WORKING PAPER

East Asia’s decoupling

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ABSTRACT

A decade ago, East Asia's economies were largely geared towards serving Western export markets. Trade within the region was dominated by parts and components that went into products still primarily destined for the United States and Europe. But, as this working paper shows, recently updated data from the OECD suggests that is no longer the case. East Asia is now driving its own demand. Behind this development has been the huge expansion in Chinese demand, which has now eclipsed the United States as the leading source of 'final demand' for the rest of the region. As a result, East Asia is somewhat less vulnerable to rising US–China trade tensions than commonly thought. More importantly, regional integration efforts, including the Belt and Road Initiative, are now more viable platforms for securing future economic growth, even if the rest of the world turns inwards. The key question is whether these opportunities can be capitalised on by deepening economic integration. Finally, with China cementing itself at the core of East Asia's heavily integrated economy, any US decoupling effort aimed at pushing other East Asian economies to forgo closer economic relations with China will inevitably struggle.

INTRODUCTION

Is East Asia's economic miracle under threat?[1] For decades East Asia has been the world's most dynamic region, on the back of an export-oriented growth model that has served it remarkably well. Today, Donald Trump's trade war, and the wider populist backlash against globalisation, threaten to throw a major spanner in the works. More worrying, the United States is also pursuing explicit geostrategic competition with China, with economic confrontation forming a central pillar of its strategy. Regardless of whether some kind of deal is reached on the US–China trade war, pressures towards further economic decoupling are likely to persist.

Yet, as this paper shows, new data suggests East Asia is no longer as reliant on US or Western markets as it once was. Instead, led by a huge expansion in Chinese demand, the region has become far more internally driven, making it somewhat less vulnerable to current global trade tensions than commonly thought and, more importantly, giving it much greater room to manoeuvre.

AMERICA WANTS TO 'DECOUPLE' FROM CHINA

The Trump administration's international economic agenda is still haphazardly playing out, but the basic contours are clear. At its core, it seeks to disrupt the world's pre-existing trajectory by moving away from the 'positive-sum' economics of globalisation towards the 'zero-sum' logic of mercantilism and geostrategic competition. At a minimum, it wants to rewrite the global economic rules in ways it finds more favourable.[2] At worst, it may seek to reverse globalisation itself.

A new mantra of 'decoupling' is also emanating from Washington, with the goal of disentangling America's economy from China's so as to no longer facilitate the latter's rise and to reduce their interdependencies.[3] Related to this are growing concerns that a new Cold War may be emerging, with the United States and China each looking to establish their own economic blocs and spheres of influence.[4]

What a US decoupling agenda might entail exactly is still unclear. In its most narrow form, it would target specific security risks (e.g. critical infrastructure). More damaging would be a broader approach to reduce entanglements with China across large swathes of the US economy. Most aggressive would be a multilateral approach, where America would seek to enlist other countries to also decouple from China in some way. So far we have seen elements of each, including tighter inward investment screening and export controls on technology, broad-based tariffs on Chinese imports, and the inclusion of a so-called "poison pill" clause in the US–Mexico–Canada agreement aimed at forcing America's trading partners to choose between closer economic ties with either the United States or China — a choice US Commerce Secretary Wilbur Ross says it may also seek to force upon others.[5]

The potential economic costs of decoupling will depend on how far such measures are pursued. Even seemingly targeted policies can easily blur into more expansive restrictions. For example, there is already a concern that new technology export controls might be applied too broadly.[6] Crucially, the risk of further escalation is high. In the short run, Trump's unpredictability and penchant for cutting deals offers some hope that the current tariff war with China may be resolved or at least stabilised. However, support in the United States for decoupling runs broader and deeper than the Trump administration alone.[7] Ultimately, rising commercial and geostrategic competition with a more advanced and powerful China risk becoming structural geopolitical drivers towards further escalation. Avoiding this, and containing the economic costs, will require a far more nuanced policy strategy from both the United States and China than seen to date.

