Post-Crisis Structural Changes in Global Growth Trends

Half a decade after the global financial crisis, the global economic environment remains confronted with challenges that are both structural and cyclical in nature. Economic activity in the advanced economies continues to be sluggish, as these economies deal with the legacy of excessive leverage, continued weaknesses in the labour markets and the challenge of reforming existing institutional frameworks. The emerging economies, however, are leading the global economic expansion, amid ongoing efforts in implementing structural reforms to accelerate the shift of the drivers of growth from exports towards domestic demand. These asymmetrical growth patterns are cumulatively contributing to the emergence of an increasingly multi-polar world which may have profound implications for economic relationships between nations and policies globally. This article aims to identify the structural changes that are driving global growth, with a special focus on Asia.

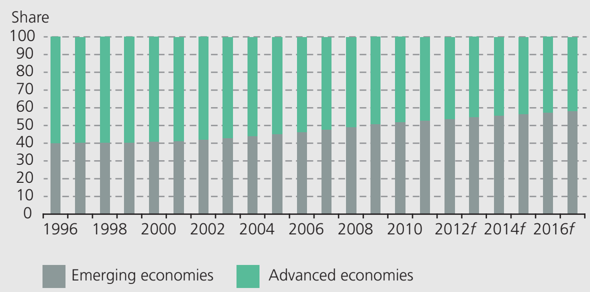
The Great Recession

In 2008-09, the global economy experienced the worst synchronised recession since World War II. Global output contracted by 2.2% while international trade activity weakened by 12% relative to 2005 levels. In response, the swift and aggressive countercyclical monetary and fiscal policy measures undertaken by both advanced and emerging economies managed to cushion the negative impact of the crisis and paved the way towards economic recovery in 2010.

While global output is gradually returning to the pre-crisis levels, the crisis exposed considerable structural weaknesses in the world economy, which are particularly acute in the advanced economies. In contrast, the emerging economies are exhibiting greater resilience and have accounted for more than three quarters of global growth between 2010 and 2012. Emerging economies' share of global growth also rose from 37% in 2000 to 49% in 2011 with a corresponding decline in the share of the advanced economies (Chart 1). Such heterogeneity in economic performance underscores the reshaping of the economic and financial landscape to a new global environment with multiple growth poles.

Chart 1

Share of Global GDP



f Forecast

Source: International Monetary Fund (IMF)

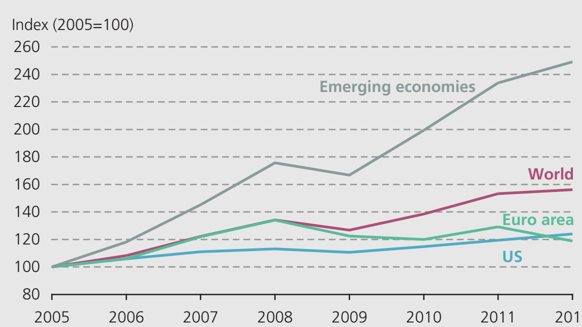
The Rise of a Multi-Polar World

Slow recovery in the advanced economies

In the past five years, growth in the advanced economies has averaged at a lower rate of 0.5% (2000-2007: 2.6%). The pace of increase in economic output in the major economies from pre-recession levels considerably lagged that of the emerging economies (Chart 2). The relatively muted growth prospects of these economies are attributable to several factors, namely private sector deleveraging, fiscal austerity, impaired financial intermediation and structural rigidities in the job market. These factors will be explored further in the next section.

Chart 2

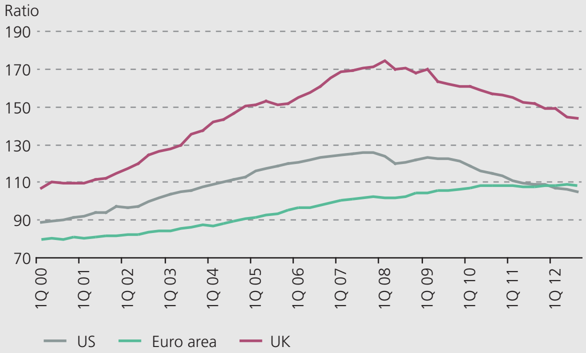
Economic Growth of Selected Major Economies since 2005



Source: Haver

Chart 3

Ratio of Household Debt to Personal Disposable Income



Source: Haver

1) *Continued deleveraging by private sector*

The most immediate constraint to a more robust economic recovery originates from the ongoing deleveraging process across most advanced economies. In the past two decades, several advanced economies experienced excessive debt growth which fuelled a prolonged consumption boom. Of significance, the rising trend of household indebtedness of several major economies was supported by a few key developments in the property and financial markets. The relaxation of mortgage underwriting rules in an environment of abundant liquidity allowed households with lower creditworthiness to purchase properties. Financial innovations also made it easier for homeowners to borrow on overvalued homes. The situation became unsustainable when falling house prices led to defaults, turning into a vicious cycle which cumulatively depressed aggregate demand. As a result, highly-indebted households have been forced to reduce debt and rebuild wealth positions that were severely affected by the negative equity in the housing market. A survey of past systemic crises has shown that in balance sheet recessions, the recovery process is often delayed and lengthy (Reinhart and Reinhart, 2010). Currently, household debt relative to personal income remains elevated by historical standards (Chart 3), indicating that the deleveraging process is still ongoing and would continue to inhibit private consumption activity.

