[ISIS Focus Oct-Dec 2004]

Second East Asia Congress

Sustaining East Asia's Economic Growth and Dynamism: The Macro & Micro Challenges

*Many experts believed that the Asian Crisis of 1997-98 spelled the end of the East Asian miracle economies. But recovery was rapid, and growth rates are positive again. Four East Asians shared their views on how East Asian economies can better prepare themselves for outside shocks and globalisation. T**he ISIS Editorial Team** reports.*

The session began with Dr Fan Gang, Director, National Economic Research Institute, China, who spoke of steps taken to retard the "overheating" of the Chinese economy for the benefit of China and East Asia.

Dr Fan noted that sustaining high growth in a developing country is very difficult. In the long run, key issues that are not dealt with could result in financial and social crises. These issues include institutional reforms, economic restructuring, and dealing with state-owned enterprises, unemployment and income disparities.

Dr Fan said that as a low-income developing country and economy of transition, China would find it difficult to balance the enormous opportunities for investment and the resulting overheating because of institutional weaknesses.

This is because those managing these institutions are first generation entrepreneurs, macroeconomic managers, lawyers and judges. Compared with people of other developing countries, they have less of a sense of risk of the market and fluctuations, and are therefore more liable to misinterpret market opportunities. Dr Fan said that this was the fundamental reason for the overheating and recession, in the '90s and at the present time.

Recently, China experienced high growth and high investor expectations, particularly because of China's WTO accession and the government's recent adoption of the urbanisation policy. Dr Fan explained that three factors have contributed to the overheating of the Chinese economy in recent years.

(1) **The WTO push.** Before the WTO accession, FDI and export demand increased dramatically.

(2) **Rapid private sector growth.** China saw an improvement in the institutional and policy environment, contributed by WTO accession, which led among other things to companies asking for national treatment equal to that of state-owned companies.

(3) **Growth in infrastructure and urbanisation programmes.** High growth of infrastructure investment and urbanisation programmes occurred in all localities in China.

Recently in China, there was a realisation that urban rather than rural industrialisation was needed to ensure WTO accession. Dr Fan said that China wants more FDI, more private sector growth, and more urbanisation. This has led China to experience another overheating situation as indicated in the first quarter investment growth of 47 percent in nominal terms and 38 percent in real terms (i.e. increasing demand for domestic industries and materials, and also external demand). He added that there was also a shortage in energy, electricity and other utilities, resulting in high prices and a trade deficit of US$8 billion from January to May 2004.

Optimistic about a soft landing

Dr Fan was optimistic, for two reasons, that China would successfully deal with this overheating situation, and that it would experience a "soft landing" in the short term.

First, compared to the '90s, this time around the government responded quickly. The government started talking about overheating in June 2003, and by the end of August had started increasing the deposit reserve ratio in the central bank and tightening monetary supply. In October, it controlled the use of land, which is the basis of the urbanisation programme, and in the first quarter of 2004, the government got serious in its policies to curb over-investment. These macroeconomic adjustments in the early stages of overheating were positive.

Second, the government was able to implement realistic and effective policies for dealing with non-government and non-economic agents like local government and state owned enterprises, i.e. bodies that were not sensitive to interest rates.

Dr Fan said that these were the reasons why government policies have been effective. In May 2004, the investment growth rate slowed down to 18 percent in nominal terms and 12 percent in real terms. Prices of commodities and materials decreased. China started to see a slowdown not only in demand for domestic commodities but also demand for imports. The timeframe of nine months began to show results, and the assessment is that overheating did not reach high levels due to the effectiveness of policies and quick reaction of government policies.

Dr Fan believed that the Chinese economy will slow down to a growth rate of between 8 and 9 percent in the near future, a scenario which will be favourable for China and East Asia.

Asian savings

Professor Yoshino Naoyuki of the Faculty of Economics, Keio University, Japan, elaborated on the growth rates in the region, and promotion of small savings and infrastructure with regard to the development potential of the East Asian region.

Prof Naoyuki cited figures on the growth rates of East Asian countries. He noted that in 1998, right after the Asian Crisis, most countries like Malaysia, Thailand and Indonesia recorded negative growth. However by 2002, growth rates had recovered in these countries.

One characteristic of Asian countries, Prof Naoyuki said, was their high domestic savings compared to other countries. He added that while the growth rate of money supply in Laos, Cambodia and Myanmar was very large, resulting in these countries suffering a high rate of inflation, other countries recorded moderate or negative rates of inflation. In 1998, all Asian countries suffered negative growth, but recovered quickly and now enjoy stable economic growth. Growth in exports between Asian countries more than doubled, and imports and exports increased drastically within the region. Mutual trade balances in the Asian region are growing very rapidly.

