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**The Development of East Asia**

**by**

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Globalization, economic growth and the new economy

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# **The development of East Asia**

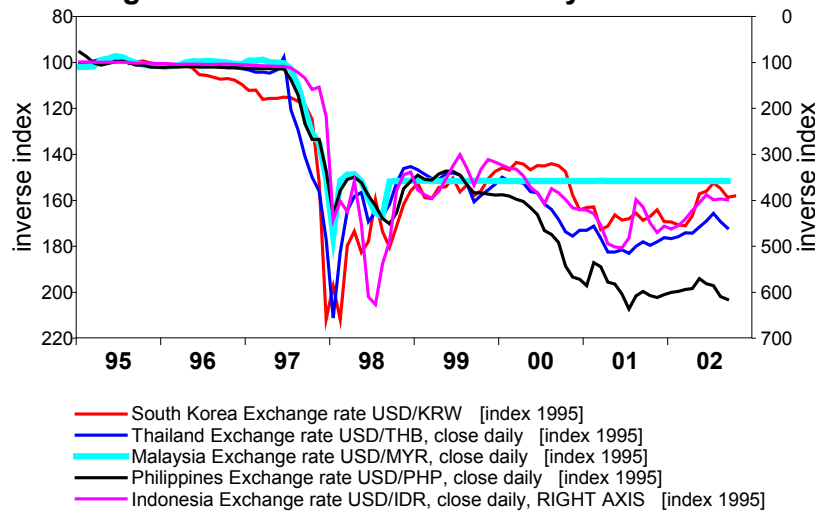
## **Introduction**

The objective of this report is to present some of the issues that are driving the economic development in East Asia. The report will not include a discussion of the development and challenges in Japan, as this would double the demand for content. After briefly having discussed the history of how the East Asian region has developed from developed country-status to one that consists mainly of emerging and newly industrialized countries, I will go on to the more current issues. First the rebound after the Asian crisis is described. Thereafter, an overview of the recent economic development of the region is presented. The development of both the region as a whole and that of the main countries is included. Following this, a discussion on how Chinese growth is affecting the region is presented, with an emphasis on how the growth of China forces the other countries to reorient their economic development strategies. Under this heading, the content of the new development plan of Thailand's Prime Minister Thaksin is presented and discussed. Finally, there is an evaluation on the extent of regional economic cooperation and integration in East Asia.

## **1) Tiger growth**

Between 1960 and the mid-1990s Asia saw its economic growth outperforming that of any other continent. Growth did not occur at the same pace all over Asia, however. The growth rates of the western part of Asia were about the same as those of the rest of the world, but, as a whole, the eastern half (ten countries: China, Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand) were showing a superior performance. Of course, there were differing degrees of success within East Asia, too. The worst performer was the Philippines, which grew at about 2 percent a year (in per capita terms), about equal to the average of non-Asian countries. China, Indonesia, Japan, Malaysia, and Thailand did better, achieving growth rates of 3-5 percent. The truly impressive achievements, however, were achieved by Hong Kong, Korea, Singapore, and Taiwan, known as the "Four Tigers". The Tigers had for three decades annual growth rates of output per person well in excess of 6 percent. These growth rates, sustained over a 30-year period, are quite amazing. While the average resident of a non-Asian country in 1990 was 72 percent richer than his parents were in 1960, the corresponding figure for the average Korean is no less than 638 percent. Hence, the talk of economic miracles seemed justified. Then, of course, the Asian crisis hit several of the East Asian economies. Starting with Thailand during the summer of 1997, large capital inflows were dramatically reversed and several countries were forced to let their currencies be depreciated substantially by the powerful market forces.

### Exchange rates of the currencies hit by the Asian crisis



Source: Ecowin

The recession that followed was deep but not as protracted as one might have feared. Positive growth returned, even though in dollar-terms the economies still look weak. Over the past couple of years, several of the East Asian economies seem to have managed well even though demand growth from the US and the EU has been relatively weak. What we will want to focus on here are the main factors contributing to the regions economic performance.

## 2) What kind of economic growth did the Tigers have?

First, however, we should take a look at how the economic growth was achieved. This is important for several reasons: i) what can we expect from these economies in the future?, ii) how are we to evaluate the economic growth of other countries in the region?, and iii) how should we evaluate how new policy initiatives affect the potential for economic growth? In the most fundamental way, economic growth can be achieved either by increasing the amount of factors of production available (primarily capital and labor) or by increasing the efficiency in the utilization of the existing resources, that is by increasing the total factor productivity. If we let the labor force be constant, increasing the amount of capital available to the economy will increase the total production, but the pace at which this happens will decline as capital gets more abundant. This is just the general principle of diminishing returns. Gains to the total factor productivity raise the growth rate of the economy without employing more scarce resources, and hence without diminishing returns setting in. Therefore, when we are speaking of long term growth, improvements in the way we are employing our resources are preferable to just increasing the amount of resources itself, as diminishing returns will make sure that the growth rates gets more and more moderate over time.

