Economics

Asia: arresting the Great Investment Slowdown

DBS Group Research

5 June 2015

- **Asia's investment growth has slowed to a crawl**
- **Some of the slowdown owes to falling savings rates that typically accompany rising incomes. But investment has slowed far more than higher incomes alone can explain**
- **If the slowdown is not arrested and turned north again, incomes and employment will suffer**
- **China's new AIIB won't turn the tide. It's far too small**
- **The real problem is Asia's current account surpluses. Asians are lending, not borrowing – investing abroad rather than at home**
- **Some good old-fashioned deficits are what the region needs. It's not heresy, it's Finance 101. But mindsets will have to change if deficits (and greater domestic investment) are to return to Asia**

Asia's investment growth has slowed to a crawl. After averaging 15% per year for decades, real investment growth in the Asia-10 has slowed from an 11-odd percent pace in 2008, to 6.5%, on average, in 2009/10, 5% in 2012, 4% in 2013 and below 3% in 2014. The drop isn't just about China, where many would say a slowdown is overdue. These figures are simple averages of the Asia-10, so tiny Singapore counts just as much as the massive mainland.

Savings and investment have been key to the growth equation in Asia since 1950 as indeed they are everywhere. Higher incomes tomorrow can only come from sacrificed consumption today. With few exceptions, the more you save, the faster

Nomenclature

References to economic regions in this report adhere to the following conventions:

Asia-10: CH, HK, TW, KR, SG, MY, TH, ID, PH, IN

Asia-9: A10 less CH

Asia-8: A10 less IN, CH

Asean-5: SG, MY, TH, ID, PH

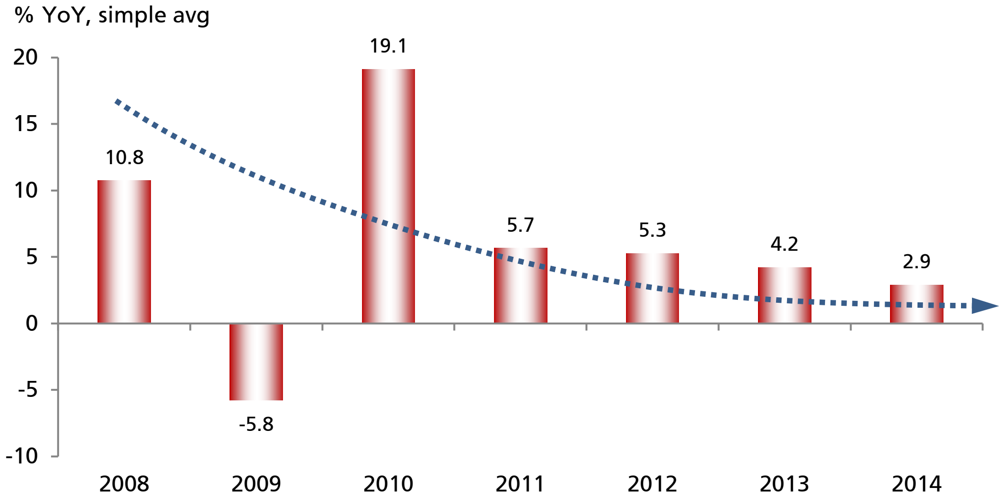
Asia Big3: CH, IN, ID

G4: US, EU, JP, A10

G3: US, EU. JP

EU: EU18

Asia 10 – real investment growth



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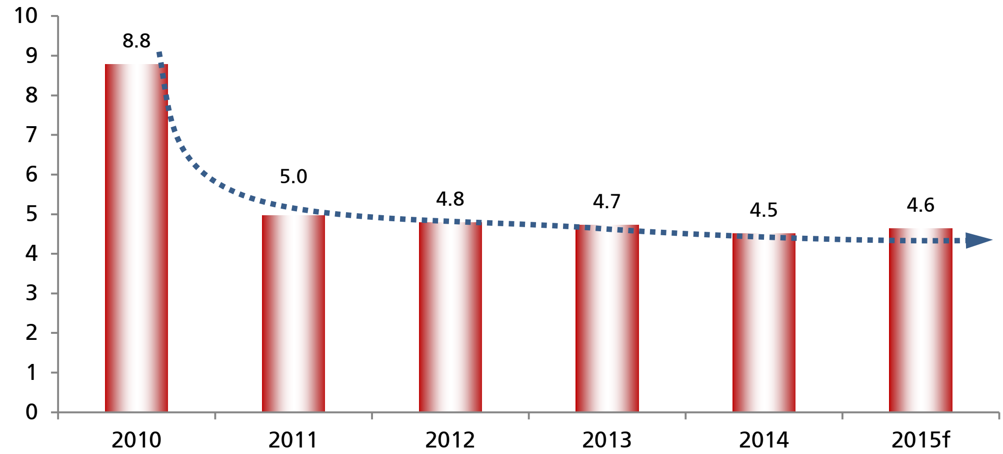
Asia10 – GDP growth

% YoY, simple avg



If investment doesn't pick up, growth will fall. Incomes may too

you grow. So far, Asia's GDP growth hasn't suffered much. In simple average terms (again to avoid heavily biasing the picture with China), growth has run between 4.5%-4.75% for the past four years [1]. But it won't stay there if investment doesn't stabilize soon. Output, incomes and employment will all take a hit. How do you arrest Asia's great investment slowdown? How do you turn it around?

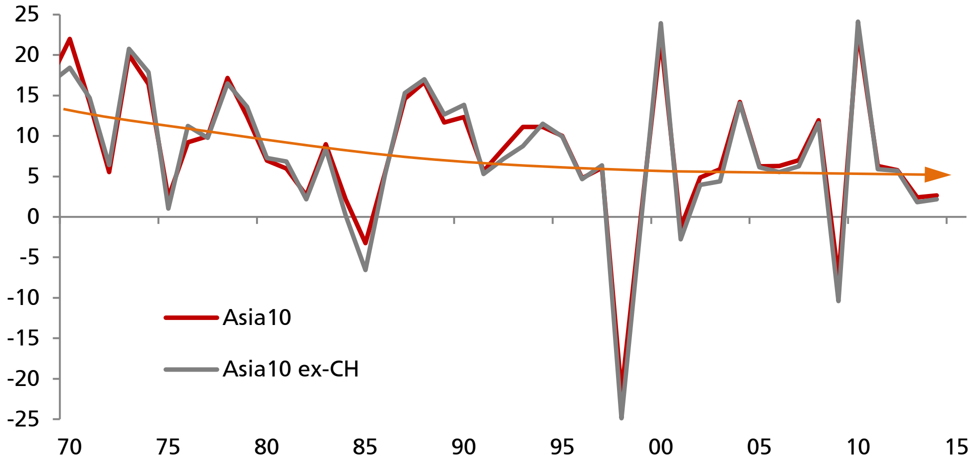
Of structures and cycles

Alas, a big part of the answer is, you don't. As discussed below, much of the great investment slowdown is 'structural' – owing to the steady rise in incomes over the past few decades. To this extent (but no further), slower investment is good news, not bad.