International reserves in multilateral currencies

From 1996 to 2002, international reserves increased in the region. Reserves in Korea and China increased by three times during these five years. Due to export and trade relations, international reserves in the region increased, with most countries holding the reserves in US dollars rather than multiple currencies. He said that the next step for Asian countries was to diversify into multilateral currencies which will accelerate the bond market and basket of currency in the region.

Prof Naoyuki noted that FDI supports domestic activity of capital stock, and is not guided by government capital. It is, therefore, a good method of increasing activity in each country.

Currency union

Prof Naoyuki also noted that there were a lot of fluctuations in many countries in the 1998-99 period. China, Hong Kong and Malaysia had fixed exchange rates. Indonesia suffered a huge depreciation of its currency. Asian countries generally depended heavily on exports and imports, and suffered as a result of huge fluctuations in exchange rates. This, Prof Naoyuki said, signaled a clear need for some kind of management of exchange rates. One way was the basket currency system, leading in the long term to a currency union. However, Prof Naoyuki said that before achieving a currency union, each country must adopt its own clearly defined exchange rate mechanism, be it floating, a combination, or some other system.

Domination of small business

Prof Naoyuki then spoke of the high savings ratio in the region, compared to Latin American and African countries. He observed that in many countries the domestic savings was sufficient to support domestic investment due to the high savings ratio.

In many Asian countries, he said that the majority of businesses were small businesses. This was based on the number of offices and employees.

The important question now, therefore, was how to circulate money to these small-scale firms and businesses. Prof Naoyuki discussed the mobilisation of small savings including working with small banks, promotion of small savings (including micro-finance), and data collection of small firms to enable a “ratings” system similar to that for large corporations.

Two other issues to be considered for the future were the aging population and the budget deficit. To deal with an aging population, Prof Naoyuki recommended postponing the retirement age and basing the wage rate on productivity rather than seniority. This, Prof Naoyuki said, would also help compensate for the budget deficit.

Finally, Prof Naoyuki discussed monetary policy indicators for the East Asia region. He said the although at the moment most countries were experiencing deflation or recession, many may yet face inflation in the near future due to the high price of oil and other commodities. Thus, independence of monetary policy is important. However, Prof Naoyuki added, the coordination of monetary and fiscal policies was also important. Aggregate supply factors like technology, labour, private capital and government capital must be closely monitored. Technological progress is important to keep the economy growing, while a high quality of labour is equally essential. This would require long term investment in education and training of employees.

Prof Naoyuki also noted that many Asian countries were infrastructure-based, and they should therefore strive to reduce the infrastructure-based economy. He said that this could be achieved by using revenue bonds rather than government tax. The bond is issued on a project basis and the rate of return of the bond is based on the return from the infrastructure project, he explained.

Prof Naoyuki concluded by saying that if Asian countries could increase technology, labour and investment, there would be a lot of potential for the development of the Asian economy.

A “new” integrated East Asia

Dr Bandid Nijathaworn, Deputy Governor, Bank of Thailand, focused on the “new” emerging East Asia and the challenges it faced.

On the “new” East Asia, Dr Bandid said that contrary to expectations, economies of East Asia recovered quite quickly. What was most promising of this new East Asia, he explained, was that it was stronger economically and financially than before, more integrated, with greater economic autonomy and authority, and was moving rapidly to capitalising on long-term benefits and advantages of an integrated regional economy.

Dr Bandid elaborated on the four aspects of the "new" more integrated East Asia. First, the increased specialisation and development of closely linked production networks has resulted in greater intra-regional trade and investment, which in turn has become an important source of growth in East Asia. This, he added, was likely to intensify and transform development into a more dynamic process. These features made the East Asia recovery much more broad-based and less dependent on global economic cycles.

Second is East Asia's strength in its external financial position. A positive current account balance against the rest of the world, lower levels of indebtedness, and healthy international reserves have safeguarded against outside shocks or disturbances that may otherwise have threatened the region's economic stability.

Third, East Asia has emerged stronger on the structural front. Structural deficiencies that were identified in the miracle economies of the past, such as loose governance structure, and non-transparent domestic markets, have been reduced through economic reform. Another positive example is the restructuring of the banking sector in the region.

Fourth, is the greater political will and support among governments to move rapidly into a framework of financial and economic cooperation. Significant developments occurred after the Crisis. Dr Bandid reiterated that the aim was to enhance the region's long-term prospects for closer economic integration, and strengthen its potential through the region's ability to identify and cope with financial instability.

East Asia: three levels of challenges

In the context of these positive developments, Dr Bandid said that the biggest challenge was how to capitalise on the current positive trend so that the region's economic strength and potential could be utilised in full to achieve a sustained improvement in living standards of its people.

