AFTER THE PERFECT STORM: MAKING EAST ASIAN ECONOMIES MORE SUSTAINABLE

Session One of the 7th East Asia Congress was moderated by Ambassador Wiryono Sastrohandoyo, Senior Fellow of Centre for Strategic and International Studies (CSIS), Indonesia, and Ambassador Yoshiji Nogami, President of the Japan Institute of International Affairs (JIIA), Japan. The speakers were Dr Kim Chulsu, Chairman of the Institute for Trade and Investment, Korea; Dr Young Soogil, Chairman of Korea National Committee for Pacific Economic Co-operation, Republic of Korea; Ms Elena Okorotchenko, Senior Director, Standard & Poor's Ratings, Singapore; and Professor Emeritus Datuk Dr Mohamed Ariff Abdul Kareem, Executive Director, Malaysian Institute of Economic Research (MIER), Malaysia. ***Susan Teoh****, Director of ISIS Information Services reports.*

Dr Kim Chulsu noted that the East Asian economy has begun to show signs of a rebound since the second quarter of 2009. A number of forecasting institutions have revised upward the Gross Domestic Product (GDP) growth in emerging East Asian economies. Although the rebound may not have reached pre-crisis levels, there were 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 East Asia. The early rebound was also a reflection of the resilience 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. The region's well-capitalized banks and the much improved banking supervision helped to contain the contagion and the impact of the global recession.

Kim noted China's role in this economic rebound in East Asia. China's infrastructure-focused stimulus package, a surge in automobile production, and its strategic stock of new materials, have all boosted China's imports. This, in turn, contributed to the recovery of exports in other countries in the region. Korean exports also rebounded due to the China factor.

(From left) Elena Okorotchenko, Kim Chulsu, Ambassador Wiryono Sastrohandoyo, Yoshiji Nogami, Young Soogil and Mohamed Ariff Abdul Kareem

Although China was attributed to be the driving force of the current East Asian economic rebound, there are some negative effects of its efforts such as wasted investment and high inflation. In the future, it is likely the Chinese authorities will consider `exit strategies' to remove these negative effects.

China, however, will not be able to replace the US, the EU and Japan as East Asia's major export markets for some time to come. The East Asian economies continue to be dependant on these industrial markets for about three-quarters of their exports today.

In answer to the question of how East Asia can maintain its economic growth during this period of global recession, Kim suggested three major sources of growth. Firstly, the region must find a way to substitute external demand with domestic demand. The Chinese government was the first to recognize the problems of its investment-centered, industry and export-led manufacturing growth of the past. China made adjustments and introduced new measures to support private consumption as part of its economic stimulus package. These included tax breaks for automobiles, subsidies for electronic product purchases, increases in pensions and a new health reform programme. Similarly, other East Asian countries introduced various schemes to stimulate their own domestic demand.

A second source of growth for East Asia is the services sector. This sector has been underdeveloped because of the traditional bias towards the manufacturing sector. However, the share of the value-added services to GDP has risen slowly in the region as a whole. An example can be seen in South Korea where the services sector accounted for half of the increase in Korea's real GDP.

Regional economic integration is the third source of growth. Intra-regional trade has increased rapidly in the last three decades, and it has now reached a level which surpasses that of Nafta. This has been largely due to market forces and production networks in the region.

In addition, a significant number of new regional trade agreements have either been signed and implemented, or are under negotiation. Kim noted that the current crisis appears to be a catalyst for strengthening regional economic integration, whereas East Asian regionalism was the driving force for the 1997-98 Asian financial crisis. According to the database of the Asian Development Bank, as of June 2009, 49 regional trade agreements were under implementation, ten new agreements were signed, and 54 were under negotiation with the countries of Asean Plus Six.

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He concluded by stating that though Asean will remain the anchor, any region-wide arrangement without co-operation and accommodation among China, Japan and Korea would be unthinkable.

Dr Young Soogil focused his remarks on the challenges of structural reforms, and on the G20 and East Asia. The global financial crisis has demonstrated that East Asia's export-led growth model is no longer sustainable. While the growth of exports from East Asia to the US has hinged on high private consumption demand in the US, this demand is being financed largely by the continuing inflows of foreign capital, especially from China and other East Asian economies, and sustained by persistent current account imbalances across the Pacific. These capital inflows to the US, together with lax financial supervision, brought about the global financial crisis.