2) *Fiscal austerity*

In response to the severe economic downturn, governments in the advanced economies undertook massive fiscal stimulus measures and provided support to troubled financial institutions through large-scale equity injections and debt guarantees. The deterioration of government finances was further compounded by the operation of automatic stabilisers such as higher expenditure on unemployment benefits and lower tax revenues. The IMF estimates that almost half of the public debt increase among advanced economies is attributable to automatic revenue losses, with another 17% being accounted for by the stimulus packages (Allen, 2012). As a result, the public debt of the advanced economies had escalated to very high levels after the crisis, reaching 105% of GDP in 2011 (2001: 72%), with a fiscal deficit of 4.7% of GDP (2001: +0.7%). Governments in the advanced economies are hence forced to cut spending and strengthen fiscal positions, thereby limiting the ability to further support economic recovery.

Beyond the immediate future, the restoration of sustainable fiscal positions remains challenging, due to other underlying structural impediments. In particular, unfavourable demographic trends of ageing population and rising dependency ratios will exert further strains on public finances. This will constrain the governments’ ability to finance the increased public expenditure on healthcare and pension systems. In 2008, age-related spending such as health and pension expenditure averaged 13% of GDP in the advanced economies. By 2030, these expenditures are expected to increase further by as much as 4.5 percentage points to account for 17.5% of GDP, thereby placing further pressure on their fiscal positions (IMF, 2010).

3) Impaired financial intermediation

Financial institutions in the crisis-affected economies are also deleveraging to repair balance sheet positions that had impaired the banks’ capacity to provide an adequate flow of credit to finance economic activity. The bursting of the housing bubbles caused an immediate and sizeable reduction in the value of bank assets as homeowners defaulted on mortgages and mortgage-based securities experienced a significant deterioration in value. Balance sheets were also affected by the diminishing value of sovereign paper holdings amid heightened fiscal sustainability concerns in several advanced economies. Compounding the situation is the tighter regulatory environment. In 2012, European banks underwent a recapitalisation exercise to raise capital buffers to 9% in core Tier 1 capital. The possible future implementation of more stringent requirements such as Basel III could indirectly tighten lending standards and increase borrowing costs for households, businesses and governments. While recent policy actions by central banks, such as the introduction of Operation Twist in the US and Outright Monetary Transactions in the euro area, have lowered the cost of short-term lending and somewhat eased funding strains, many challenges remain. European banks are estimated to still face a €400 billion shortfall in capital (4.5% of euro area's GDP). Insufficient provision of credit to the real economy may continue to be a major constraint to a full recovery.

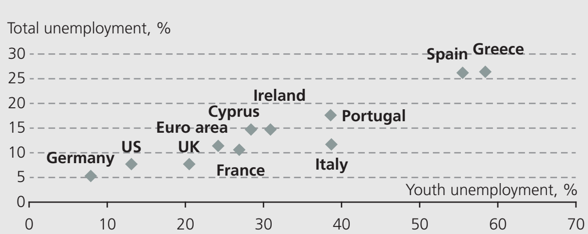
4) *Employment rigidities*
On the employment front, labour market conditions remain weak in most advanced economies. Of significance, the ongoing fiscal austerity in an increasingly uncertain economic environment have cumulatively dampened hiring rates and exacerbated the dislocation of workers from the labour market. In the US and UK, unemployment rates continue to hover around 8%, and in most euro area economies, the rate exceeds 11% (Chart 4). The slowdown in economic activity has had a disproportionate effect on workers in industries that were more affected by the crisis, such as construction and financial services. These job losses, however, are spreading to other sectors that were not directly implicated in the financial crisis such as the manufacturing sector, due in part, to weak consumer confidence and impaired credit flows to consumers.

The slower recovery in employment is also symptomatic of other trends that are structural in nature. Given the uncertain global environment, businesses are more cautious and increasingly opting to hire more temporary workers. Since the onset of the global crisis, part-time employment has increased in more than 60% of the advanced economies and temporary employment was higher in 25% of these economies (ILO, 2012). This is worsened by geographical mismatches; where workers with the desired skills are unable to accept employment in another geographic market, further contributing to the labour market rigidities and higher structural unemployment. In the US and UK, lower labour mobility also partly reflects the lingering effects of the collapse in the real estate market, where most individuals with negative equity mortgages are unable to relocate given the sharp fall in house prices.