This outlook has serious implications not only for China but also the rest of East Asia. Complex global value chains mean higher US tariffs on China indirectly hit other East Asian economies along the way.[8] A general rise in US protectionism and the desire to re-shore manufacturing activity will also directly disrupt broader East

Asian access to the US market. Meanwhile, there is a real risk that other countries might also pursue greater protectionism, as the rules-based system built around the World Trade Organization withers, and possibly cracks under pressure. Finally, the US decoupling agenda could either present other East Asian economies with opportunities as supply chains relocate out of China or force them to confront a stark choice between the world's two largest economies if the United States does indeed seek to multilateralise decoupling. In any case, a fragmenting global economy will be less prosperous, undermining the global flow of goods, capital, people, and technology that has historically propelled East Asia forward.

EAST ASIA IS ALREADY DECOUPLING

Interestingly, the last time 'decoupling' was an important topic of debate was on the eve of the global financial crisis, although this was of a different variety. Then, many economists and pundits wondered whether the huge amount of trade between East Asia's economies meant the region's business cycle might actually decouple from its Western counterparts. In the end, that hypothesis proved quite wrong. What was missed was that much of East Asia's intra-regional trade was simply in parts and components that went into finished products still destined for the United States and Europe. 'Factory Asia' was still ultimately beholden to the Western consumer for 'final demand'. While East Asia had its own burgeoning consumer market, this was still more about future potential than present-day realities.

Is this narrative still correct? If it is, then East Asia's growth model is indeed under significant threat and US proponents of a multilateral decoupling may well have the leverage needed to convince others to join them. Importantly, looking only at gross export flows, it might seem that little has changed over the past decade, with the share of East Asia's gross exports going to others in the region largely unchanged since 2003 at around 50 per cent.[9]

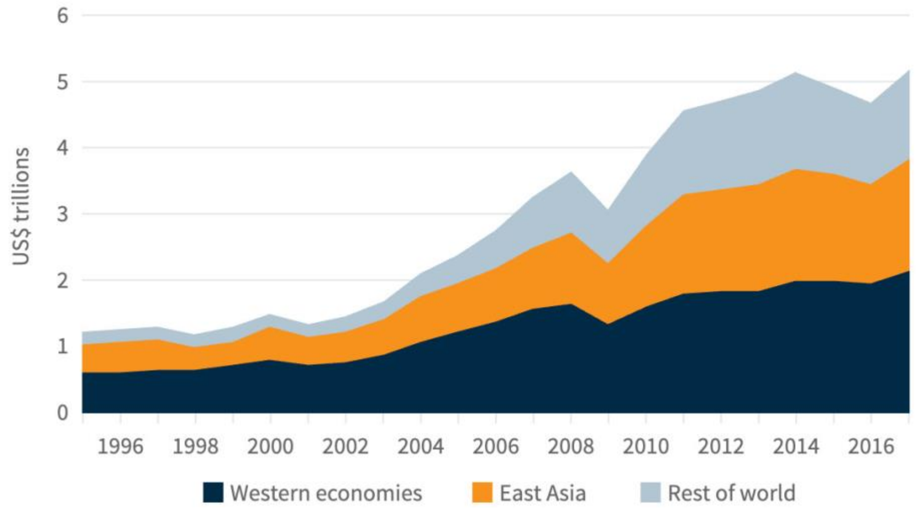
This paper revisits East Asia's decoupling story, drawing on recently updated data from the OECD Trade in Value Added (TiVA) database.[10] TiVA provides the most authoritative data tracing a country's exports on a value-added basis to their ultimate source of final demand. It was recently updated to cover the period from 2005 to 2015, providing a timely opportunity to examine how much has changed over the past decade (TiVA previously covered the period 1995 to 2011). Estimates by the author for pre and post this period are added to give a more up to date and comprehensive picture.[11] What the analysis reveals is that East Asia's trade dependencies have changed dramatically in the decade since the global financial crisis.

