ISIS Focus

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In this Issue

The Fed's Tapering: Economic and Strategic Impact from Advanced Economies to Emerging Asia

*D**r Dan Steinbock** is the Research Director of International Business at the India, China and America Institute, USA. He spoke of the economic and strategic impact of the Federal Reserve tapering from advanced economies to emerging Asia at an ISIS International Affairs Forum on 11 April 2014. Dr Steinbock is a Visiting Fellow at the Shanghai Institutes for International Studies in China. He is also a Visiting Fellow at the EU Centre in Singapore. The Forum was moderated by **Tan Sri Rastam Mohd Isa**, Chief Executive of ISIS Malaysia. ISIS Analyst **Zarina Zainuddin** reports.*

The day Dr Dan Steinbock first visited ISIS Malaysia in February 2009, export-led growth economies plunged that morning. Many thought the financial crisis in the United States, which had spread to Europe, was simply a bump on the road. However, Steinbock predicted a long recovery — a prediction which, unfortunately, proved to be true for many countries.

During his most recent visit to ISIS, Steinbock touched on a wide range of issues including the impact of the Federal Reserve (Fed) tapering, the disconnect between the real and market economy, the impact of the economic crisis on the advanced economies, China and the emerging economies as well as what to expect next.

Steinbock believes that the current situation reflects a major shift from advanced economies to large emerging economies. Together the emerging economies become multiple sources of growth for the world economy and this shift has 'huge ramifications'.

Not long ago our world economy was fuelled by the US consumption. While this offered some predictability and stability to the market, over-reliance on a single economy also meant dangerously tying the world's well-being to the health of one country, namely the United States. According to Steinbock, business cycles work simultaneously with structural transitions and this creates much volatility.

Such precariousness generates a great deal of opportunities for Wall Street. In fact, the number of Dow Jones investors is higher than it was before the crisis. It is thus natural to assume that the economy is doing fine but there is a problem — the total debt burden has not changed, let alone been reduced.

While the markets have been soaring, the real economy reveals a different picture. The Baltic Dry Index (BDI) is currently hovering around 1,200. (BDI is a shipping and trade index that 'measures changes in the cost to transport raw materials such as metals, grains and fossil fuels by sea'. BDI indirectly measures the global supply and demand for the commodities shipped aboard dry bulk carriers, and because these commodity consists of materials that function as raw material inputs to the production it is also seen as an efficient indicator of future economic growth and production.) The BDI soared near the 12,000 level in May 2008. Real economic activities are significantly lower than its pre-crisis level.

According to Steinbock, the US government was printing a lot of money and this caused a disparity between the soaring markets and the sluggish real economy (the Fed was engaging in expansionary money policy which increased liquidity in the economy). Steinbock believes it was a necessary action in the early stages of the crisis. However how long can such a policy be carried out before it accumulated significant collateral damage not only in the United States but other economies as well?

Dan Steinbock

… the current situation reflects a major shift from advanced economies to large emerging economies.

The US economy

The US economy, Steinbock feels, managed better compared to other troubled advanced economies because of the actions of the Fed and US government at the onset of the crisis. European countries had initially opted for austerity measures before embracing the expansionary policies but the impact on their economies may not be as positive as in the case of the United States due to the time lag and worsening economic conditions. It is important therefore to study the US monetary policy which has paced, dictated and shaped other monetary policies.

In December 2008 the Fed reduced the fund rates to 0-0.25 per cent and implemented a 'non-traditional' monetary policy which encompassed three strategies. The first strategy was through 'Forward Guidance' where the Fed informed on the future direction of interest rates ahead of time. This reduced uncertainty and increased transparency on its intentions.

Second, the size of the Central Bank (CB) balance sheet or QE (Quantitative Easing) was increased. Three large-scale asset purchases increased the balance sheet from $0.4 trillion in 2007 to $4 trillion at the end of 2013. Third, the composition of the CB, which included purchasing long-term bonds to reduce its long-term interest rates, was reformed.

