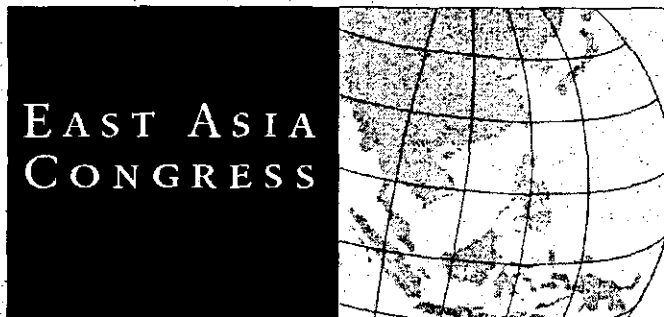


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SESSION ONE

“After the Perfect Storm: Making East Asian
Economies More Sustainable”

by

Dr Chulsu Kim
Chairman

Institute for Trade and Investment, Korea and
former Deputy Director of World Trade
Organisation
Republic of Korea



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**Finding New Sources of Growth
in East Asia**

by

**Chulsu Kim
Chairman
Institute for Trade and Investment**

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Finding New Sources of Growth in East Asia

Since the second quarter of 2009, the East Asian economy has been on a rebound from the economic downturn caused by the global financial crisis. For much of 2008 and in the first quarter of 2009, East Asia, as elsewhere, was suffering from sharp decline in industrial production and exports, rising unemployment, and outflow of capital, weakening asset values and currencies.

In the second quarter of this year, however, the East Asian economy began to make a vigorous rebound which has led many forecasting institutions to revise upward GDP growth in emerging East Asian economies. Although the performance so far has been uneven across the region and the rebound was by no means strong enough to reach the pre-crisis levels, there are strong signs of recovery in industrial production and exports. Economists have attributed this rebound to a combination of timely and large fiscal stimulus packages in most countries in East Asia, notably in China, and a powerful process of inventory restocking that began in mid-2009 in the industrial markets around the world.

The early rebound in East Asia was also the reflection of the resiliency of the regional economy with its solid macroeconomic fundamentals, such as high foreign reserves, large corporate and private savings, and low corporate and government debt. Also, the region's well-capitalized banks and the much improved banking supervision since the financial crisis ten years earlier helped to contain contagion and the impact of the global recession. East Asia, in other words, was better prepared to deal with the current economic crisis compared to the 1997-1998 Asian financial crisis.

As previously pointed out, the role of China was particularly important in the process of this economic rebound in the other countries of East Asia. While China's imports fell sharply in the last quarter of 2008 and the first quarter of 2009, they fell less than those of the U.S., the EU, or Japan, and they rebounded much more strongly than these industrial countries in the second quarter. In particular, China's infrastructure-focused stimulus package, combined with the surge in automobile production, and strategic stock of new materials have boosted China's imports, and this, in turn, contributed to the recovery of exports in other countries in the region.

The Korean exports, for example, rebounded strongly due to the China factor. Its exports to China fell considerably less than its total exports in the first ten months of this year. Moreover, Korean exports to China registered a positive growth of 3.4 percent for the first time

this year in September from a year earlier, whereas the overall exports showed a minus 9 percent growth.

While China has driven the current East Asian economic rebound ~~during the crisis~~ primarily through its massive and timely stimulus packages, there are limits as to what China can do alone in terms of providing the continued import demand for the countries in the region. First of all, while the economic stimulus packages in China are likely to remain in place for sometime, the negative effects of doing so would become more evident the longer they continue, in the form of excess capacity, wasted investment, high inflation and other problems. The authorities in China will likely consider "exit strategies" eventually to remove these negative effects sometime in the future.

Secondly, China is not likely to replace the U.S., the EU and Japan as East Asia's major export markets for sometime to come. East Asian economies typically depend on these industrial markets for about three-quarters of their exports today. Moreover, China's economy still accounts for less than one-tenths of the global economy with a low consumption to GDP ratio, further limiting its ability to function as the substitute for the major industrial markets for other East Asian countries.

Given these China's limits, can industrial countries continue to serve as a source for the East Asian economic growth in the post-crisis world? Although we are seeing some recovery in recent months in these countries, it does not seem likely that they will return to full recovery any time soon. The recovery from the worst recession in generations is expected to take longer than usual, and it has been suggested that, in the near term, demand in such industrial countries will remain weak, limiting external demand for East Asian products. Also, many governments will have to maintain their stimulus packages for sometime; public debts will arise; and the banks will be cautious about lending again, which will slow the recovery.