Initially the growth of the Asian tigers was explained by growth in total factor productivity. Western technologies were imported and utilized, letting the Tigers gain from fast technological catch-up. In the mid-1990s this consensus was broken. Young (1994) and

Krugman (1994) claimed that growth in the Tiger-economies to a great extent was driven by the mobilization of capital, which explained between 48 and 72 percent of the growth. For the G5 economies, on the other hand, growth was driven by gains in total factor productivity. These analyses cast a pessimistic outlook for future growth. The miracle seemed to be no miracle, as growth 'just' was driven by an immense degree of mobilization of resources. Sooner or later diminishing returns would set in, and growth rates would become moderate. To this comes the fact that the mobilization of capital demanded extreme saving rates, which meant that current consumption was sacrificed. So even though future generations would gain from higher output, the loss from such a degree of the postponement of consumption was too high.

The story does not end here however. The results of the analyses saying that growth was driven by capital accumulation are not very robust. There is a great deal of uncertainty as to what is the correct measure of the capital available in the Tiger economies in 1960, as the statistics are poor. Further, growth accounting, as most other statistical analysis, is tricky, as, for instance, questions arise as to what the correct measures for economic depreciation rates of different types of capital are, and to what the distribution of production attributable to capital and labor looks like.

It is not hard to present evidence that the percentage of growth attributable to total factor productivity has been just as high in the Tiger economies and China as it has been in the rest of the world. It turns out that the conclusions to a great extent depend on how one parameterizes the model that is used to get the results. The standard model for growth accounting is the Solow model. Typically, this is estimated using Cobb Douglas technology, which makes it easy to incorporate the diminishing returns from each factor of production. The basic Solow growth model looks like this:

$$Y = AK^\alpha L^{(1-\alpha)},$$

where Y is output, A is total factor productivity, K is capital, L is labor, and the factors  $\alpha$  and  $(1-\alpha)$ , which sum to one (constant returns to scale), represent the shares of output attributable to capital and labor, respectively. Typically  $\alpha$  is set to 1/3. When this is done, the results are in line with the view that total factor productivity growth in the Tiger economies has been rather good. When  $\alpha$  is set to 0,45 however, the Young/Krugman results are the ones that look correct. So if capital contributes to a relatively large share of production in Asian countries, factor productivity growth looks weak, as the mobilization of capital has been more intense than the mobilization of labor.

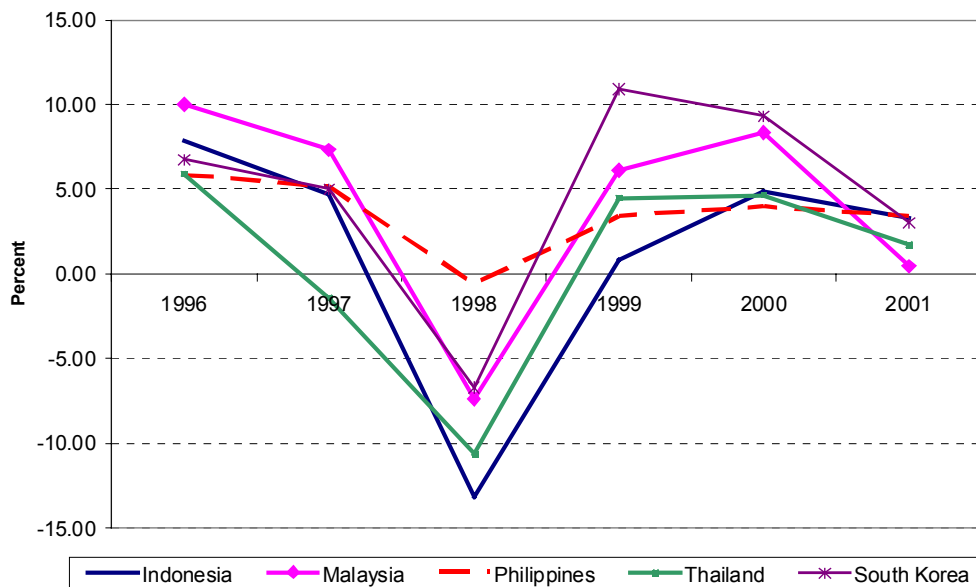
Still, the consensus view is that  $\alpha$  is closer to 1/3 than to 0,45, so one should perhaps not be too pessimistic about the Asians ability to make improvements in the way they utilize their resources. On the other hand, however, the uncovering of the latent weaknesses of the economic systems (banking systems, inefficient conglomerates, etc.) in many Asian countries seems to indicate that something has been wrong. But then, if the Asians can change their ways, things can only get better when it comes to the efficient allocation of scarce resources.