As a result of the measures taken, combined with expansionary monetary and fiscal policies, the US economy has improved. US economic growth is expected to be at 2.6-2.8 per cent for 2014 with an inflation rate of 1.6-2 per cent and unemployment rate will decrease from 6.2-5.8 per cent. Inspite of the rosy outlook, Steinbock remains cautiously optimistic. He thinks that the consensus view may have underestimated the robustness of the housing market, strength of the labour market and challenges of structural debt. In addition, there are downside risks which include external risks from the eurozone and emerging markets that took a toll on the US economy in the first quarter of 2014.

However, the central issue for Steinbock is unemployment rate. The Fed will begin tightening monetary policy once unemployment rates approach its trigger rate of 6.5 per cent. The unemployment rates are at 6.8 per cent and the participation rate (to labour market) has also declined. Steinbock estimates that at least half to two-thirds of the decline is caused by an aging population and not by the recession. If this proves to be the case then there is a possibility of the Fed hiking interest rates prematurely.

… China should be examined both in terms of its regions and sectors. Different regions require various levels of development and needs and these present diverse business opportunities for Malaysia.

China

Many have described the change of leadership in China in 2013 as a victory for the conservatives over the liberals. Steinbock, on the contrary, deems Xi Jinping and Li Keqiang, as consensus leaders — mainstream leaders who enjoy support from a wide range of segments within the Chinese society. Xi, he admitted, wields a lot of economic power and while the Chinese President makes some understandably uneasy, Steinbock contends that it would be difficult to implement change without having real concrete power.

Steinbock also pointed out that China's leadership is in transition. The current leaders would likely retire within five years and the next generation of liberal reformers, such as current Deputy Prime Minister Li Yuanchao, would lead China.

China's real gross domestic product (GDP) growth was 7.7 per cent last year and Steinbock expects a real growth of 7-7.4 per cent for 2014 and 2015, with an inflation rate or consumer price index (CPI) of 3.5 per cent. The policy rate is projected to remain at 4 per cent in 2014. Nevertheless corruption remains a challenge in China; while one should not underestimate the problem of corruption, one should not overestimate its extensiveness either.

Steinbock thinks China's growth will remain at 5-6 per cent for years to come, assuming the situation in South China Sea remains peaceful. The downside risks could come from its property market, where there is a danger of property prices declining too much, or from 'faster-than-anticipated' deleveraging efforts as well as from its shadow-banking defaults.

Malaysia

According to Steinbock, Europe's stable albeit slow economic recovery, progress in Japan's economy and continued improvement in the US economy all work in Malaysia's favour. Their increase in demand will help boost Malaysia's exports.

Where China is concerned, Steinbock highlighted that the development in its third- and fourth-tier cities now needs commodities that the first- and second-tier cities no longer need. In Shanghai, Foreign Direct Investment (FDI) in manufacturing is leaving but other types of investments, such as business-FDI, are going in. Hence China should be examined both in terms of its regions and sectors. Different regions require various levels of development and needs and these present diverse business opportunities for Malaysia.

The downside risks in China — a faster-than-expected deceleration in its economy, the inability to implement full economic reforms, and increased isolation due to its noneconomic policies particularly on the South China Sea — is likely to impact Malaysia negatively. Pertaining to MH Flight 370, Steinbock is not overly worried about the ramifications; he believes there is real intention and desire on both sides to develop cooperation beyond the daily issues.

Fed tapering

The key issues to consider here are when and how long is the interim period before the Fed starts hiking interest rates as well as the kind of impact it would have on the world and emerging markets in particular. Increased interest rates would make US financial instruments more attractive as they offer better returns to investment and may cause capital outflows from some regions, namely the emerging markets. Nonetheless, China would still be attractive provided its extensive reforms are implemented accordingly.

As for the rest of Asia, Steinbock feels that there will be increased volatility and more uncertainty and more importantly, there will also be differentiation in emerging markets. Factors such as fiscal deficit or surplus, current account balance, inflation level, macroeconomic policies, stability, and so on, will be important considerations for investors. The better managed emerging markets are likely to benefit in a market differentiation situation than those which are not.