It's no surprise then that Hong Kong, Korea and Taiwan – Asia's three highest income countries after Singapore – have experienced the most marked slowing in investment (charts at top of next page). China and India, at the lower end of the income spectrum, haven't experienced much if any slowdown in trend investment growth. Most would agree this makes sense for India, where per-capita income

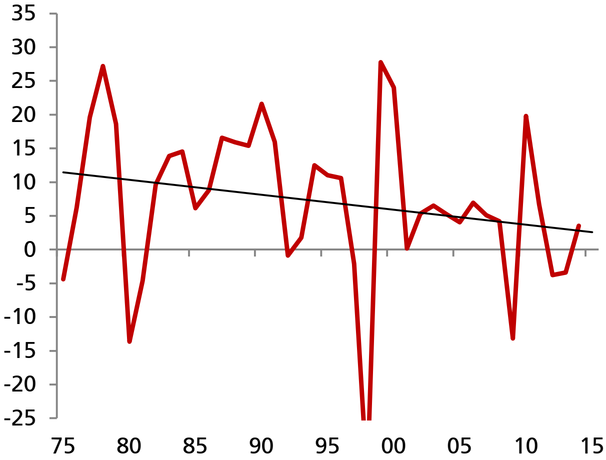
Asia-10 – real investment growth

% YoY, Gross Fixed Capital Formation, simple avg



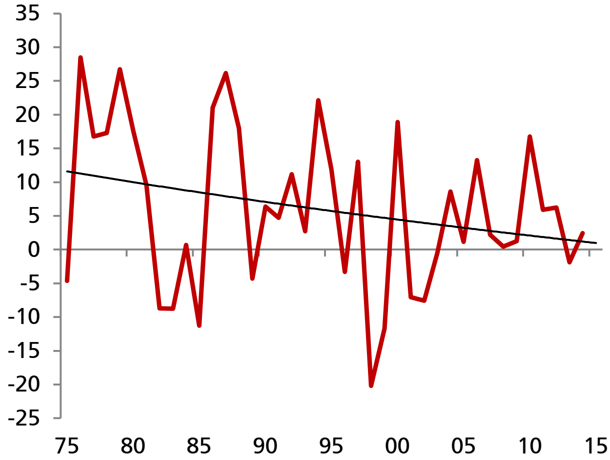
Korea – real investment growth

% YoY, GFCF



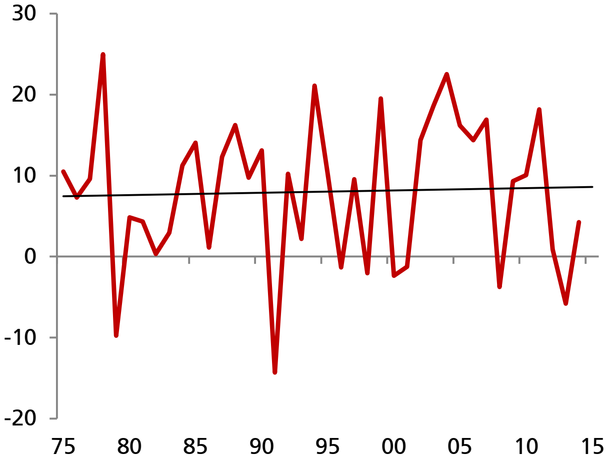
Hong Kong – real investment growth

% YoY, GFCF



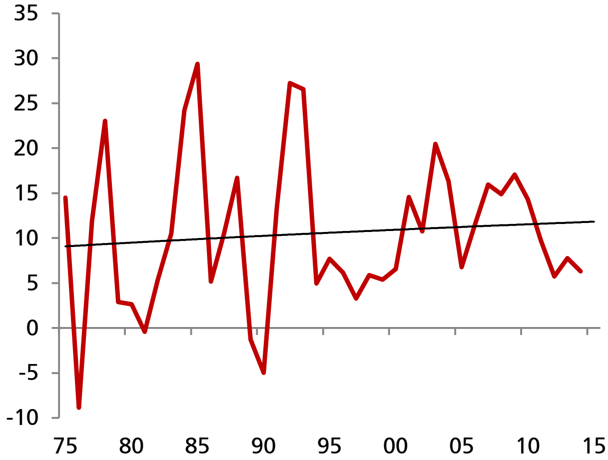
India – real investment growth

% YoY, GFCF



China – real investment growth

% YoY, GFCF



is Asia's lowest at USD1,700 (chart at top next page). But even after years of fast growth, China's income remains low by Asian standards at $7,600 and, from this perspective, the recent 'slowdown' could prove to be more cyclical than structural. In the event, it hasn't been especially large to begin with (chart above right). (See also Appendix I for additional Asia-10 investment growth charts).

