

# Policy Brief

## A Lot of Reasons Why We Should Invest More in East Asia

1. Impacts of the current financial crisis
2. Investment as short-run stimulus
3. Investment in the long-run perspectives
4. The importance of public initiatives in recession

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*Although the impact of financial crisis originated from North America and Europe has come to East Asia through both the financial link and the real economy link, the East Asian countries have so far largely responded to it calmly and cautiously. There are now a lot of reasons why we should invest more in East Asia not only for providing short-run stimulus but also for strengthening long-run growth basis. The introduction of market forces in infrastructure development in the form of public-private partnership (PPP) is delayed in East Asia and is thus to be promoted. However, the importance of public initiatives including official development assistance (ODA) and other official flows (OOF) must be emphasized in recession.*

### 1. Impacts of the current financial crisis

The current financial crisis originated from North America and Europe is still enhancing uncertainty in the world economy.

The impact has come to East Asia with two links: the financial link and the real economy link. The effect from the financial link started from a sharp drop of asset prices and exchange rates, due to the expected massive withdrawal of funds originally from North America and Europe. Then the liquidity of financial resources went down because of the conservative move of financial sector. The final stage, though it has not yet to come, would be the collapse of financial sector with bank runs. All of these are subject to the “fear” that people may hold in such a crisis, which can generate a downward spiral of the whole economy.

The East Asian countries have so far controlled their own fear pretty well. Although some countries such as Singapore got a large impact due to their relatively high exposure to risky assets, other countries did not suffer much directly from subprime loans. Asset prices and exchange rates were affected but seemed stabilized at least temporarily. There is no sign of going into a serious financial sector trouble at this moment.

The impact through the real economy link is now coming. The shrinkage of export markets, particularly in North America and Europe, negatively affects activities of manufacturing and logistics sectors in East Asia. The reduction in remittances from abroad must also be substantial for some countries. Although trade and production statistics are announced with some delay, the seriousness of the real economy link will soon be recognized, and macro growth forecasts are likely to be revised downward.

The real economy link, however, can be calmly analyzed and predicted. It is much less prone to being dominated by the fear. North America and Europe are certainly important markets for East Asian products, but their shares are steadily decreasing due to the growth of our own market. Even in the case of machinery finished

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products manufactured in East Asia, the share of North American market is now less than 20%, while the share of East Asia itself becomes more than 50% (Ando and Kimura (2009)). As far as the East Asian market grows, we can grow.

It is now extremely important to keep optimism and continue investing in East Asia in order to avoid unnecessary downturns in the short run and strengthen the basis of economic growth in the long run.