### 3) The rebound after the Asian crisis

Let us now take a look at how the countries hardest hit by the Asian crisis have recovered after 1997/98. When one think of the economic development of Asia during the 1990s, there are three main topics: Japan's lackluster development, the growth of China, and the Asian financial crisis. With regard to the latter, one should not forget that only five countries were involved in the crisis, and among them only South Korea was (and still is) a major economic player.

Park and Lee (2001) have studied the stylized pattern of recovery from 160 currency crises episodes from 1970 to 1995. The general story is a V-type adjustment of real GDP growth in the years prior to and following a crisis. What the crisis-hit Asian countries have shown us has not been much different from this stylized view. However, there has been one difference in that both the fall and the rebound in economic growth were stronger for these countries compared to what one normally experience during financial crises. The graph below illustrates this point quite explicitly. The initial contraction in economic activity experienced by all five countries was primarily caused by a collapse in investment, as the level of capital formation plummeted, while the rebound to a large extent was caused by a boost in net exports.

**GDP growth (y/y), Asian crisis countries,**



Sources: ASEAN, The Bank of Korea

Park and Lee have analyzed what factors are determining the strength of recovery after a currency crisis. They identify the following four main factors, all of which are suitable when we want to explain the economic development in the crisis countries:

i) ***the origin and nature of the shock***: this has to do with the interplay between macroeconomic (mis)management, investor psychology and the term structure of the capital flows.

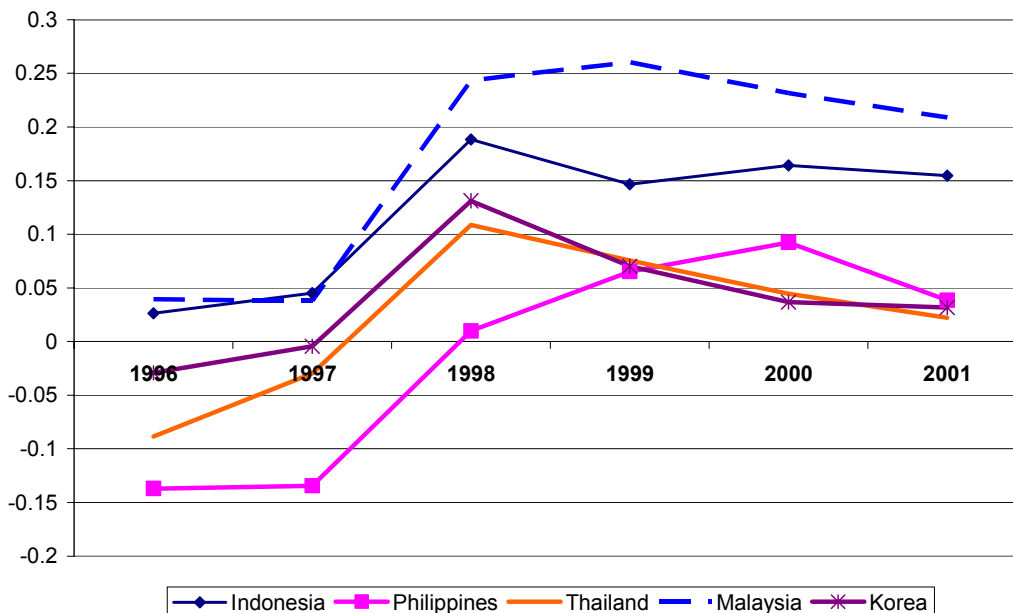
ii) The shock causing the Asian economic crisis was composed of two main ingredients. The first one was the problems in the underlying economic and political systems, which implied the socialization of risk taking, overinvestment in some sectors of the economy, and economic systems that were troubled with rent seeking activities and crony capitalism. The second ingredient was a financial system that was built on fixed exchange rates, low interest rates, and a term structure of the capital flows biased towards short term inflows. In addition, the central banks had provided implicit guarantees for the funds provided by foreign investors (which dramatically reduced the amount of foreign reserves the central banks had available for defending the currencies). At the same time the balance sheets of the corporations were filled with debt denominated in foreign currency, which made the economies vulnerable to exchange rate devaluations.

