening its monetary policy so as to cool down its economy. If its exports to America plunged, it could quickly reverse these measures to bolster domestic demand.

Economies in Asia are so far holding up well as America's stumbles. In turn, stronger demand abroad is helping the United States to export more, thereby propping up its economy. Its merchandise exports have risen by 15% over the past year, their fastest pace since 1988. America's sales to China rose by a third, almost twice as fast as its (admittedly larger) imports from that country. As a result, America's trade deficit has started to narrow.

Thanks to the shifting balance of economic power, when America sneezes, the rest of the world's economies will hopefully no longer catch a cold.

About Pam Woodall

Ms. Woodall is one of the world's leading journalists on the global economy and the emerging markets of Asia.

She is Asia Economics Editor with *The Economist*, based in Hong Kong, focusing most of her time on Asia – and the economies of China and India in particular – but also writes regularly about international economics and financial markets. She writes economic leaders for *The Economist* and is the author of *The Economist*'s widely-respected annual survey, *The World Economy*.

She was co-winner of the 2006 Wincott Foundation award for "senior financial journalist of the year", won "best economics journalist" of 2006 at the *Business Journalist of the Year* awards and won the 2005 *Rybczynski Prize*, awarded by the Society of Business Economists. She is interviewed regularly on international radio and television.

Pam is regularly sought-after as a speaker not only in Asia and the UK but around the world, at international conferences and also as a moderator of dialogue at client business events.

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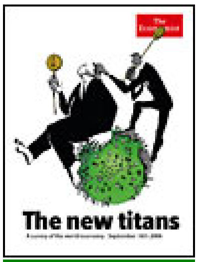

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www.insightbureau.com +65-6300-2495 engage_us@insightbureau.com