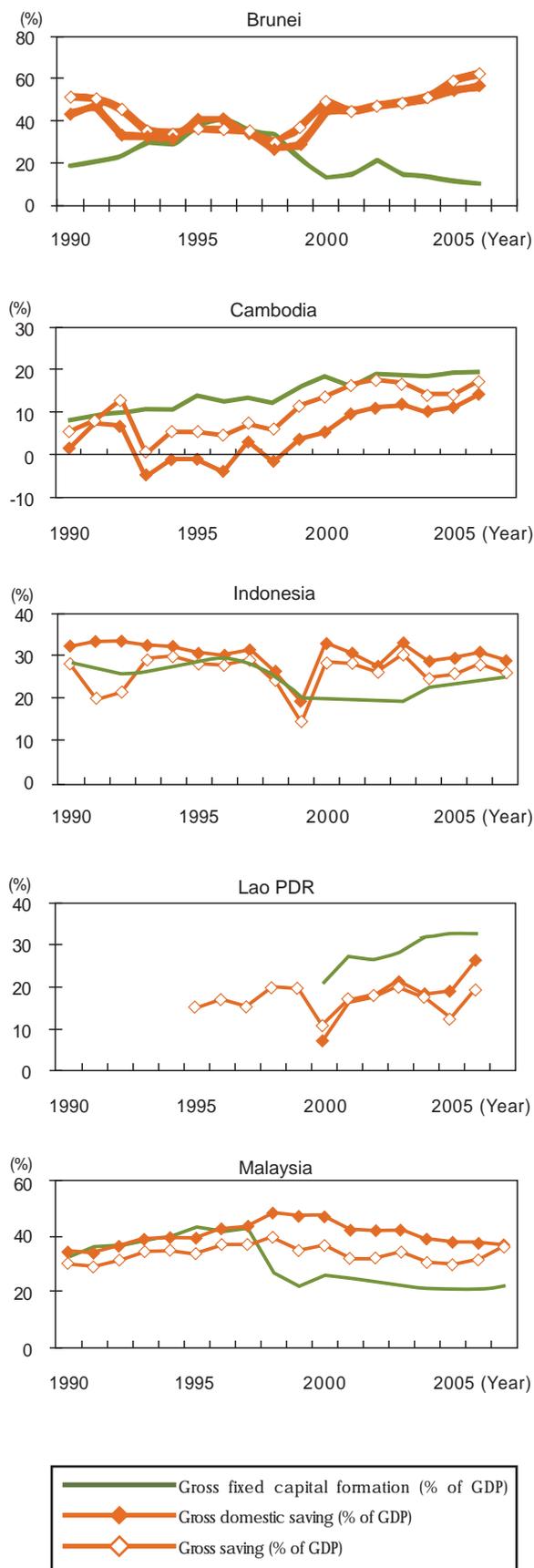
## 2. Investment as short-run stimulus

Except countries under the IMF Program, typical macroeconomic policies applied by countries in the world are now expansionary monetary policy and expansionary fiscal policy. Actually, these are exactly opposite to what was applied in the Asian currency crisis. Expansionary monetary policy tries to keep the liquidity of financial flows in order to avoid serious financial crunch and prevent from financial panic. Expansionary fiscal policy, on the other hand, is intended to provide fiscal stimulus so as to fight against economic downturns.

There has been a long-lasting debate over the effectiveness of fiscal stimulus in recession. Mainstream scholars in macroeconomics have basically presented a skeptical view and have rather emphasized negative side effects, despite the popularity of such a policy among politicians. However, we recently observed a historical change in the attitude of them including economists in the fortress IMF. A recent research note by Spilimbergo, Symansky, Blanchard, and Cottarelli (2008) admits the possible effectiveness of fiscal stimulus and discusses the speed and characteristics of various kinds of fiscal measures. Expansionary fiscal policy is now supported much more widely than ever.

In East Asia, how far fiscal stimulus is introduced widely varies across countries because of different impacts of the current crisis. As the seriousness and longevity of the crisis are recognized, however, we expect that the increasing number of countries may start considering the introduction of serious fiscal stimulus.

Figure 1 Resource balance in ASEAN member countries



### 3. Investment in the long-run perspectives

Even if we do not believe the effectiveness of short-run stimulus without reservation, there still exist a lot of reasons why investment must be encouraged in the long-run perspectives.

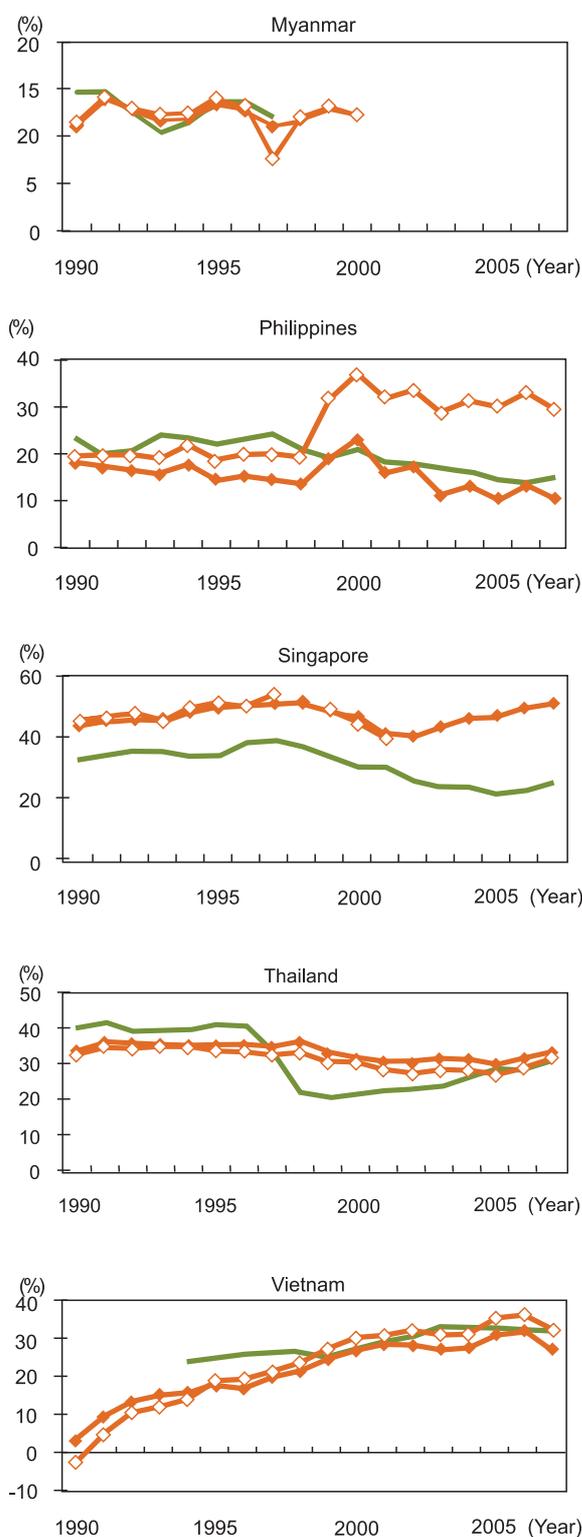
Figure 1 presents gross fixed capital formation, gross domestic saving, and gross saving as ratios to gross domestic products (GDP) in ten ASEAN member countries; these are so-called the gross domestic investment ratio ( $I/Y$ ), the gross domestic saving ratio ( $S_d/Y$ ), and the gross saving ratio ( $S/Y$ ), respectively. To realize sustained long-run economic growth, a country must keep substantially high  $I/Y$  with good investment efficiency, which is backed up by high  $S/Y$ . In this regard, most of the countries in ASEAN should promote domestic investment more. Reasons are threefold.