Dr Bandid identified the challenges for East Asia on three broad levels. The first level involves sustaining regional rapid growth and development without running the risk of financial or macroeconomic instability. This requires prudent macroeconomic management. The second level involves ensuring that the fruits of development and growth trickle down to the people in terms of improving living standards, falling poverty levels and reduced income disparities. The third level involves ensuring that economic and social gains benefit all countries. Countries in the region must allow all to move forward together in a fair and balanced manner. Dr Bandid said that it was the duty of East Asia's scholars to help governments come up with an appropriate agenda for development.

Dr Bandid then shared five thoughts on how to approach these challenges so East Asian countries could move forward.

First, for sustaining growth, countries should attach high priority to the sound economic fundamentals which have been instrumental to the success of East Asia in the past.

Reaffirming fundamentals of high domestic savings, opening trade and investment regime, establishing efficient systems of resource allocation and macroeconomic discipline are important.

Second, the region must maintain stability. Dr Bandid believes that the Asian Crisis was in essence a form of integration into free market processes which became problematic because institutions were not prepared or strong enough to handle the shocks. Thus, he said, the reform process must continue and include the resolution of non-performing loans, corporate restructuring and legal reforms to help release a substantial amount of economic resources, locked up since the Crisis, into productive use. Dr Bandid said that this could be done by moving forward to the next level with strengthened roles and markets, institutions, governance and public policy processes. Promoting financial stability would also help. Here, Dr Bandid asked for East Asia countries to move towards a more solid financial arrangement.

Third, financial market development with East Asia's savings surplus would benefit investment and growth in the region. A more developed financial market could help improve financial intermediation. He said that the Asian bond project was a good start, and urged support from the region. As for financial arrangements, Dr Bandid said that East Asia should introduce common requirements and regulations for short-term capital flows.

Fourth, the region must ensure equitable income distribution. A balance between urban and rural poverty reduction could be achieved by better access to finance, infrastructure and investment.

On the last point, Dr Bandid said that while the current process was achieved without a formal process or arrangement, a multilateral framework is now required for effective policies and for dynamism in the region to continue. He urged East Asian scholars to not let these opportunities slip by but to instead capitalise on its benefits for the people of East Asia.

Managing volatility

Professor Augustine HH Tan from Singapore Management University focused on two issues: how to manage in an era of rapid changes and increased volatility, and how small states can survive economically in a world dominated by the EU and NAFTA.

Prof Tan saw steady, recession-free growth as a thing of the past. Singapore, for example, had gone from a positive 10 percent growth rate to a negative 2 percent rate in the past two years, a situation worse than Indonesia's. This situation is attributable to globalisation and rapid technological changes which had resulted in rapid changes in comparative advantages, with competition now potentially coming from anywhere in the world.

Prof Tan discussed ways of managing these rapid changes. On the macro level, he spoke of human capital development and fiscal, monetary and exchange rate management.

The need for human capital development, i.e. training and retraining, was an important one. However, the challenge was how to anticipate the market. Governments used to decide on manpower plans but have had to revise targets in recent years. He said that countries were now faced with the challenge of producing people who were flexible and who were increasingly moving towards thinking, creative and processing skills.

As for fiscal, monetary and exchange rate management, Prof Tan noted that much more could be learned from the Asian Crisis. He believed there was not enough analysis on the recovery process, for example the question of how Malaysia bypassed "IMF wisdom" and came out unscathed. Thailand, meanwhile, moved from export-oriented FDI to internal demand; the Thaksin experiment had also produced results and needed to be watched closely. Prof Tan believed that Japan was finally showing signs of life and may surprise the world with a burst of fresh vigour. China has been warned by some of a "hard-landing". Prof Tan reiterated that the role of East Asian scholars was to see opportunities and surmount the challenges.

On the micro-level, globalisation had thrust major burdens of adjustment upon workers. Trade unions cannot play the role they used to because of the new marketplace, where moving to other markets was now a common occurrence. Emphasis now was on the American business model. The premium on loyalty, seniority, and morale (which bore on productivity, and motivation) was missing. A worker could lose his job not because he was unskilled or unqualified but because of an economic downturn, technology, or outsourcing, said Prof Tan. He warned that with this burden increasingly falling on workers, a major political backlash is imminent. Thus training and retraining, and subsidised programmes by government are needed. During the rapid growth era, East Asia ignored social safety nets. This, Prof Tan said, must now be revisited without undermining incentives to work. Here governments should also promote NGO efforts in this direction.

As for the problem of small states, Prof Tan said that for these countries, the impetus to move towards regional integration was greater than ever, as this was a means of dealing with change and volatility.