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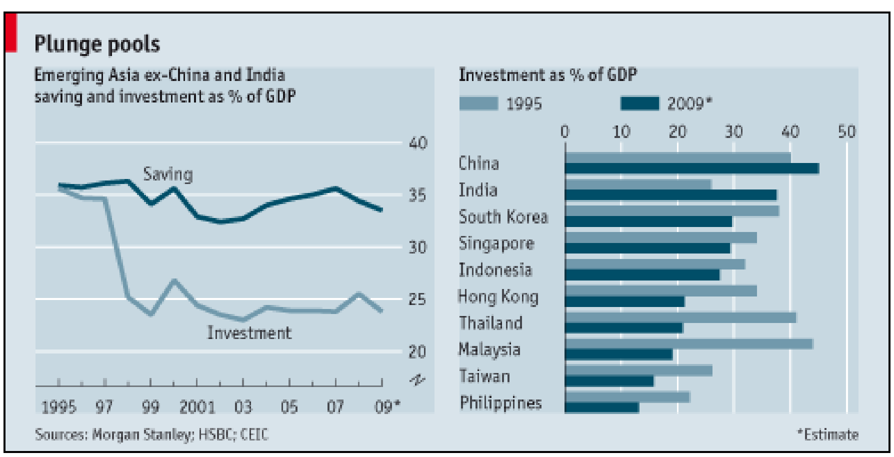
China aside, most Asian economies need to invest more, not consume more

ASIA'S current-account surpluses have been widely (if unfairly) blamed for causing the global financial crisis. Large inflows of foreign money helped inflate America's housing bubble, the argument runs. Many Western economists say that Asians should squirrel away less of their income and consume much more. But a more rigorous analysis suggests that in most Asian economies it is investment, not consumption, that is too low.

Even economists who believe that most of the blame for the crisis lies in Washington, DC, argue that Asian economies need to shift from exports and investment to consumption as their new engine of growth. In "The Next Asia", a recently published book, Stephen Roach, chairman of Morgan Stanley in Asia, calculates that consumption in emerging Asian economies fell from 65% of GDP in 1980 to 47% in 2008. American consumer spending, by contrast, accounts for more than 70% of GDP. "Until export-led growth gives way to increased support from private consumption," he argues, "the dream of an Asian century is likely to remain just that." His prescription certainly applies to China, where private consumption fell to only 35% of GDP in 2008. But what about the rest of Asia?

A country's current-account surplus is, by definition, equal to its domestic saving minus its domestic investment. So Asian economies can reduce their surpluses by saving less (ie, consuming more) or by investing more. Which route is appropriate depends in part on why their current-account surpluses widened during the past decade. In China the blame lies entirely with saving, which rose faster than its investment rate. (India's saving rate climbed just as steeply, but it was matched by an even bigger jump in investment, which kept its current account in deficit.)



In all the smaller emerging Asian economies, however, saving has either fallen or remained broadly unchanged as a share of GDP. The reason these countries have large current-account surpluses is because investment plunged after the 1997-98 Asian crisis and did not recover (see chart). Malaysia's investment rate, for example, fell from 44% of GDP in 1995 to an estimated 19% last year. Thailand's dropped from 41% to 21%.

The widespread belief that Asian households do not spend is also flawed. According to a study by Eswar Prasad of Cornell University, private consumption accounts, on average, for 58% of GDP in emerging Asia outside China. That is lower than in America, which has been overconsuming for years, but it is slightly higher than in Japan or the European Union. In the eight years to 2008, investment accounted for half of China's GDP growth and private consumption for less than one-third. But in most other Asian economies the relative shares were almost exactly the reverse, with consumption the dominant source of growth.

A report by the Asian economics team at Barclays Capital concludes that to reduce their excess saving, most Asian economies need to invest more rather than consume more. Higher investment, especially in infrastructure, they argue, would not only reduce current-account surpluses but also boost growth and living standards. Better roads and railways would help farmers get their produce to cities and enable manufacturers to export their goods abroad. Clean water and sanitation could raise the quality of human capital, thereby lifting labour productivity.

Do unto others

Investment in the smaller Asian economies has certainly fallen sharply, but does that really mean it is too low? These economies could simply have been overinvesting in the 1990s. The goal of economic policy should be to maximise households' well-being and hence their consumption—but over time, not just today. Consuming too much today will make the next generation poorer. By investing (and saving), a country sacrifices current consumption but future output and consumption will be higher. The optimal level of investment is the rate that generates the highest sustainable level of consumption over time. That, in turn, depends on a country's "marginal product of capital", or how much output is produced by new investment. The higher this measure, the more it should invest. Assuming extra investment increases output by progressively smaller amounts as the capital stock expands, then at some point extra investment will reduce, not increase, the long-run sustainable level of consumption.

Calculating the marginal product of capital is devilishly difficult. However, it is likely to be higher in emerging economies than in developed ones, because their capital stock is much smaller in relation to their labour force. Estimates by Yuwa Hedrick-Wong, an economic adviser at MasterCard, suggest that in China, India, Indonesia and Thailand capital per person is only 2-6% of that in America. This means there is huge scope to boost productivity by giving workers new machines and better infrastructure. The optimal rate of investment will therefore be much higher than in developed economies, and may even justify the pace of China's investment of more than 45% of GDP. Yet in Taiwan, Malaysia, the Philippines and Thailand investment is no higher (and in some cases lower) as a share of GDP than in Japan or the euro area. This helps explain why these countries' growth rates have slowed over the past decade. Mr Hedrick-Wong finds that among emerging economies, those that invest a bigger share of GDP tend to enjoy faster growth.

More developed economies, such as South Korea and Singapore, where both the rate of investment and the capital-to-labour ratio are relatively high, are probably not underinvesting. But Indonesia's investment rate (27% of GDP) looks much too low given its tiny capital stock. Barclays Capital argues that it needs to raise it to India's rate of 38% if it wants to achieve annual GDP growth of 8%. In the Philippines, which probably has the worst infrastructure in the region, investment is running at only 15% of its GDP. It is no coincidence that the Philippines has the highest rate of consumption (about 80% of GDP) in emerging Asia but one of the lowest growth rates. Higher consumption may suit the West, but more investment is in Asia's longer-term interests.