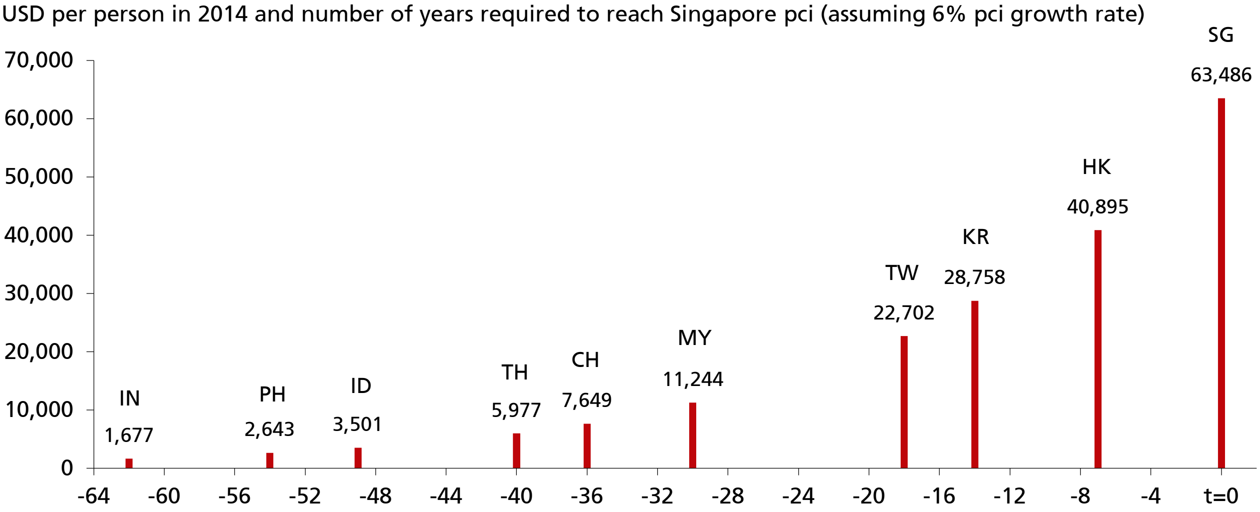
Why does investment slow?

Why does investment slow when incomes go up? The main reason is people save less / consume more. And at the end of the day saving and investment are one and the same. It doesn't start out that way of course. At *very* low incomes, the opposite is true. At very low incomes most economies are agrarian based and most of what gets produced, by necessity, gets consumed. But if you can scrimp and save a bit, the surplus can be invested in better seeds or capital equipment – productivity and incomes jump sharply. This allows more saving and more investment. A virtuous circle ensues.

But as incomes continue to rise, two things happen. The returns from more machinery or fertilizer, say, grow smaller. The second 'tractor' doesn't bring the same bang

Asia – per capita GDP timeline

USD per person in 2014 and number of years required to reach Singapore pci (assuming 6% pci growth rate)



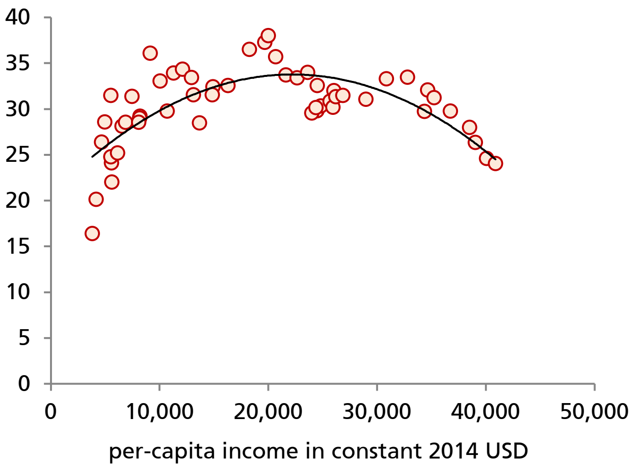
as the first; the third even less, and so on. All countries find it increasingly difficult to lift productivity the higher it already is. This is the technical, supply-side of the equation: returns to saving fall.

The second thing that happens is on the softer, demand side: people themselves change. As incomes go up, most want to enjoy the fruits of their labor. Another dollar in the bank becomes less attractive than a new dress, a night on the town, a trip to Spain. Falling returns from saving and a rising preference for consumption join hands and bring a reduction in savings as a proportion of income [2]. Less savings means less investment.

U-shaped savings rates are seen virtually everywhere, eventually [3]. Hong Kong's saving rate peaked when incomes hit US$20,000 in today's prices. The same is true for the US and Japan. Malaysia's saving rate turned south when incomes reached a much lower $8000 per person – thankfully the rate itself remains a very high 35% of GDP. The same occurred in Thailand (see additional plots in Appendix II).

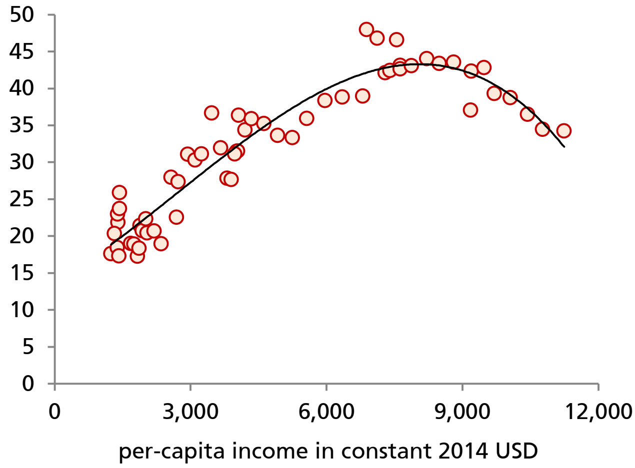
Hong Kong – saving / GDP and per-capita income

Saving / GDP (%)

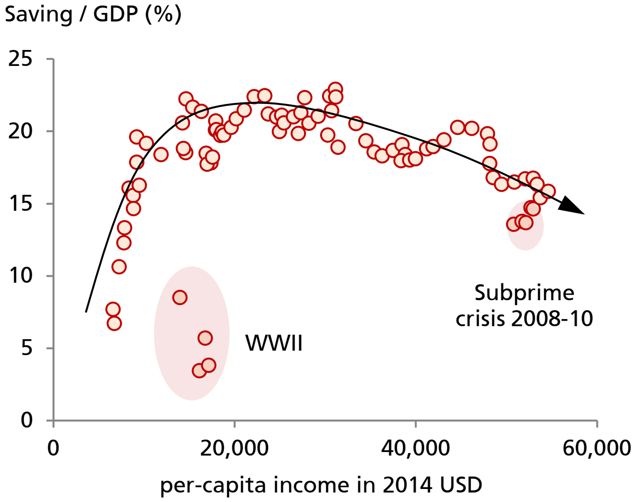


Malaysia – saving / GDP and per-capita income

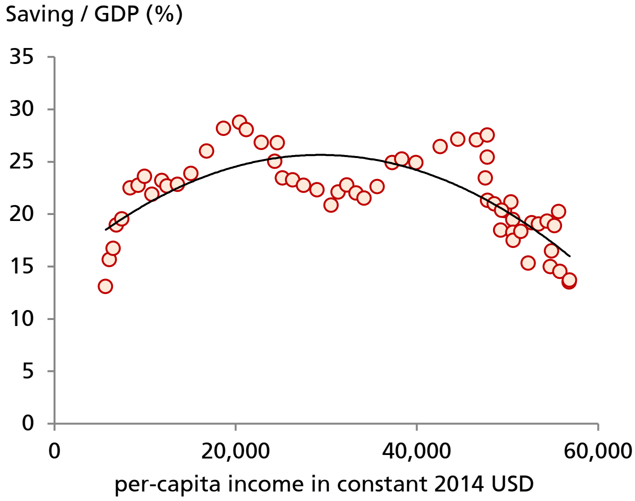
Saving / GDP (%)