In view of this global crisis, Soogil stressed that East Asian countries would have to `rebalance their growths, shifting to a new, region -led growth paradigm in which growth engines are found within the region as well as in respective national economies.' Such a shift requires a complex array of structural reforms. He suggested the following:

1. Increasing domestic aggregate demand by increasing household incomes through deregulation of labour and other market factors, increasing incomes and other support, such as education and housing for low income people, and discouraging precautionary savings through enhancement of social safety nets such as health care, unemployment insurance, and pensions.
2. Switching demand from the tradables sector to the non-tradables sector, especially services, through real exchange rate appreciation, and extending market-oriented reforms to the services sector.
3. Investing in the development of new growth engines such as the silver industry, tourism, 'conversion technologies,' 'green technologies,' etc.
4. Real exchange rate appreciation through flexible adjustments in the nominal exchange rate, coupled with increases in domestic demand.
5. Creating new growth engines which can be carried out more effectively as regional initiatives such as:

   - 'Connected Asia' -- through strategic investment in infrastructure for connectivity;
   - Greener Asia -- through investment in infrastructure for adaptation to climate change;
   - Secure Asia -- through building programmes in education, health, and social safety nets;
   - Innovative Asia -- through investment in technology and reforms to improve financing and other business environments for SMEs; and
   - Market integration through a region-wide FTA and other arrangements that will help increase regional demand and facilitate the development of new growth engines.

The structural reforms suggested above could be undertaken effectively in co-ordination, and in conjunction with, the concomitant structural reforms undertaken by the US and other chronic current account deficit countries.

G20 Summit

Soogil stressed the importance of the G20 Summit which has brought together those economies that account for more than 85 per cent of global production. These economies could work together in order to play the leading role in promoting global efforts. That was why two meetings of the G20 Summit have been scheduled for 2010 and thereafter annually.

The G20 Summit can be seen as the 'premier forum for international economic co-operation' because nearly half of the members are from Asia Pacific. These include the six Asian countries of China, Japan, India, Korea, Indonesia and Australia. The large representation from Asia signifies 'recognition of the global power shift from West to East,' particularly to East Asia.

The coming G20 Summit, to be held in Seoul, South Korea, from November 13-17, 2010, will have great significance as it will be the first in which an Asian country will be the host. The success of this global endeavour to launch strong, sustainable and balanced growth will depend critically on East Asia's ability to take the global structural reform agenda to the Seoul G20 Summit, as well as exercising leadership in implementing the agenda.

Ms Elena Okorotchenko gave an overview of Standard & Poor's (S&P) use of sovereign ratings (SR) in the region. The SR of Asia in 2009 was quite mixed. By December 2009, most of the Asian countries had shown positive SR except for five countries, in particular Thailand and Vietnam, which had negative SR.

Okorotchenko stressed that the speed of recovery of the US and Europe will have a great impact on Asia. The global economic slowdown has affected Asia as domestic demand was not sufficient to compensate for a reduction in exports, especially to US and Europe. There was a sharp fall in GDP growth in the high-value manufactured export reliant countries of Asia. Corporate defaults have also risen, while Non-Performing Loans (NPL) have grown modestly, except for Malaysia, where NPL has declined.

S&P suggested that Asia's growth could pick up from 2010, but it will not be able to reach pre-crisis levels. The region would still be dependent on government stimulus packages for recovery. These would include the easing of central banks' monetary policies, fiscal stimulus packages, and increasing government debts.

For the SR to be able to sustain these kinds of economic stimuli, one approach would be to have `exit strategies.' The timing of these strategies would be very important as there can be a high possibility of exiting too late or too early. It is also important to set in place medium-term strategies for fiscal consolidation and debt reduction.

With the introduction of stimulus packages, the external position of Asia has remained stable. Signs of this include the lowering of imports, low levels of external debt with some exceptions, rising or stabilized foreign exchange reserves after a modest reduction, and external liquidity remaining moderate in credit strength.

However, Asia has had to deal with some pressure in relation to the appreciation of Asian currencies. These include the question of protectionism with regards to capital flows or trade, complications in monetary policy, exchange rate and reserve management in Asian countries, and the new challenges of coordinating currency appreciation strategies with trading partners.