Looking at the region as a whole, Figure 1 shows how demand for East Asia's exports has evolved over the past decade. In 2007, the United States, European Union, and other major Western economies (Canada and Australia) provided almost half of all final demand for East Asia's exports. Less than 30 per cent came from within East Asia itself. When Western markets dried up in 2008–09, unsurprisingly the region was not able to decouple as many had hoped.

The global financial crisis, however, also substantially reshaped this picture, delivering a sizeable level shift as output (and thus demand) in the United States and Europe suffered a permanent setback. By contrast, East Asia, and to a lesser extent other parts of the world, enjoyed a V-shaped recovery. By 2011, the share of final demand coming from Western markets had shrunk to 40 per cent. It has largely stayed at that level since, with a partial recovery in the United States offset by prolonged economic weakness in Europe. As a result, East Asia's exports are no longer primarily driven by Western demand.

Figure 1: East Asia's exports are no longer driven by Western demand

US$ trillions, final demand for East Asia's exports

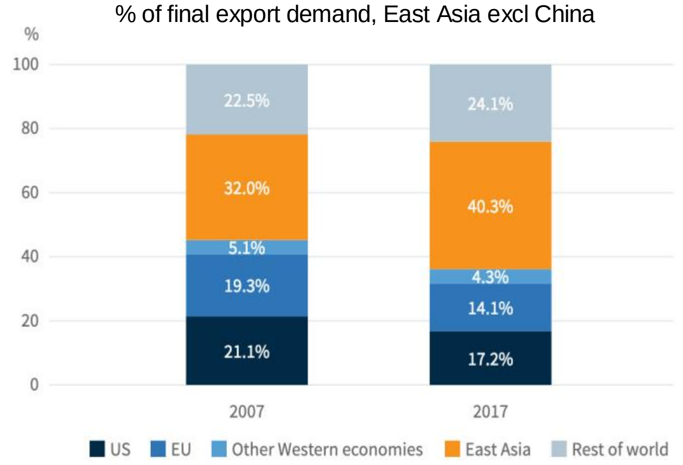


Source: Author's calculations and estimates based on OECD, IMF, and CEIC data

An even more striking development is how China's rise has dramatically reshaped the rest of the region. For the rest of East Asia, the region itself is now a more important source of final export demand than Western export markets (Figure 2). What's more, this shift has been entirely due to rising Chinese demand. China's share of final demand has more than tripled from just 6 per cent in 2000 to almost 20 per cent in 2017, just enough to overtake the United States as the single most important final market for the rest of East Asia's exports (Figure 3). Importantly, this is not solely due to the level-shifting effects of the 2008–09 crisis but also reflects a longer-term structural trend driven by China's rapid growth and rising income level. America's share of final export demand is still ahead of China's in Japan, Philippines, Vietnam, and Cambodia. But, even in these economies, there is a similar trajectory in China's favour and at the regional level this is more than outweighed by China's leading role in other East Asian economies.

Figure 2: A big shift towards East Asian demand

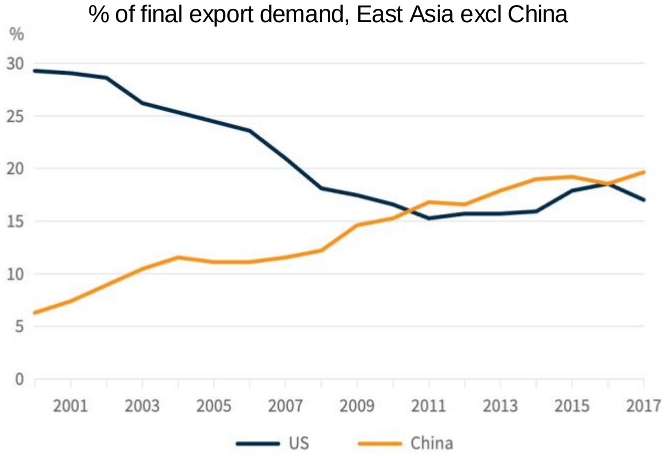
% of final export demand, East Asia excl China