US – saving / GDP and income (1929-2014)



Japan – saving / GDP and per-capita income



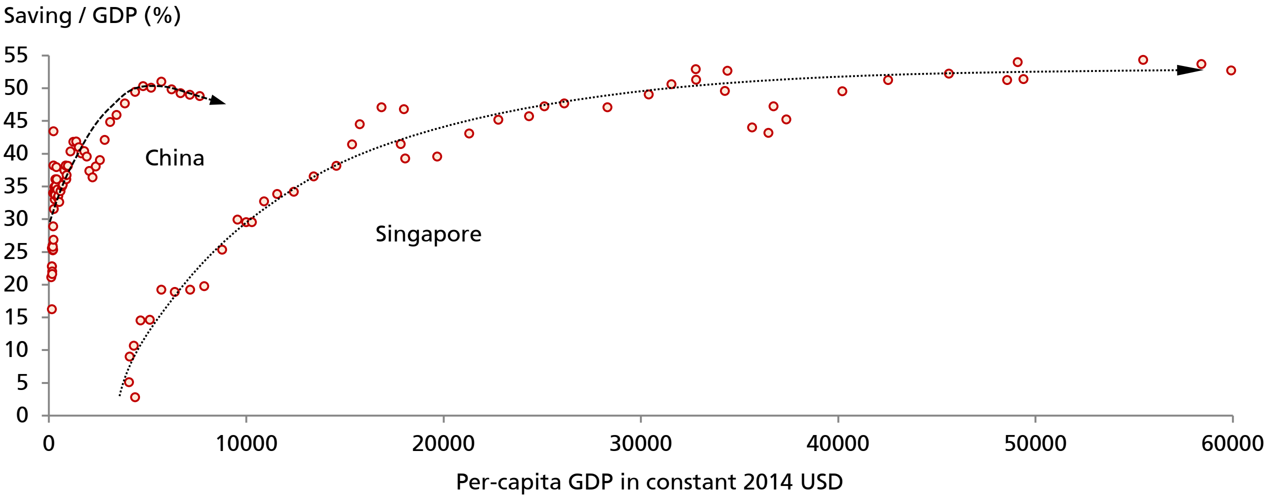
Over-investment? Or poor investment?

The experiences of China and Singapore are interesting and instructive (chart below). China is often accused of 'over-investing' – it saves too much and consumes too little, or so it is said. Saving and investment close to 50% of GDP can only lead to the kind of debt trouble that China seems to be in today. A greater consumption share in GDP 'is needed'.

But is it really? Singapore saves and invests just as much as China – and it's done so for 30 years – but nobody accuses Singapore of macro mismanagement. On the contrary, Singapore rightfully receives kudos all the time for its growth record. What gives? Why is Singapore a hero; China a reprobate?

Whatever it is, it has nothing to do with 'over-investment'. Fifty percent of GDP is fifty percent of GDP whether it's China's or Singapore's. China may have invested poorly, as most countries do from time to time. But that's different. Even China's infamous 'ghost towns' – built but not yet occupied cities – are, at worst, an example of poor investment, not over-investment. Any technocrat could have used the money spent on the ghost town to build something more immediately beneficial to society and have been praised for his efforts. Which isn't to say that 'immediately

China and Singapore – saving / GDP and per-capita income



beneficial' is the most important criteria to judge investments by. A 7% growth rate, like China's, means a lot of things that look strange today look less so tomorrow. Singapore's 4th and 5th terminals at Changi airport come to mind.

Four quick points: First, roads always go nowhere when you build them. It's what happens later that counts. Second, over-investment from a national / macro perspective isn't a well-defined term; it's nigh impossible to induce. If poor investment is the worry, call it poor investment.

Singapore has saved and invested 50% of GDP for decades and has nothing to show for it but one of the highest income levels in the world

Third, a high consumption share in GDP is not something to strive for, as if having one provides some sort of macro benefit, like 'sustainability'. Singapore has sustained a saving / investment ratio of 50% of GDP for decades and has little to show for it but one of the highest incomes in the world. Falling savings rates *tend* to occur as incomes go up. But the process isn't set in stone and when it occurs it occurs naturally. Most importantly, there's nothing good or bad about it. If a country prefers to work 12 hours a day and save half of it for a better life tomorrow, wonderful. If a country prefers a lower 'income' in return for cleaner air and more time at the beach, wonderful too. Consumption, saving and investment shares in GDP are choices, not exam grades.

Finally, judging by relative income levels, Singapore's experience and China's vast undeveloped inland areas, it could well take another 50 years before China's investment rate starts to fall. And the country could well be better off for it than were it to pursue greater consumption today.

Arresting the slide in investment

For most Asian countries, including China and Singapore, the issue isn't how to guard against 'over-investment', it's how do you arrest its slide of the past few years? Asia-10 growth in real fixed capital formation has fallen below 3% per year (chart page 1) and that simply won't sustain the kind of GDP growth needed to raise incomes and employ growing populations.

Some good old-fashioned red ink is what the region needs

Enter China's new Asian Infrastructure Investment Bank (AIIB) – might that turn the tide? Unfortunately no, and not because Japan and the US remain petulantly reluctant to join. The AIIB aims to raise $100bn for regional investment projects, which simply isn't a large amount of money. In 2014, Asia-10 gross fixed capital formation amounted to US$6,700bn. If the AIIB raised and then dispersed all $100bn of its funds over the next three years – a highly unlikely event – it could finance an additional 0.4% of Asia-10 investment over and above what is already likely to occur on that time frame. That's better than nothing but not by much. The AIIB's significance is more political than economic [4].

Asia's current account surpluses have to go

There's a bigger reason why the AIIB is unlikely to lift investment in Asia: all the Asia-10 countries, save for India and Indonesia, are running current account surpluses and have been for the past 18 years. Why does that make the AIIB irrelevant? Because if you're running C/A surpluses, you're lending to the rest of the world. You don't need to borrow funds from the AIIB if you're a lender yourself. You don't need to borrow funds from *anyone* if you're a lender yourself.