First, countries such as Cambodia need higher  $I/Y$  if they want to keep rapid economic growth in the long run. There is a simple formula to check the required level of  $I/Y$  for economic growth,

$$g = (1/ICOR)(I/Y)$$

where  $g$  is the annual real GDP growth rate ( $\Delta Y/Y$ ),  $I/Y$  is the real gross domestic investment ratio, and  $ICOR$  is the incremental capital-output ratio defined as  $I/\Delta Y = (I/Y)/(\Delta Y/Y)$ .  $ICOR$  represents investment efficiency; the smaller  $ICOR$  is, the higher the investment efficiency is.

We know that  $ICOR$  is around 3 to 6 when the economy is in good shape. Table 1 tabulates  $ICOR$ s in ASEAN member countries. Except the period of the Asian currency crisis (1997-2000),  $ICOR$ s largely fall into that range. Suppose that  $ICOR$  is 4.5. Then, if a country would like to grow at 6%, the investment ratio should be 27%. In the case of 8% growth, the investment ratio must be 36%. Cambodia is exceptionally efficient in investment; i.e.,  $ICOR$ s are less than 3. We expect that such high efficiency is not sustainable in the long run and Cambodia will eventually need a higher investment ratio in order to keep rapid economic growth.



Gross fixed capital formation = All outlays on addition to the stocks of fixed assets Sales of second-hand and scrapped assets  
 Gross domestic saving = GDP Final consumption expenditure  
 Gross saving = Gross national disposable income Final consumption expenditure

Source: World Bank, "World Development Indicators".

Table 1 Incremental capital-output ratios (ICORs) in ASEAN member countries

	Brunei	Cambodia	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
1993-1996		2.07	4.04	5.18	5.62	3.64	5.61	2.99
1997-2000		2.14	-25.30	9.84	7.07	5.75	-26.19	4.72
2001-2004	6.44	2.42	4.74	5.18	4.79	7.03	4.10	4.69
2005-2008	9.10	1.97	4.07	4.32	3.32	4.43	5.50	4.64

Calculate from national accounts real-price series using the cumulative method.

Brunei: 2001-2007; Cambodia: 1994-2006; Indonesia:1994-; Vietnam: -2007.

*Sources:* Statistical Agencies in each country.

Second, the resource balance, i.e.,  $S/Y$  minus  $I/Y$ , is also important. Figure 1 indicates that a number of countries have positive resource balance, particularly after the Asian currency crisis; see Indonesia (until recently), Malaysia, the Philippines, Singapore, and Thailand (until recently). These countries have high saving ratios. However, just a part of financial resources is invested in the domestic economy while the rest is invested abroad. We are not claiming that investing abroad is something bad. What we would like to ask is whether or not we can find some more good investment opportunities domestically.

Third, East Asia has a problem in the circulation of financial resources. Since the macroeconomic data presented in Figure 1 are those after netting out of back-and-forth cross-border transactions, we cannot directly see it. However, the recent work by Prof. Sayuri Shirai (2009) estimates capital movements between East Asia and the rest of the world. One of the important findings is as follows: in the pre-crisis period, a large portion of our financial resources is once going out of East Asia to invest in riskless assets in the rest of the world, and then investment banks in North America and Europe invest back in East Asia with taking risks. This means that East Asia does not yet have a strong “investment bank” function so as to find good projects by ourselves and invest in them with taking our own risks. We obviously need some effort to foster more active circulation of financial resources within East Asia.

#### 4. The importance of public initiatives in recession

The relationship between public and private sectors in the investment scene in the world has drastically changed since the 1980s. Infrastructure development and services used to be provided directly by the governmental sector. However, various forms of public-private partnership (PPP) have recently been applied to a wide range of projects in order to pursue the efficiency of project

implementation and complement limited government revenues. East Asia is relatively lagging behind in the introduction of PPP and should think of it seriously.

However, in recession, private investment is naturally slowed down, and the introduction of PPP scheme may take time. In such a case, public investment is still important. Wider usage of public funds, including domestic and foreign sources such as official development assistance (ODA), other official flows (OOF), and trade/investment insurance, must be allowed and promoted in the current financial crisis. It may also be effective to prepare some form of facilities for a country to get access to additional borrowing. In recession, public investment may take advantage of cheaper asset prices, too.

The most important thing is of course whether or not projects are good for long-run economic growth. Let us be aggressive in finding good projects and investing in them in East Asia.

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