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A participant poses a question

Beyond GDP: Towards an Inclusive Measure of Wealth

*P**rof Anantha Duraiappah**, the author of the Inclusive Wealth Report (IWR) spoke on the Inclusive Wealth Index (IWI) as a measure of progress towards sustainability beyond the Gross Domestic Product (GDP) at an ISIS International Affairs Forum on 25 April 2014. Prof Duraiappah is the Executive Director of the International Human Dimensions Programme on Global Environmental Change (IHDP), based in Bonn, Germany. He was also the former Chief of the Ecosystem Services and Economics Unit of the United Nations Environmental Programme (UNEP) and helped initiated the Intergovernmental Platform on Biodiversity and Ecosystem Services (IPBES). The session was moderated by **Dr Hezri Adnan**, Director for the Technology, Innovation, Environment and Sustainability Programme (TIES), ISIS Malaysia. ISIS Intern **Michelle Kwa** reports.*

The Gross Domestic Product (GDP) as a quantitative measure of economic growth has traditionally underpinned growth as a necessary condition for development. Notably, not just monetized expansion as measured by GDP, but the growth curves of many indicators have plunged dramatically since the 1950s as a result of physical expansion such as population growth and natural resources consumption. Shortcomings of GDP and criticisms of it as a wealth and welfare measure have led to many discourses as well as the establishment of alternative assessments. One such cited progress indicator is the Human Development Index (HDI) developed by Amartya Sen. HDI, as a normative concept conflates qualitative improvement with quantitative growth in the economy. However, it is argued that HDI's lack of completeness regarding environmental aspects calls for a broader and holistic concept to truly capture the sustainability aspects of societal wellbeing. Only in such manner, can it respond specifically to a country's challenges and policy agendas.

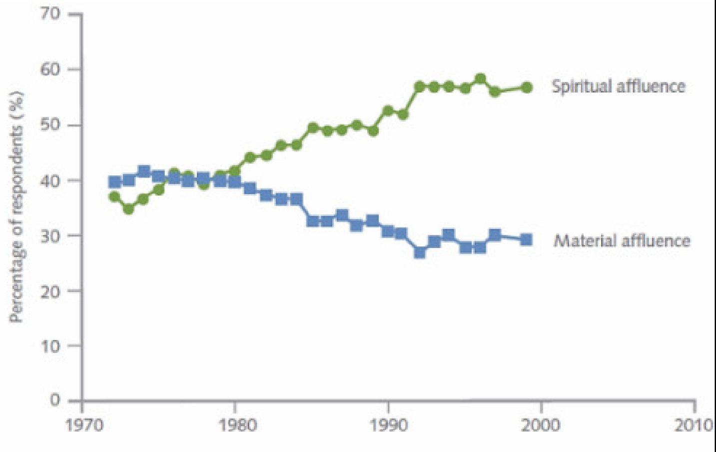
Duraiappah first drew upon the building blocks of the economic growth paradigm in the pursuit and use of economic indicators. He then offered a brief analysis on how GDP alone as a statistical pillar is an overriding concern of human beings striving towards progress and the achieving of sustainable development goals (SDGs). Given this context, he further discussed the approach, main findings and policy implications of the Inclusive Wealth Index (IWI) as an alternative integrated indicator to measure a nation's wealth comprehensively.

Anantha Duraiappah

Is GDP an indicator for sustainable progress?

Duraiappah introduced the discussion by contesting the idea that GDP mirrors economic growth and therefore identifies with the progress and wealth of a nation. GDP for all its practical purposes has (except for Bhutan's Gross National Happiness since the 1970s) failed to capture the progress of literacy, education, environmental security, biodiversity conservation and value of ecosystem services. This method of measuring national production was dominantly catalyzed by the Keynesian view of economic theory during the Great Depression, centred on the idea of the circular flow of income. Such thinking lifted consumption as the primary role in economic management. Reportedly as early as in 1934, Simon Kuznets, the indicator's inventor, warned that such national economic statistics can scarcely be used to assess the overall welfare of the nation. Kuznets again testified in 1974 on GDP's limitations and stated:

'Distinctions must be kept in mind between quantity and quality of growth, between its costs and return, and between the short and the long run. Goals for "more" growth should specify more growth of what and for what'.