But if Asia has been lending to the rest of the world for the past 18 years, it's immediately clear how to raise investment at home: stop lending and start borrowing. Stop running C/A surpluses and start running C/A deficits. Stop investing in US Treasuries and start investing domestically, where the income-lifting capital equipment and infrastructure is needed.

Run current account deficits? Sounds pretty heretical. To most, it is. Foreign investors wouldn't like it. Rating agencies wouldn't like it. Local officials wouldn't like it. It's unanimous.

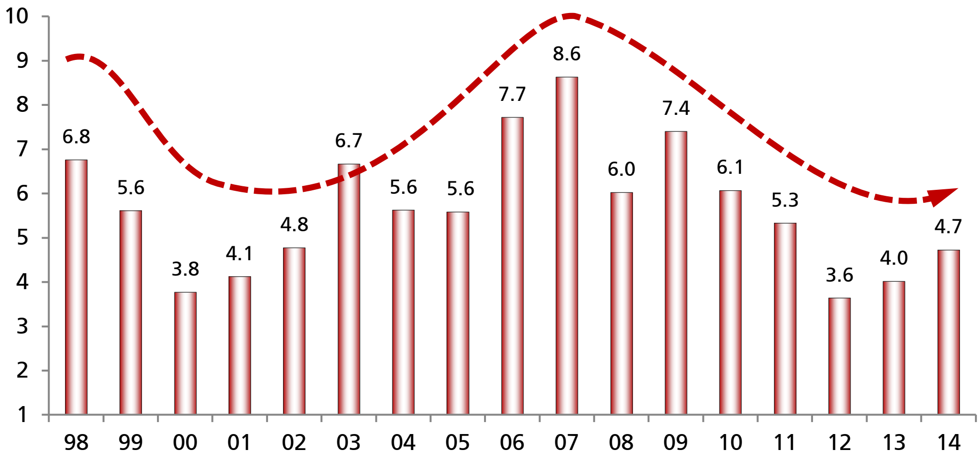
And unanimously wrong. Running deficits in Asia isn't heretical. It's Finance 101. It's the way things are *supposed* to be. Higher income / capital abundant countries are supposed to lend to lower income / capital scarce countries, not vice-versa. The foreign lender earns a higher return than he can at home; the local borrower can invest more than his own savings will allow. And – most importantly – everyone's incomes go up more than they otherwise would. It's a handshaking deal that benefits both sides of the borrower/lender equation. Why rating agencies, officials and Boston fund managers see heresy in this is anyone's guess but for the sake of higher incomes of everyone involved, mindsets need to change. Emerging economies are supposed to be borrowers, not lenders.

A current account swing equivalent to 6% of GDP would bring boatloads of needed domestic investment to the region

But what kind of money are we talking about here? Would moving from surplus to deficit really make much of a difference to Asia's investment equation? Yes it would – a very large difference. On average, Asia-10 countries have run C/A surpluses to the tune of 6% of GDP every year since 1998. That means they have lent 6% of their income to foreign countries every year for the past 17 years. They could have been investing that much at home instead.

Asia 10 – current account surplus

% of GDP, simple average



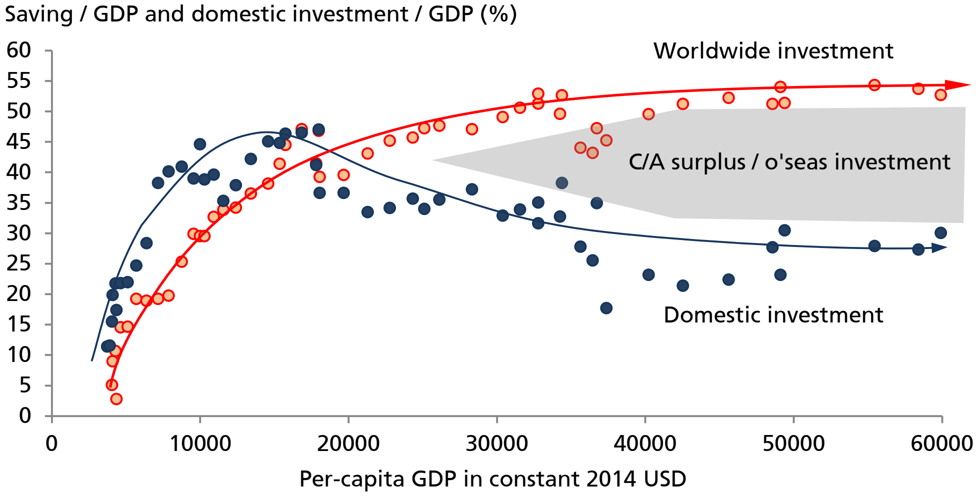
And that's without any red ink. If they ran deficits of 2%-3% of GDP, domestic investment could be 8%-9% of GDP higher than it currently is. That's a boatload of investment dollars that could be improving Asia's infrastructure, lifting Asia's growth rates and lifting Asian incomes. To be sure, the 2%-3% deficit represents borrowing and returns on those funds go the foreigner. But the 2%-3% rise in the capital stock each year lifts labor productivity and wages too, and that portion stays at home. Again, it's a handshaking deal.

Asia-vu?

Too much borrowing is dangerous of course. After all, the reason deficits are anathema to foreign investors, public officials and ratings agencies alike is because too much borrowing led to the Asian financial crisis of 1997/98. But that was 17 years ago and deficits back then were 10% of GDP in some countries for a good many years. It's time to let go.

Who would benefit in Asia by a swing to deficit? Everyone, save, as mentioned, for India and Indonesia, where deficits of 2%-3% of GDP are already being run. Malaysia would benefit greatly, as domestic investment has fallen sharply and it runs a current account surplus of 5%-6% of GDP. Korea and Taiwan run surpluses of 6%

Singapore – saving and domestic investment shares in GDP and per-capita income



and 12% of GDP respectively and few would argue that those economies couldn't use some more local investment.

The Asian Financial Crisis was 18 years ago. It's time to move on. Mindsets must change

Singapore might benefit more than most (chart above). It is grappling with below-normal GDP and productivity growth and has been attempting to raise both with a significant restructuring exercise that is now entering its fifth year. Results have been mixed. Singapore is a high income country and so, by the logic outlined above, ought to be lending abroad. But its current account surplus was 19% of GDP in 2014 and has averaged 20% of GDP since 2010! With productivity growth negative in 2014, it's hard to argue that some of that 19% of GDP current account surplus couldn't be spent on domestic investment instead of overseas investment, helping raise domestic productivity and incomes in the process.