Even though the basic macroeconomic factors seemed to be sound, these flaws in the general economic system and in the financial system made the countries extremely sensitive to changes in the psychology of the financial market, and they also implied that the real costs of a currency crisis would be large in the short run.

ii) ***initial economic conditions***: this factor focuses on the economy's performance relative to the trend and the trend growth rate, and also on the openness of the country, which determines the importance real depreciations have on economic activity.

iii) It is well-known that the East Asian countries have pursued a strategy of export-oriented industrialization. This meant that the crisis-hit countries had a high level of openness. If we measure openness in terms of the share of export and import in GDP, this measure ranges from 200% in Malaysia to 60% in Indonesia. This implies that the considerable real depreciations that followed the crisis would have a large impact on economic activity in general. The external balance was restored quite rapidly in these countries, and one might suspect that flexible labor markets which facilitate a swift movement of resources to the external sector of the economies played an important role in this regard.

### Crisis Countries, Net Exports of Goods, % of GDP



Sources: ASEAN, Korea National Statistical Office

- iii) **domestic policies:** Both monetary and fiscal policy play a crucial part in stimulating domestic demand. In addition, structural reform programs can have considerable effects on the adjustment part during and after a crisis, perhaps, though, primarily with respect to the long run development.
- iv) If one has listened to the critics of the IMF over the past few years, it is hard not to have heard about the initial medicine the IMF prescribed. Tight monetary policy combined with fiscal austerity was supposed to rebuild the confidence of investors. However, it was not until the policies turned expansionary that the growth momentum was regained. It seems clear that the shift to expansionary monetary and fiscal policy during 1998 supported the quick economic recovery. The policies in Korea, Malaysia and Thailand swiftly turned expansionary when the worst pressure in the financial markets had passed away, while the continuing pressure against the rupiah did not allow expansionary policies in Indonesia until 1999.
- iv) **external environment:** Especially for open economies, the global economic environment is decisive for the post-crisis economic development. The situation in the global economy during 1999 and 2000 was definitely supporting the strong recovery in the crisis countries. The growth rates were above trend in both the US and in Europe, and for economies dependent on trade, the short-term climate for growth was quite ideal.

Even though the recovery was swift and seemed strong, one component of GDP does not seem to have fully recuperated (see table below). The investment ratios of the crisis-hit countries are still below what they were before the crisis, and this has made Robert Barro (2001) state that this might suggest 'that something permanent has happened'. On the



other hand, cross-country analyses seem to indicate that investment ratios tend to recover more slowly than the rates of economic growth after currency crises. It seems clear, however, that the drop in investment ratios was associated with the Asian crisis. In some sectors there would eventually have been a fall in investment even in the absence of a crisis, as the over capacity was substantial. Still, the large currency depreciations deteriorated the balance sheets of the highly leveraged companies of these countries. In Korea the foreign liabilities accounted for about 16% of total corporate debt in 1997, and the losses associated with the depreciation of the won amounted to about 3,8% of GDP. The twin effect of this balance sheet effect and the increase in foreign debt financing costs reduced the present value of the equity of the corporate sector by a substantial amount. The second round effect of this was that the financial sector was burdened with a large portfolio of non-performing loans. Decapitalized financial institutions were forced to curtail their lending to both viable and non-viable firms, thereby exacerbating the downturn in investment.

Private Fixed Investment			
As % of GDP			
	1980-89	1990-97	1998-00
Malaysia	17	26.9	12.9
Philippines	17.2	18	14.9
Thailand	21.1	30.9	12.1
Korea	24.2	31.4	24.3

Source: The World Bank

The financial sector itself also suffered directly from the currency depreciations, as the foreign liabilities were larger than the foreign assets. As the financial systems of the East Asian countries were dependent upon a sound banking sector, the result of this weakening of the financial sector's balance sheets and the increase in country risk premiums and hence also financing costs, was a costly credit squeeze and falling investment.

Structural reforms, especially in the financial sector, were put high on the agenda during and after the crisis. Some reforms have been implemented, but the financial and corporate sectors have still got a long way to go. The banks in Korea, Indonesia, Malaysia, and Thailand are still holding in their balance sheets a large volume of non-performing loans, and they remain undercapitalized in all four countries. Many corporations in the region are still unable to service their debts, and there is a potential problem with what is called evergreening, that is, banks handing out new loans that are used to repay the old ones. The continuation of the strengthening and diversification of the financial system seems of great importance if the region shall be able to establish the foundation for long-term sustainable growth.

#### **4) East and South East Asia now: Current performance**

This part is aimed at explaining the strong growth of the East Asian region during the first half of 2002, and to discuss some of the underlying factors driving the economies.