Spiritual affluence: willingness to focus on life with spiritual affluence, as material affluence has been already satisfied to some extent.

Material affluence: willingness to focus on making life materially affluent

Source: Based on result of opinion polls by the Cabinet Office, Government of Japan

Figure 1: Aspiration for spiritual richness versus material richness (1972–99); source: (JSSA, 2011)

Paradox of wellbeing and income

Duraiappah then reinforced Easterlin's findings on the paradoxical relationship between happiness and income, indicating that happiness does not always increase in parallel to the rise in income of a country over the long term. This statement was vividly described in his study on Japan which highlighted the negative consequences for human wellbeing as biodiversity diminishes. As Figure 1 shows, since 1980, it can been seen that increasing monetized economic growth in Japan has not translated into contentment as seen in the aspirations of the majority of the population to pursue spiritual richness in their future lives.

… [there is] a shift in emphasis from production beyond GDP to greater attention to social and environmental wealth in the context of sustainability.

Rethinking growth

The economic crisis and stagnation of 2008 led to a shift from assessing growth based on GDP. There was an increasing demand for sustainable measurement marking a 'change in the scorecard'. Following this, a report by United Nations Secretary-General's High-level Panel on Global Sustainability, with the title *Resilient People, Resilient Planet: A Future Worth Choosing* called for the strengthening of the interface between scientists and policymakers. Analogously, a 'Sarkozy Commission' led by Joseph E. Stiglitz, Amartya Sen and Jean-Paul Fitoussi was established to evaluate the relevance of GDP. Their report, *Measurement of Economic Performance and Social Progress*, suggested a shift in emphasis from production beyond GDP to greater attention to social and environmental wealth in the context of sustainability. Crucially, the importance of reflecting tradeoffs and synergies of environmental, social and economic goals are stressed to identify system interdependencies, as such, deriving meaningful public policy processes.

Scope of Inclusive Wealth Index (IWI)

Against this backdrop, the IWI, published in the *Inclusive Wealth Report (IWR) 2012*, aims at being a comprehensive index, more inclusive than GDP and HDI — one that incorporates social and environmental costs or benefits in a long-term perspective. Contrary to GDP, which focuses on monetary flows in the short-term, the IWI focuses its attention on the stock of assets by assessing three components of wealth in a country as follows: changes in human capital (education, demographic curve, income, and so on), natural capital (fossil fuels, minerals, forests, farmland, fisheries) and manufactured capital. This index shows whether a country's wealth has been increasing or decreasing, thus making it an inclusive accounting tool for policymakers and national planning authorities.

The prototype report of IWR was first released in 2012 during Rio+20. It was designed to draw the attention of decisionmakers from 20 countries. With a focus on natural capital, it covered high, middle and low-income economies from all the continents, over a period of 19 years (1990–2008). The selected country samples represent 58 per cent of the global population and 72 per cent of the world's GDP in 2010.

Accordingly, the mathematical model of IWI is based on three assumptions of the notion of sustainability:

- Sustainability is achieved if wellbeing is positive;
- Inclusive wealth of a country is the shadow value (internalizing externalities) of all its capital assets; and
- Intergenerational wellbeing is positive if the changes in inclusive wealth are positive.

Key findings from IWR

Duraiappah highlighted a few key findings of the report. Firstly, he underlined the significant role of population growth rate in determining a country's sustainability. Changes in population size affect capital distribution considerably. Colombia, Nigeria, Saudi Arabia, South Africa and Venezuela indicated negative growth on the IWI, signaling that they are on an unsustainable track. One of the primary reasons for this was high population growth rates. (See Figure 2)

Secondly, the case study of Japan showed it was the only country to experience an increase in natural capital stocks. While agricultural land has been steadily declining since 1990, forest resources have been increasing and this was the primary reason for the country's positive, natural capital growth rate.