In the medium term, the countries in East Asia can achieve rapid economic growth in a slowly growing world to the extent that they are able to extract more growth from domestic demand, improve the environment for private investment, enhance competitiveness, penetrate new markets, and attract more foreign investment. East Asia also must find new sources of growth to maintain its dynamism of the previous decades. In my view, there are three major sources of growth which East Asia must tap. The first is the domestic demand. The second is the services sector. And the third is the regional economic integration.

How should East Asia sustain its growth under the environment of weak demand in the industrial countries? I believe the answer lies ^{first of all,} in finding the domestic sources of growth. In
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by the East Asian economies during the current crisis

other words, the region must find a way to substitute external demand with domestic demand.

Until recently, East Asia has pursued export-oriented development policies. The limits of such policy have become evident during the current economic crisis. The Chinese government was first to recognize the problems of its investment-centered, industry-led, and export-led manufacturing growth of the past. These policies have led to domestic and external imbalances, and the Chinese authorities seem committed to rebalancing growth by giving greater attention to domestic sources of growth.

While East Asia came out of the Asian financial crisis 10 years ago through exports to industrial markets, the sharp decline in import demand in those countries was the main cause for the contraction.

This was evident in the introduction of new measures by China to support private consumption as a part of the economic stimulus packages introduced this year. These included, among others, tax breaks for automobiles, subsidies for electronic product purchases, increases in pensions, and a new health reform program. Elsewhere in East Asia, various schemes to stimulate domestic demand were also introduced.

The second is the importance of the services sector in the region. The services sector holds an enormous potential as a new source of growth in East Asia. The sector is underdeveloped in many East Asian countries because of the traditional bias in favor of the manufacturing sector. The share of the value-added services to GDP has risen rather slowly in East Asia. For example, in China, it rose from 32 percent in 1960 to only 40 percent today. The potential of the service sector is evident in the example of Korea. Despite the low labor-productivity in the service sector, services accounted for half of the increases in Korea's real GDP over the last 25 years.

An ambitious agenda to develop service sectors in East Asia could help create substantial new sources of growth in many countries. Such agenda may include, among others, the reduction or elimination of tax incentives given to export-oriented manufacturing, opening up of the services sector to foreign investors, helping improve the access to finance for SMEs, and facilitating migration throughout the region.

The third is the importance of regional economic integration as a new source of growth in East Asia. The intra-regional trade increased rapidly in the last three decades and now stands at a level which surpasses that of NAFTA and approaches the European Union's. This has largely been the result of market forces and production networks in the region, rather than a result of the policy-driven integration in the region.

Even during the current global economic crisis, a significant number of new regional trade agreements have been signed or implemented, or for which the new negotiations have

begun. If the Asian financial crisis of 1997-1998 was one of the main driving forces of East Asian regionalism, the current crisis seems to be acting as a catalyst for strengthening regional economic integration initiatives. According to the ADB database, as of June this year, there were 49 regional trade agreements under implementation, 10 signed, 54 under negotiations in the countries in the ASEAN plus six region.

The sheer number of regional trade agreements underscores the urgent need to consolidate the wide-ranging, complex and sometimes overlapping agreements in the region. Rather than boosting trade, these multiple agreements, with their "noodle bowl" effects, have the potential to inhibit trade or increase transaction costs. Moreover, many of these agreements fall considerably short of being agreements of high level of trade and investment liberalization. Therefore, a simple harmonization of the existing agreements would contribute little to the acceleration of regional trade flows and growth.

While the ASEAN should remain the anchor of any region-wide integration process, China, Japan and Korea which together make up about 85 percent of the regional economy, are also key to the process. Any region-wide arrangement without the cooperation and accommodation among these three countries would be unthinkable. The missing link today among the three countries in the East Asian network of trade agreements must soon be connected by accelerating the on-going dialogue among China, Japan and Korea on this issue.

The recent events in Dubai have underscored the fragility of the global economic recovery and the need for vigilance in addressing the global economic situation in these turbulent times. While the G-20 meetings since November of last year has helped to put in place a mechanism for the macroeconomic policy coordination at the global level, I believe it is also very important for the East Asian countries to advance the regional dialogue to enhance financial cooperation, and to coordinate policies in other areas in the context of ASEAN plus three or the ASEAN plus six.

Thank you.