Okorotchenko highlighted the economic situation in Malaysia. In June 2009, the sovereign rating of its foreign currency was A-, while that of its local currency was A+. Though Malaysia's economy was hit by the sharp global economic decline, loan quality has not deteriorated and absolute NPLs have continued to decline.

The 2010 Malaysian budget could reduce the fiscal pressure. The government's target for a fiscal deficit of 5.6 per cent in 2010 was a significantly reduced one compared to the 2009 estimate of 7.4 per cent. There were plans to structurally improve expenditure, and to cut subsidies for fuel, food and education by 15 per cent. Malaysia's SR is likely to depend on how quickly growth recovers, how feasible the fiscal consolidation plans are, and how quickly these are implemented.

In her conclusion, Okorotchenko noted that Asia seemed to lean towards a positive bias in its SR. Asia's structural reforms will remain a key factor in the medium term. The structural reforms -- reforms in the financial sector and service sectors, fiscal and labour reforms, public sector and administrative capacity reforms, development of domestic capital markets and strengthening of domestic demand to create alternative export-led growth and regional integration -- will be the drivers of sovereign ratings for Asia.

Dr Mohamed Ariff gave an initial overview of the economic situation of East Asia before the crisis, before raising issues affecting the region's economies with the global downturn.

The growth strategy of East Asia has been export-led, focusing on the US market. Savings are very high -- about one third of GDP is saved. Most East Asian countries have enjoyed large current account surpluses, with some larger than 20 per cent of their GDP. East Asian reserves are about US$13 -14 trillion and East Asia has been recycling this surplus to finance US deficits. The US is continuing its deficit and continuing to import from East Asia and in so doing, is helping to keep the dollar strong.

The key lessons learnt from this crisis will enable East Asia to chart a new course of action. One of the lessons to be learnt is to avoid excessive financial exposure (although East Asia has not been exposed much, as revealed during the last crisis). Another lesson is to reduce market concentration -- some East Asian countries have been relying very heavily on the US market. Thirdly, East Asian countries have to build up the 'dollar trap' as it is important to have a strong dollar to protect their reserves and competitiveness. Fourthly, there is a need to check and rectify global imbalances, thus strengthening domestic economies.

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Ariff proposed a few options for East Asia in the face of the global crisis. The first option is for East Asia to stop going in the same direction as before, wholly dependent on the US market, because the US will not consume as much as before. As can be seen, some re-balancing has taken place in the US. Their savings have increased from 2 per cent to 6 per cent of GNP, while their current account deficits came down from 6 per cent to 5 per cent. The US will consume less, save more and import less, which in turn means that East Asia will export less to the US.

The second option is for East Asia to make a U-turn and look inward. This option is suicidal. To be inward looking and self-dependent is a retrogressive step for East Asia.

The third, more viable, option is for East Asia to stay outward-looking, but with a distinct difference. Currently, much of East Asia's investments abroad are outside the region. East Asia has to learn to invest its savings within the region, instead of trying to finance current account imbalances elsewhere, and exporting to these countries. Investing in East Asia, in the process creating a demand, and expanding regional demand, as well as creating employment, will make East Asia a region of growth. It should stay focused in the region, though not at the expense of the rest of the world, because the rest of the world is still important to East Asia.

US and European joint consumption is estimated to be about US$ 20 trillion whereas Asian consumption is only US$ 5 trillion. East Asia will continue to need a large external market. It is therefore imperative that East Asia remains outward-looking, but with changes in the direction and composition of its external market.

Finally, Ariff suggested some regional initiatives for East Asia while still participating in the global economy. Many regional initiatives are already in existence such as Asean, Asean Plus Three, East Asia Summit (EAS) and Apec.

East Asia has to be borderless to facilitate trade and investment flows. Although many FTAs have been signed, the FTAs actually act as barriers to trade because there are too many exemptions, and the rules of origin are too rigid, leading to higher transaction costs. East Asia may need to harmonize and standardize the rules of origin in order to expedite flow of goods and services within East Asia.

Another initiative Ariff proposed was that of expediting integration of the highly segmented financial market. Policy driven initiatives in East Asia are necessary to support market-driven forces so that East Asia can be a viable entity on its own.

Finally, Ariff suggested that a coordinated exchange rate policy is important for the East Asian region to avoid a situation of one country within the region negating another country's effort in market intervention. Such a regime may assist in stabilizing East Asian currencies. The Asian Monetary Fund (AMF) may perhaps be the future of East Asian financial stability.