Thirdly, the study shows that the increasing human capital in most economies has been the key form of capital to offset the decline in natural capital. However, in elucidation, he revealed that health capital is treated separately from human capital in this study due to its high intrinsic value. (See Figure 3, page 8)

Finally, the clear signs of the tradeoff effects among different forms of capital are witnessed in the changing of capital stocks for 20 countries over 19 years. The identified major driver of the difference in performance was the prominent decline in natural capital.

He drew upon another facet of the analysis which takes into account three determinants affecting a country's aggregate output resulting in the 'Adjusted Inclusive Wealth Index'. These elements are potential climate change damage, oil capital gains and total productivity factor (TFP). This has been of relevance to Nigeria, Venezuela, Saudi Arabia and Russia as they moved away from the unsustainable path fundamentally attributed to TFP and oil capital gain.

	Inclusive Wealth Index	Population growth	IWI per capita
Australia	1.41	1.29	0.12
Brazil	2.30	1.38	0.91
Canada	1.41	1.03	0.37
Chile	2.56	1.35	1.19

Key
3.0 – 2.0
2.0 – 1.0
1.0 – 0.5
0.5 – 0.0
0.0 – -1.0
-1.0 – -2.0

Figure 2: Measuring countries' progress. The average annual growth rate, period 1990–2008. IWI per capita = IWI – Population growth

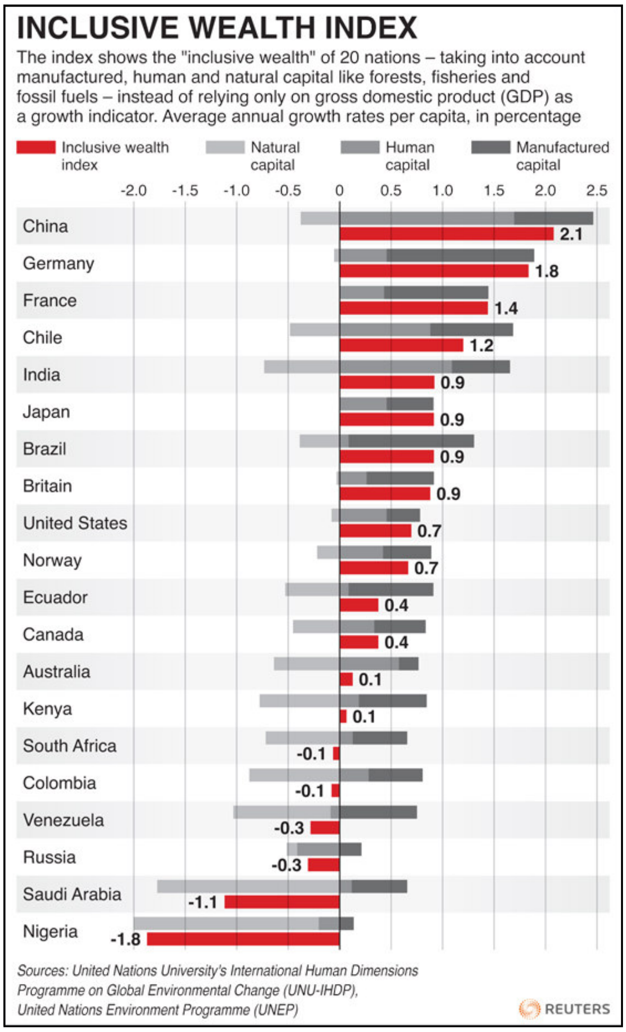


Figure 3: Average annual growth rates (per capita) disaggregated by capital form

Key lessons and challenges

The key strength of the inclusive wealth framework is rooted in the shadow price which is determined by the degree to which the various forms of capital can be substituted. Shadow price essentially captures:

- Each capital's contribution to intergenerational wellbeing at each time period;
- Expected future scarcities; and
- Externalities produced in the use of the capital.

He concluded that estimating the shadow prices of capital, especially natural capital, remains the main challenge due to a number of different methodological approaches.