The elevated long-term unemployment rates carry serious social and economic costs such as persistently high jobless claims, permanent loss of skills or hysteresis and an increased risk of social unrest and poverty. This has also affected the youth segment of the population more adversely than others. The ILO estimates that youth unemployment in the advanced economies has risen to almost 20% in 2012 from 11.7% in 2007. The situation is more severe in the economies that are in recession, such as Greece (55%), Spain (53%) and Portugal (39%). The exclusion of the young from the labour market may have detrimental effects on future employability and wage growth, especially when many young workers are currently employed in low productivity jobs.

Chart 4

Youth and Overall Unemployment Rates in Selected Advanced Economies

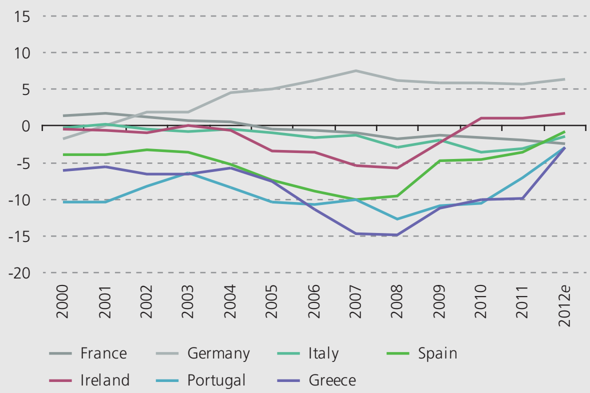


Source: National Authorities, Haver

The crisis has also highlighted other existing structural rigidities in the labour market which have significant bearing on the overall competitiveness of the advanced economies. Many advanced economies have high unit

Chart 5

Current Account Balance of Selected Euro Area Economies (% of GDP)



e Estimates

Source: International Monetary Fund (IMF), Eurostat

labour costs as a result of prevailing wage structures. This is not fully compensated with similar increases in productivity. Among the G7 economies, productivity growth (measured as the change in output per hour worked) has been on a weakening trend since 2005 before declining by 2.4% during the peak of the crisis in 2009. This is particularly acute in the euro area as the shift towards a monetary union has increased the importance of national competitiveness based on real factors such as unit labour costs. The difference in labour compensation and productivity has resulted in differing competitiveness among euro area economies, as reflected by the divergence of external imbalances within the region (Chart 5). In this respect, governments have been undertaking structural reforms in the product and labour markets to improve competitiveness, but the positive effects can only be observed in the real economy over the medium term. In the foreseeable future, the combination of slower economic activity and prolonged and deep weaknesses in the labour market will cause unemployment to remain high, depress income growth and create a huge strain on government finances.

Prospects for the emerging economies

Economic activity in emerging economies remains robust. The IMF projects that the emerging economies are expected to expand by an average of 6.0% annually over the next 5 years. In Asia, growth is increasingly underpinned by the rising strength in domestic demand, which contributed to more than two-thirds of the region's growth in 2011. The Asian economies have weathered the global economic upheaval relatively well compared to the advanced countries. In the immediate aftermath of the crisis, stimulus packages put in place by the authorities played a key role in mitigating the adverse impact of weaker global trade. In addition, policy and market reforms undertaken in response to the 1997/98 Asian financial crisis have enhanced the region's macroeconomic fundamentals and financial market resilience, which allowed for these countercyclical expansionary measures to be quickly transmitted to the real economy.

The experience from the global financial crisis provides several crucial insights to the region. Weakness in global demand has reinforced the need for ongoing economic reforms in Asia to reorient growth towards domestic demand. Beyond national borders, the crisis has also expedited efforts to advance greater intra-regional and inter-regional economic linkages. Given the prolonged nature of the current economic recovery, the growth challenge is premised upon efforts to generate and sustain new sources of growth whilst leveraging on existing favourable trends.

The sustainability of Asia's growth path going forward will also be underpinned by several structural factors. The **rapid expansion of the middle-class population** in Asia will contribute to a shift towards greater domestic consumption in regional economies. This transition is already underway, with private consumption contributing to almost half of Asia's growth in 2011. In Developing Asia[1], the share of the middle-class[2] population has doubled to 56% of total population in 2008 (1990: 21%).

[1] Developing Asia - Armenia, Azerbaijan, Bangladesh, Cambodia, People's Republic of China, Georgia, India, Indonesia, Kazakhstan, Kyrgyz Republic, Lao People's Democratic Republic, Malaysia, Mongolia, Nepal, Pakistan, the Philippines, Sri Lanka, Tajikistan, Thailand, Turkmenistan, Uzbekistan, Vietnam (ADB, 2010).