Source: Author's calculations and estimates based on OECD, IMF, and CEIC data

Figure 3: China versus the United States

% of final export demand, East Asia excl China

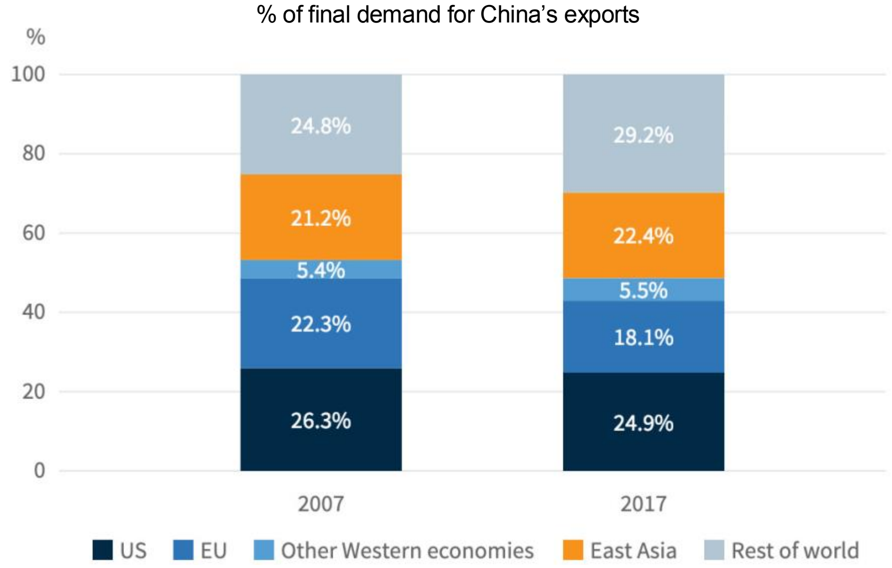


Source: Author's calculations and estimates based on OECD, IMF, and CEIC data

China, however, has undergone a different transition. Western economies still provide almost half of all final demand for China's exports (Figure 4). Yet this is simply the result of the obvious fact that China technically cannot export to itself. Just as China has become the leading source of final demand for the rest of East Asia, so too has it been increasingly fuelling its own demand. Since the 2008–09 crisis, China's economy has shifted away from its previous export-intensive growth model towards one driven by its own domestic demand. Exports were as high as 36 per cent of China's GDP in 2006 but have since dropped back to 20 per cent in 2017. Indonesia, with the next largest internal market in the region, has also seen a similar shift.

Figure 4: Chinese exports are still reliant on the West

% of final demand for China's exports

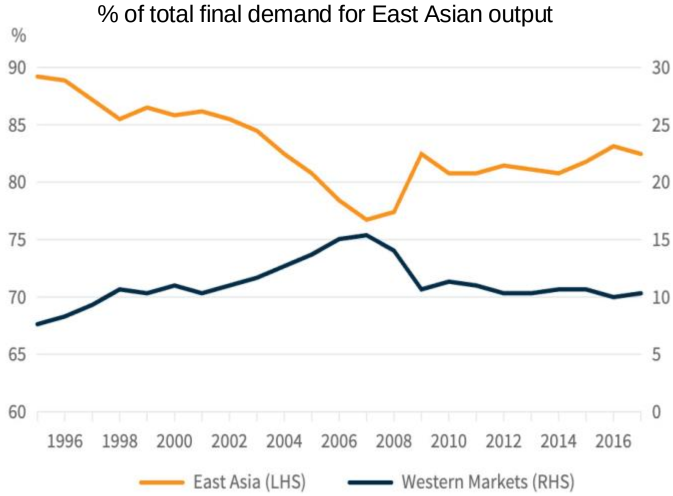


Source: Author's calculations and estimates based on OECD, IMF, and CEIC data

The overall result is that East Asia's economies are now principally being driven by what happens inside the region, rather than outside it. Figure 5 shows the share of final demand for all East Asian production coming from Western economies versus that from within East Asia itself. In the lead up to 2007 there was a precipitous drop in the role of East Asian demand as that from the West and other parts of the world increasingly fuelled the region's growth. However, since the crisis, there has again been a substantial level shift and the importance of Western demand is back to where it was 20 years ago. For China and Indonesia, this primarily reflects their shift towards domestically driven growth, while the rest of East Asia has kept its export-driven growth model but seen the final demand for its exports shift substantially eastwards.