Policy recommendations

He strongly urged countries to boost investments to increase TPF which will in turn enhance productivity in the generation of goods and services. Japan's models in managing both natural and human capital were embraced through its Satoyama Satoumi (symbiotic interaction between ecosystems and humans) Initiative. Ecological infrastructure in Japan is well-developed so as to avoid natural capital depletion. This is seen as a best practice.

Duraiappah explained that IWI is deemed as one of the useful policymaking tools in providing credible and policy-relevant information. It acknowledges especially the significance of ecosystem services and contributions to economic and human development. Finally, he concluded that IWI is a holistic indicator of supplementing GDP towards achieving sustainable development as it provides an inclusive view of the practical consequences for policymaking.

Looking forward

As 2015 will mark the deadline for the Millenium Development Goals (MDGs), global development agenda beyond 2015 is converging towards SDGs thereby enhancing the relevance of IWI. The discussion calls for the collective will of society as change agents to activate wide-scale implementation and change of mind-sets. Fundamentally, the Achilles heel of any transformation problem lies with political decisions and actions. The power of judgment (rationality versus gut feeling) based on a set of value systems is often anthropocentric, that is excluding intrinsic and ethical values. The discourse between development (quality) and growth (quantity) demands a systematic analysis

… estimating the shadow prices of capital, especially natural capital, remains the main challenge due to a number of different methodological approaches.

and framing of sustainability problems. The considerations of stock of assets in IWI systematically draws attention to long-term dynamics, highlighting tradeoffs and synergies of the system boundary.

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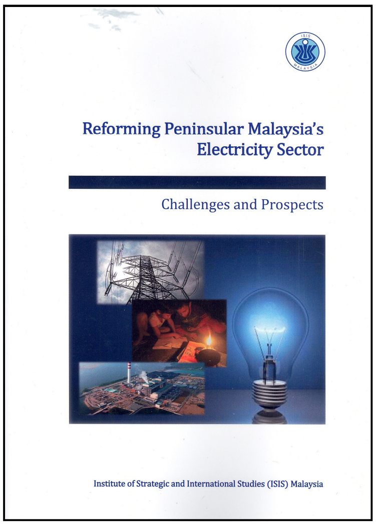
Participants of the dialogue

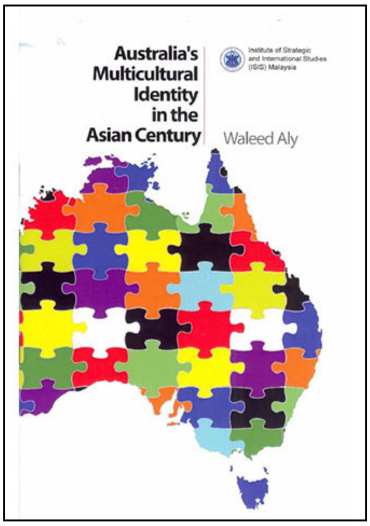
Latest ISIS Publications



Reforming Peninsular Malaysia's Electricity Sector: Challenges and Prospects (E-book)
Kuala Lumpur: ISIS Malaysia, 2014.

The e-book discusses the prospects and challenges associated with the objective of reforming the power sector in Peninsular Malaysia. It revolves around four themes, namely energy market outlook and regional experience with electricity market reform; electricity tariff review in Malaysia and its expected impact; reforms to increase competitiveness in Malaysia's electricity sector; and transition and adaptation to a new sectorial structure. These themes were drawn from the discussions that took place during the *Public Forum on Reforms in Peninsular Malaysia's Electricity Sector*, which ISIS Malaysia and MyPower Corporation co-organized on 7 November 2013.

Available at: http://www.isis.org.my/attachments/e-books/Electricity_Reforming_Final-book.pdf



Australia's Multicultural Identity in the Asian Century
Author: Waleed Aly
Kuala Lumpur: ISIS Malaysia, 2014.

This monograph is based on a talk titled, 'Australia's Multicultural Identity in the Asian Century', given by the author at an ISIS International Affairs Forum on 30 April 2013 in Kuala Lumpur.

Available at: http://www.isis.org.my/attachments/e-books/Waleed_Aly.pdf

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