A brighter future

Asia's incomes continue to rise and slower investment is a natural part of that process. But investment growth has slowed to below 3% per year and that won't sustain the GDP growth that Asia is accustomed to and needs to keep incomes rising and populations employed. Current account surpluses are standing in the way of greater domestic investment in all Asian countries save for Indonesia and India. A swing to modest 2%-3% of GDP deficits could lift investment in the region by 8-9 percentage points of GDP – a huge amount.

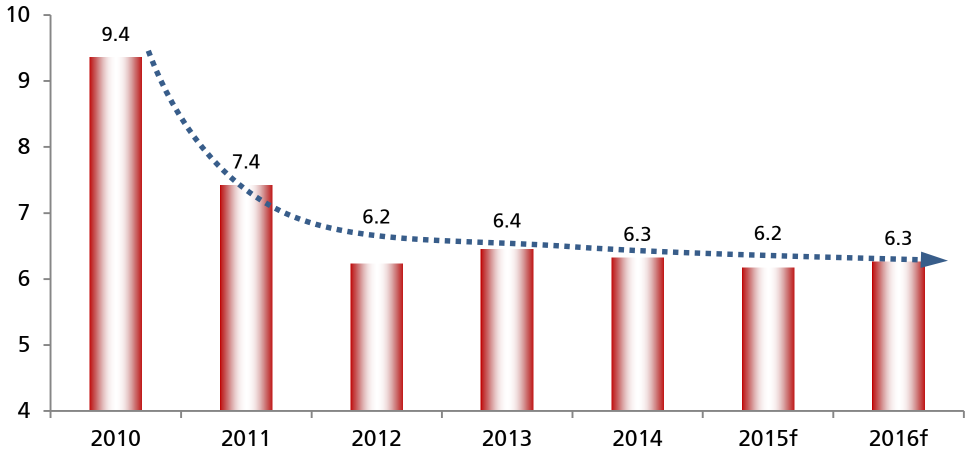
But mindsets have to change for this to occur. Officials, ratings agencies and fund managers all need to let go of 1997. Everybody wins when capital abundant investors lend to capital scare borrowers. Everyone loses when the opposite occurs, as it is today. Periodic crises shouldn't mean you throw the baby out with the bath water. Until the much-needed mindset shift occurs, no amount of funding from an AIIB or other institution will succeed in lifting domestic investment in the region. Some say you can't squeeze blood from a turnip. It's just as hard to shovel water into a fire hydrant.

Notes:

[1] Weighted average growth has also remained stable for the past four years at about a 6.25% growth rate (chart below). The lion's share of China's slowdown came in 2011.

Asia10 – GDP growth

% YoY, wtd avg



[2] Demographics may also play a role. As individuals age, they begin to work less and ultimately dis-save. If a country overall is aging, savings rates will tend to fall.

[3] See also: "Asia: U-shaped consumption paths and non-discretionary spending", 17Jan14.

[4] Nor is China's $50bn AIIB commitment particularly significant. In today's dollars, China's trade surplus of the past five years amounts to about US$1,250bn, most of which has been invested in US Treasuries and German Bunds. Shifting $50bn of that into regional infrastructure is plainly less momentous than it sounds.

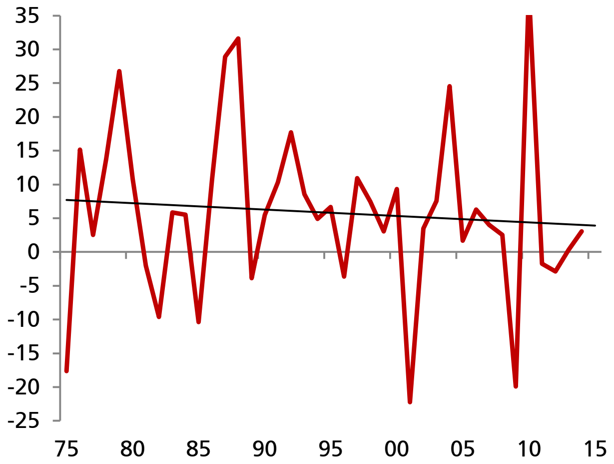
Sources:

Except where noted, data for all charts and tables are from CEIC Data, Bloomberg and DBS Group Research (forecasts and transformations).