Figure 5: East Asia is now far more internally driven

% of total final demand for East Asian output



Source: Author's calculations and estimates based on OECD, IMF and CEIC data

IMPLICATIONS

A rising East Asia has long been widely seen as the world's most important future market. What is striking, however, is the extent to which East Asia has *already* become its own most important final market. Whereas previously East Asian production was heavily integrated but still primarily geared towards serving Western markets, today the region appears to be fuelling its own demand. Behind this development has been the huge expansion in Chinese demand, which has eclipsed the United States as the leading source of final demand for the rest of East Asia. Recognising these changes has major implications in the current global economic context.

For a start, East Asia is less vulnerable to escalating global trade tensions than the narrative from just a decade ago might suggest. Most East Asian economies continue to use an export-intensive growth model but their dependence on Western markets has already been overtaken by demand coming from within the region itself, notably China — a trend that will likely continue.

To be sure, East Asia still has plenty at stake in the current context. The United States remains a major source of final export demand and the leading one for some in the region. Higher US tariffs on China could affect exports worth up to 3.5 per cent of its GDP in domestically created value and indirectly affect valued-added exports from the rest of East Asia (which go via China on their way to the United States) worth up to about 0.5 per cent of their GDP.[12] Nor has the region's business cycle fully decoupled from the West.[13] Not only are trade links still sizeable but financial linkages also remain very powerful — reflecting large portfolio capital flows and heavily dollarised debt markets. Western direct investment and technology flows also remain important, although they too are gradually becoming less central, in large part reflecting China's ongoing rise in these areas. Overall, just as weak global trade growth after the 2008–09 crisis meant a slower pace of economic growth in East Asia, so too could rising global protectionism spell a further step down in the region's growth prospects.

Yet, a world where East Asia is able to fuel its own export demand suggests it has much more room to manage and even offset these effects. Regional initiatives are now a viable platform for facilitating export-led growth, even if other parts of the world turn inward. That includes China's efforts to integrate Eurasia through its Belt and Road Initiative but also the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (which could expand to include more countries) and the Regional Comprehensive Economic Partnership (which needs to be progressed). Although there is some inconsistency between these initiatives, the real question is whether East Asia and other regional players are willing to do what is needed by increasing cooperation, further opening their markets, and deepening their integration. Similarly, the rise of other non-Western economies also presents East Asia with significant opportunities to continue fuelling export-intensive growth. Underpinning both dynamics is the emergence of hundreds of millions of middle-class consumers in the developing world and the still sizeable investment needed for these economies to continue catching-up with Western levels of income.[14]

Where does that leave the US decoupling agenda? When it comes to trade, America clearly has far less leverage than it once did. China has now cemented itself at the core of the region's economy — being both heavily integrated into regional value chains and having overtaken the United States as the leading source of final demand for the rest of the region's exports. East Asia's economic interests thus increasingly lie foremost in an integrated region with China at its core. The United States can certainly pursue decoupling unilaterally, which will impose its own economic costs. But any effort aimed at pushing East Asian economies to also forgo closer economic relations with China will inevitably struggle. More likely, East Asia will simply continue with its own version of decoupling.

NOTES

[1] East Asia refers to Japan, Korea, Brunei Darussalam, China, Hong Kong, Indonesia, Cambodia, Malaysia, Philippines, Singapore, Thailand, Taiwan, and Vietnam.

[2] See Office of the United States Trade Representative, *2018 Trade Policy Agenda and 2017 Annual Report*, March 2018, https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2018/2018-trade-policy-agenda-and-2017.