[2] Middle Class – population with expenditure of USD2-20/day.
High Class – population with expenditure >USD20/day (ADB, 2010).

By 2030, the middle-class population in developing Asia is expected to account for 42% of global expenditures, underscoring the region's evolving role as a significant consumer base for the global economy (Chun, 2010).

Furthermore, Asia is also experiencing an unprecedented rate of urbanisation and improvement in living standards. By 2025, more than 2 billion people in Asia, which accounts for half of the world's urban population, are expected to live in cities. This development is expected to contribute to the reorientation of regional economies towards stronger domestic-based growth. Furthermore, there will likely be more public investment initiatives to address the region's infrastructure needs. In particular, Asia's infrastructure investment needs are estimated at USD8 trillion for the period 2010-2020 (ADB, 2009).

On the international front, **closer economic linkages among the emerging economies** in the form of trade and investment flows will allow for greater diversification of markets, thereby reducing over-reliance on the advanced economies. The share of emerging East Asia's exports to advanced economies has been on a steady decline since 1990. Of significance, East Asia's[3] exports to G3 economies have fallen to 22% of total East Asian exports from 31% a decade earlier. This is largely attributed to the trend of rising intra-regional trade, which currently accounts for about half of Asia's total trade. Given the expected increase in consumption within the region itself, many Asian economies could leverage on this new international trade configuration to meet the greater domestic demand in the region. Foreign direct investment within the region has also grown in importance, expanding by 20% per annum over the past decade. This encouraging development is supported by the emergence of home-grown multinational firms as well as greater business opportunities in the region.

In Asia, the closer ties are also evident as authorities leverage on the existing intra-regional groupings and networks to foster greater collaboration and cooperation in key areas of interest. The reinforcement of alliances, such as the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and ASEAN+3, highlight Asia's growing economic cooperation. Several regional countries have also established bilateral agreements to use domestic currencies for trade settlement and cross-border collateral agreements aimed at enhancing liquidity facilities to financial institutions. These have cumulatively contributed to the strengthening of economic and financial linkages within Asia.

Structural reforms have also been earnestly pursued. Regional governments are placing focus on promoting policies aimed at boosting household incomes and reducing precautionary savings. These include health insurance reforms and extended pension coverage and financial sector reforms to strengthen financial inclusion. In Asia, the enhancement of social safety net schemes such as the minimum wage has played a role in boosting the incomes of households with the highest propensity to consume and subsequently raise consumption activity.

Finally, the integration of **new global players** into the market will continue to reshape the global labour, consumption and production landscape. In the past few decades, new emerging regions have made significant strides towards establishing a more market-oriented economic system amid lower bureaucratic barriers to trade and investment activity. These reforms have taken strong root in Asia over the past decade. Emerging ASEAN nations such as Cambodia, Laos, Myanmar and Vietnam have undertaken deep and significant reforms which have facilitated the liberalisation of their domestic markets. While these four economies currently account for 9% of ASEAN's GDP (2011), growth has averaged 6.6% over the past 5 years, underlining the region's potential as a new consumption centre and investment base for investors. This would cumulatively elevate the Asian region's growth prospects.

[3] East Asian economies comprise of PR China, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, Korea, Chinese Taipei and Thailand.

A New Normal

The confluence of these developments suggests that the aftermath of this recent crisis is fundamentally different from previous crises. The global economy is currently navigating through a 'new normal'. Growth in advanced economies is expected to be weighed down by continued efforts to promote structural reforms and deleveraging by governments, financial institutions and consumers. Against these developments, the emerging economies, particularly those in Asia, will remain the key drivers of global growth, leveraging on favourable trends such as rising intra-regional trade and greater shift towards domestic demand-led growth. While these factors will play a crucial role in moderating the impact of lower demand in the advanced economies, the emerging economies are not fully insulated from the weaker external environment. In mid-2012, for example, domestic demand in Asia showed signs of moderation amid sustained weakness in the advanced economies. Taking all these factors together, while the global economy is expected to continue to improve, the recovery may face prolonged downside risks and remain unevenly distributed.

Looking further ahead, global structural trends such as continued urbanisation, technological advances and the changing demographics will also play a more prominent role in reshaping the global economic and financial landscape. Of significance, efforts to enhance economic resilience, flexibility and efficiency will be a key policy focus in most regions, particularly with regard to the allocation of scarce resources and the provision of sufficient infrastructure. Beyond the national borders, the 'new normal' requires policy perspectives to transcend cyclical and domestic considerations towards one that is pre-emptive and global in nature. In this respect, structural and institutional reforms will play an important role in creating more inclusive and sustainable growth.

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