Appendix I: real investment growth

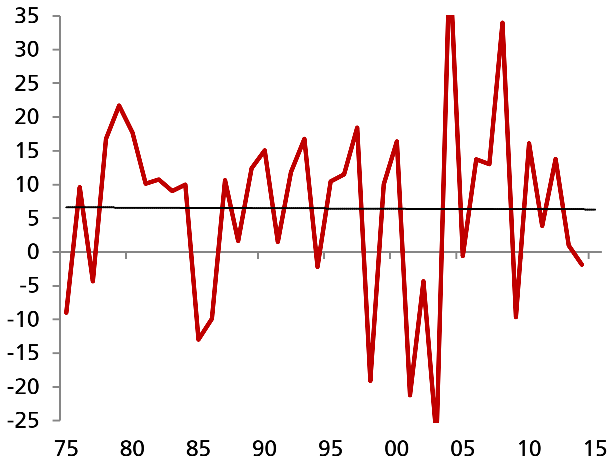
Taiwan – real investment growth

% YoY, GFCF



Singapore – real investment growth

% YoY, GFCF

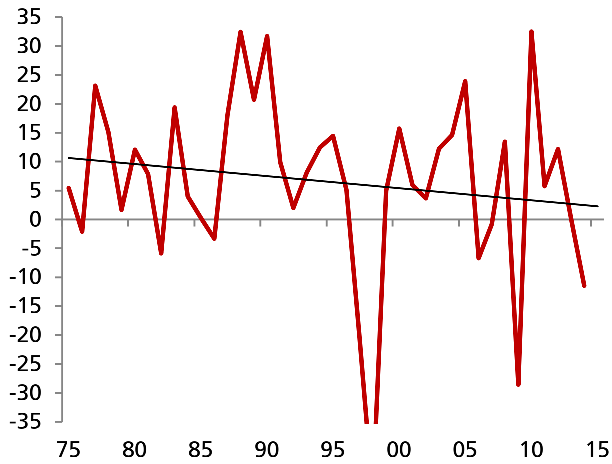


Malaysia – real investment growth

% YoY, GFCF

Thailand – real investment growth

% YoY, GFCF

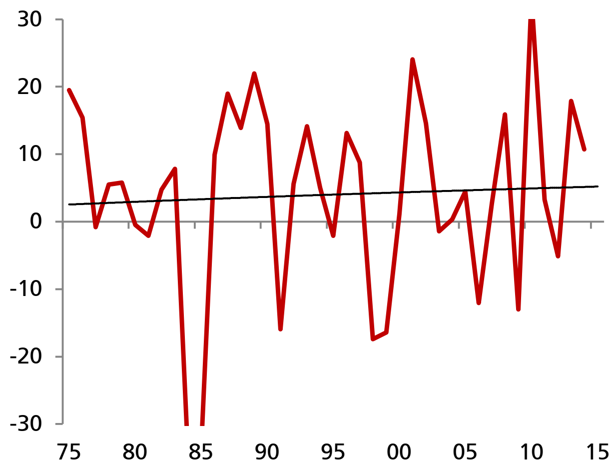


Indonesia – real investment growth

% YoY, GFCF

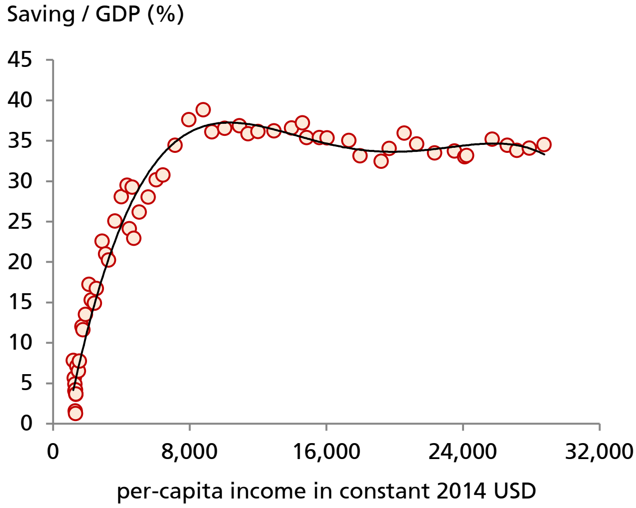
Philippines – real investment growth

% YoY, GFCF

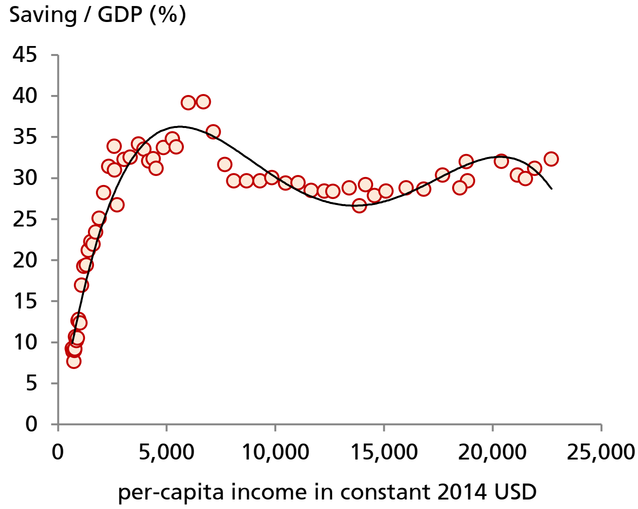


Appendix II: saving / GDP and per-capita income

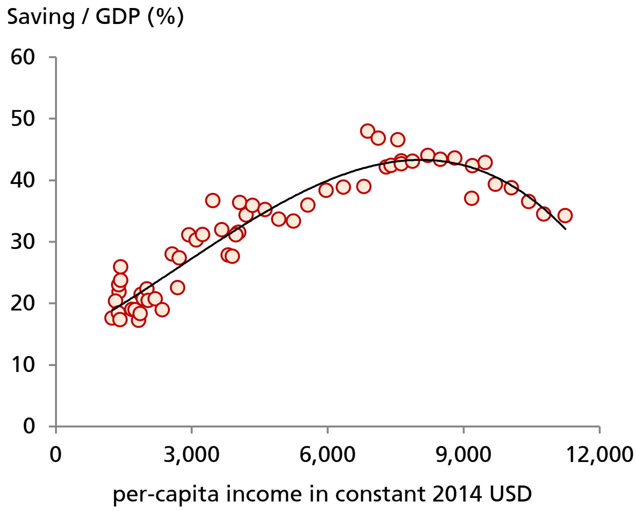
Korea – saving / GDP and per-capita income



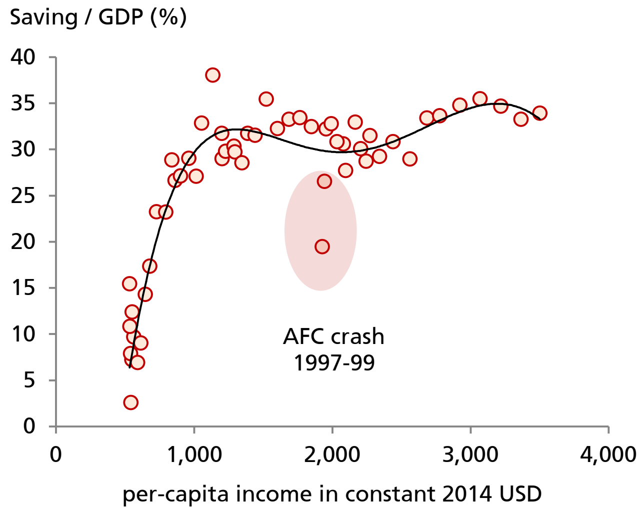
Taiwan – saving / GDP and per-capita income



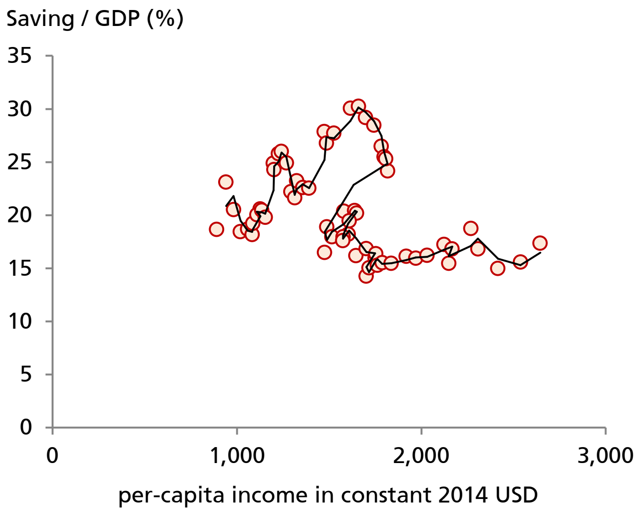
Thailand – saving / GDP and per-capita income