[3] See, for example, Richard McGregor, "Donald Trump Begins a Conscious Uncoupling from China", *Australian Financial Review*, 16 October 2018, https://www.afr.com/news/economy/donald-trump-begins-a-conscious-uncoupling-from-china-20181011-h16jf4, and recent comments by former US Treasury Secretary Henry Paulson on the risks of an "economic iron curtain": "Remarks by Henry M Paulson, Jr, on the United States and China at a Crossroads", Paulson Institute, 6 November 2018, http://www.paulsoninstitute.org/news/2018/11/06/statement-by-henry-m-paulson-jr-on-the-united-states-and-china-at-a-crossroads/.

[4] See, for example, Gary Clyde Hufbauer, "The Unfolding of a New Cold War", East Asia Forum, 18 November 2018, http://www.eastasiaforum.org/2018/11/18/the-unfolding-of-a-new-cold-war/.

[5] US Commerce Secretary Wilbur Ross has stated this view: see David Lawder and Karen Freifeld, "US Commerce's Ross Eyes anti-China 'Poison Pill' for New Trade Deals", Reuters, 6 October 2018, https://www.reuters.com/article/us-usa-trade-ross-exclusive/exclusive-u-s-commerces-ross-eyes-anti-china-poison-pill-for-new-trade-deals-idUSKCN1MF2HJ.

[6] See, for example, Martin Chorzempa, "The Trump Administration's Rush to Curb Technology Leakage Is in Danger of Backfiring", PIIE *Trade & Investment Policy Watch*, 8 January 2019, https://piie.com/blogs/trade-investment-policy-watch/trump-administrations-rush-curb-technology-leakage-danger.

[7] See, for example, Ely Ratner, "There Is No Grand Bargain with China", *Foreign Affairs*, 27 November 2018, https://www.foreignaffairs.com/articles/china/2018-11-27/there-no-grand-bargain-china.

[8] The quintessential example of the way these value chains operate is the Apple iPhone, which is designed in the United States and incorporates high-tech inputs produced in several countries (Japan, Korea, Taiwan, Germany, and the US) and is assembled in China for export. One estimate suggests China accounts for only 3.6 per cent of the value-added contained in an iPhone 7 while the United States and Japan each account for about 30 per cent of the value: see Jason Dedrick, Greg Linden and Kenneth Kraemer, "We Estimate China Only Makes $8.46 from an iPhone – and That's Why Trump's Trade War Is Futile", *The Conversation*, 7 July 2018, https://theconversation.com/we-estimate-china-only-makes-8-46-from-an-iphone-and-thats-why-trumps-trade-war-is-futile-99258.

[9] International Monetary Fund, "Direction of Trade Statistics", http://data.imf.org/?sk=9D6028D4-F14A-464C-A2F2-59B2CD424B85.

[10] OECD, "Trade in Valued Added (TivA)", http://www.oecd.org/sti/ind/measuring-trade-in-value-added.htm.

[11] Estimates for 2016 and 2017 are based on gross exports data on a directional basis and assuming the ratio to final export demand remains unchanged. This does little to change the various conclusions of the analysis, with the majority of the shifts in final demand discussed already evident by 2015. Estimates pre 2005 are derived by applying simple growth rates based on an earlier version of the OECD database covering the period 1995 to 2011.

[12] Author's estimates. Of interest, the latest OECD numbers significantly revise up the domestic value-added content of most countries' exports, including China's. This has the effect of substantially increasing the estimated impact of US tariffs on China's economy while decreasing the indirect impact on other East Asian economies.

[13] Econometric modelling by the Asian Development Bank indicates that the business cycle in developing East Asia remains heavily integrated with the global business cycle: see Cyn-Young Park, "Decoupling Asia Revisited", ADB Economics Working Paper Series No 506, January 2017, https://www.adb.org/sites/default/files/publication/221156/ewp-506.pdf.

[14] See, for example, estimates on the global middle class in Homi Kharas, "The Unprecedented Expansion of the Global Middle Class: An Update", Brookings Global Economy & Development Working Paper 100, February 2017, https://www.brookings.edu/wp-content/uploads/2017/02/global_20170228_global-middle-class.pdf.

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