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Risks of an Asian *Relapse*

The spin game is on as the world tries to talk itself out of the worst recession since the end of World War II. The good news is that there is a slowing in the rate of deterioration in the global economy. The tougher news is that this is hardly surprising. In the aftermath of unprecedented annualized plunges in real global GDP on the order of 6–7% in the fourth quarter of 2008 and the first quarter of 2009, the pace of deterioration almost had to moderate.

With history books replete with tales of V-shaped recoveries following steep downturns, financial markets have become giddy, hoping that signs of bottoming beget the long awaited rebound. Nowhere is that more evident than in Asia—an increasingly China-centric region convinced it will be first to lead the world out of its long nightmare.

If it were only that easy. Contrary to the lore of the “Asia Century,” the region continues to suffer from a lack of internal support from its 3.5 billion consumers. The private consumption share of developing Asia’s overall GDP fell to a record low of 47% in 2008—down from 55% as recently as 2001.

In other words, Asia remains an export machine. Developing Asia’s export share has risen from 36% of pan-regional GDP during the financial crisis of 1997-98 to a record 47% in 2007. And recent research by the International Monetary Fund shows that Asian exports continue to be underpinned by consumers in the industrial world—especially from the United States. Despite a surge of trade within Asia, the bulk of these intraregional flows have been concentrated in parts

and components that go into finished goods eventually consumed by developed economies.

Export-led Asia lacks support from internal private consumption and remains more dependent on external demand than ever before.

Little wonder that in the aftermath of a record contraction of US consumer spending in late 2008—4% average annualized declines in the final two quarters of the year in real terms—every major economy in Asia either slowed sharply or tumbled into deep recession. More than ever, the region’s fate remains made in America.

That is where hopes of an Asia-led rebound are most tenuous. After a dozen years of excess, the overextended American consumer is tapped out. The “green-shoots” crowd—those believing global recovery is nigh—drew special encouragement from a 2.2% rebound in real US consumer expenditures in the first quarter of 2009. That encouragement is about to be dashed. Outright contractions in retail sales data in March and April point to a renewed decline of at least 1% in real consumption in the current quarter.

Hit by the triple whammy of collapsing property values, equity wealth destruction, and an ongoing unemployment shock, the American consumer is unlikely to spring back overnight. In fact, with asset-dependent US households remaining income-short, overly-indebted, and saving-deficient, subdued consumption growth is likely for years. This is because the US consumption share of real GDP, which hit a new record of 72.4% in the first quarter of 2009, needs, at a minimum, to return to its pre-bubble norm of 67%.

That spells a sharp downshift in real consumption growth from the nearly 4% average pace of 1995 to 2007 to around 1.5% over the next three to five years. There will be years when the consumer falls short of that pace. The contraction of more than 1.5% over the past four quarters is a case a point. And there will be years when consumption appears stronger. But the die is cast for a protracted weakening of the world's biggest spender.

Unless Asia finds a new source of demand to replace the overextended American consumer, it will face surprisingly stiff headwinds for years to come.

Therein lies a critical challenge for Asia. Unless it comes up with a new consumer to support its export-led growth model, Asia will face stiff headwinds of its own. Nowhere is that more evident than in China, where the mood has turned particularly upbeat. While I no longer doubt that China's performance will be better than expected in 2009, there is good reason to be wary of extrapolation. China's incipient rebound relies on a timeworn stimulus formula: upping the ante on infrastructure spending in anticipation of an eventual rebound of global demand for Chinese-made goods. It's the latter presumption that remains iffy as American consumers now opt for prudence over profligacy.

China is vulnerable to a relapse in 2009, as a fading investment stimulus is not countered by a US-led snapback in external demand.

If export-led China doesn't get a kick from the American consumer, a relapse for China-dependent Asia is a distinct possibility next year. Don't be fooled by catchphrases such as "green-shoots" and the "Asian Century." In the aftermath of the modern world's worst financial crisis and recession, an Asian-led global healing remains a real stretch.

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