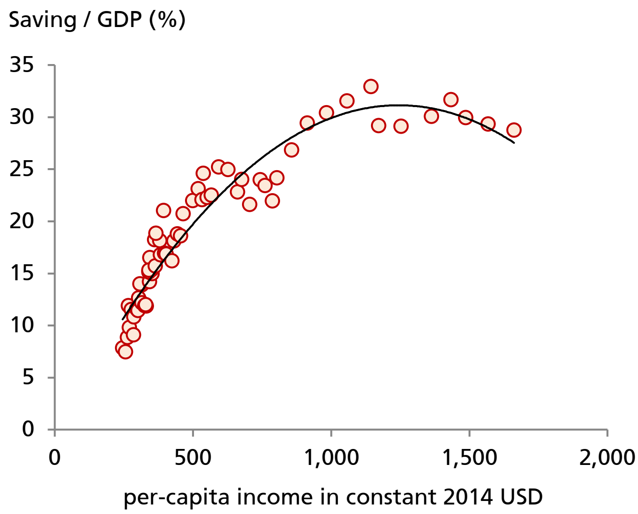
Indonesia – saving / GDP and per- capita income



Philippines – saving / GDP and per-capita income



India – saving / GDP and per-capita income



GDP & inflation forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2012	2013	2014	2015f	2016f	2012	2013	2014	2015f	2016f
US	2.3	2.2	2.4	2.2	2.4	2.1	1.5	1.6	1.2	1.7
Japan	1.8	1.6	0.0	1.1	1.0	0.0	0.4	2.7	1.0	0.8
Eurozone	-0.7	-0.4	0.9	1.0	1.3	2.5	1.3	0.4	0.4	1.1
Indonesia	6.0	5.6	5.0	5.1	5.5	4.0	6.4	6.4	6.4	5.7
Malaysia	5.6	4.7	6.0	4.9	5.0	1.7	2.1	3.1	2.1	3.0
Philippines	6.7	7.1	6.1	6.0	6.2	3.2	2.9	4.2	2.5	3.7
Singapore	3.4	4.4	2.9	3.2	3.5	4.6	2.4	1.0	-0.1	1.3
Thailand	7.3	2.8	0.9	3.2	4.5	3.0	2.2	1.9	-0.2	2.0
Vietnam	5.0	5.4	6.0	6.0	6.2	9.3	6.6	4.1	1.3	3.5
China	7.7	7.7	7.4	7.0	6.8	2.6	2.6	2.0	1.8	2.2
Hong Kong	1.7	2.9	2.3	2.8	3.0	4.1	4.3	4.4	3.7	3.5
Taiwan	2.1	2.2	3.8	3.4	3.5	1.9	0.8	1.2	-0.2	1.2
Korea	2.3	3.0	3.3	3.0	3.5	2.2	1.3	1.3	0.8	2.1
India*	5.1	6.9	7.3	7.6	8.3	7.4	9.5	6.0	5.6	5.9

* India data & forecasts refer to fiscal years beginning April; prior to 2013.
Source: CEIC and DBS Research

Policy & exchange rate forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	3Q15	4Q15	1Q16	2Q16	current	3Q15	4Q15	1Q16	2Q16
US	0.25	0.25	0.50	0.75	1.00	...	...	...	...	...
Japan	0.10	0.10	0.10	0.10	0.10	124.8	122	123	124	125
Eurozone	0.05	0.05	0.05	0.05	0.05	1.126	1.08	1.05	1.02	0.99
Indonesia	7.50	7.50	7.50	7.50	7.50	13,306	13,460	13,660	13870	14,080
Malaysia	3.25	3.25	3.25	3.25	3.25	3.72	3.64	3.69	3.73	3.77
Philippines	4.00	4.00	4.00	4.25	4.25	44.9	45.3	45.4	45.4	45.4
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.35	1.36	1.38	1.40	1.42
Thailand	1.50	1.50	1.50	1.50	1.75	33.7	33.2	33.3	33.5	33.7
Vietnam^	6.50	6.00	6.00	6.00	6.00	21,813	21,565	21,565	21,565	21,565
China*	5.10	4.85	4.60	4.60	4.60	6.20	6.24	6.26	6.28	6.30
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.75	7.77	7.77	7.78	7.79
Taiwan	1.88	1.88	1.88	1.88	1.88	30.9	32.0	32.2	32.4	32.6
Korea	1.75	1.50	1.50	1.75	1.75	1111	1133	1147	1161	1175
India	7.25	7.25	7.25	7.25	7.25	63.9	64.6	65.6	66.7	67.8

^ prime rate; * 1-yr lending rate

Market prices

	Policy rate	10Y bond yield		FX		Equities		
	Current (%)	Current (%)	1wk chg (bps)	Current	1wk chg (%)	Index	Current	1wk chg (%)
US	0.25	2.34	21	95.5	-1.4	S&P 500	2,096	-1.2
Japan	0.10	0.49	9	124.8	-0.5	Topix	1,674	0.1
Eurozone	0.05	0.88	35	1.126	2.5	Eurostoxx	3,375	-3.8
Indonesia	7.50	8.49	37	13299	-0.6	JCI	5,096	-3.0
Malaysia	3.25	4.01	12	3.72	-2.2	KLCI	1,741	-0.8
Philippines	4.00	0.00	0	44.9	-0.6	PCI	7,554	0.6
Singapore	Ccy policy	2.66	24	1.348	0.0	FSSTI	3,345	-2.3
Thailand	1.50	2.96	16	33.7	0.0	SET	1,491	-0.7
China	5.10	...	...	6.20	0.0	S'hai Comp	4,947	7.1
Hong Kong	Ccy policy	1.77	12	7.75	0.0	HSI	27,552	0.4
Taiwan	1.88	1.57	4	30.9	-1.1	TWSE	9,349	-3.7
Korea	1.75	2.49	8	1111	-0.5	Kospi	2,073	-1.8
India	7.25	7.81	17	63.9	-0.1	Sensex	26,813	-2.5

Source: Bloomberg

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