To get a brief overview of the global economy, the table below might be a useful starting point. The relative importance of the various main regions is illustrated, and shows that East

Asia ex. Japan in size is of moderate importance for the global economy (even though the importance of China for both world product prices and for the location of production seems large and growing). The table also shows how dependent the smaller East Asian countries are on trade.

<b>Regional comparison: USA, Europe, Asia</b>					
	<b>GDP (as of 2Q 2002)</b>		<b>Exports</b>	<b>Imports</b>	<b>GDP growth</b>
	Bn USD, market exch.rate	in % of US output	In % of GDP	In % of GDP	
USA	10050	100 %	9,8%	14,0%	1,3%
EMU	6680	66,5%	36,0%	33,9%	1,1%
UK	1535	15,3%	31,7%	33,7%	1,7%
(Norway)	195	1,9%	43,0%	27,0%	1,6%
Japan	4100	40,8%	11,0%	9,8%	0,0%
China	1200	11,9%	10,1%	9,9%	8,0%
South Korea	479	4,8%	41,5%	39,7%	4,5%
Taiwan	285	2,8%	53,4%	48,9%	0,1%
ASEAN (*1),(*2)	505	5,0%	62,6%	63,8%	2,5%
<b>Total East Asia</b>	<b>6569</b>	<b>65,4%</b>	<b>18,9%</b>	<b>17,8%</b>	<b>2,0%</b>

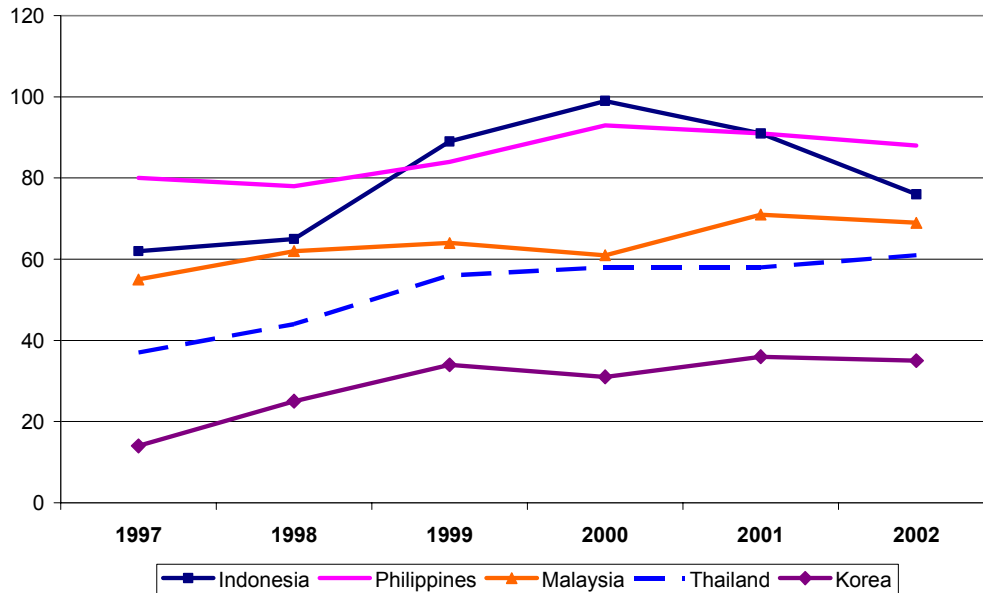
(\*1) Trade data is from 2001, GDP and GDP growth is 1Q 2000 - 1Q 2002  
 (\*2) ASEAN 5: Indonesia, Malaysia, Philippines, Singapore, and Thailand  
 (\*3) Geometrical average

#### **4.1) Regional overview<sup>1</sup>**

The East Asia region has enjoyed a strong economic rebound in the first half of 2002. 2001 was a quite weak year for the region, which is composed of countries that are generally open economies dependent upon trade. Strong growth in consumer spending reduced the impact of the global slowdown, however. This year's recovery has been driven by growth in consumer spending and exports, and in some cases also by expansionary fiscal policies. Among the crisis countries only Korea is now running budget surpluses. The deficits of the other crisis countries range from 5.5 percent of GDP in Thailand to 2 percent in Malaysia. The levels of public debt, while not non-sustainable, are becoming quite high in several of the countries now, and fiscal prudence will be important in the future. However, there is an increasing demand for improved public services, while terrorist problems are making it necessary to improve law and order. In the long run this must be financed with taxes, and if there is a lack of political will to do this at a time of uncertain economic prospects, the public budget deficits might continue for some time.

<sup>1</sup> Much of what follows has been collected from World Bank reports on the East Asian region.

### Public Sector Debt 1997-2002, % of GDP

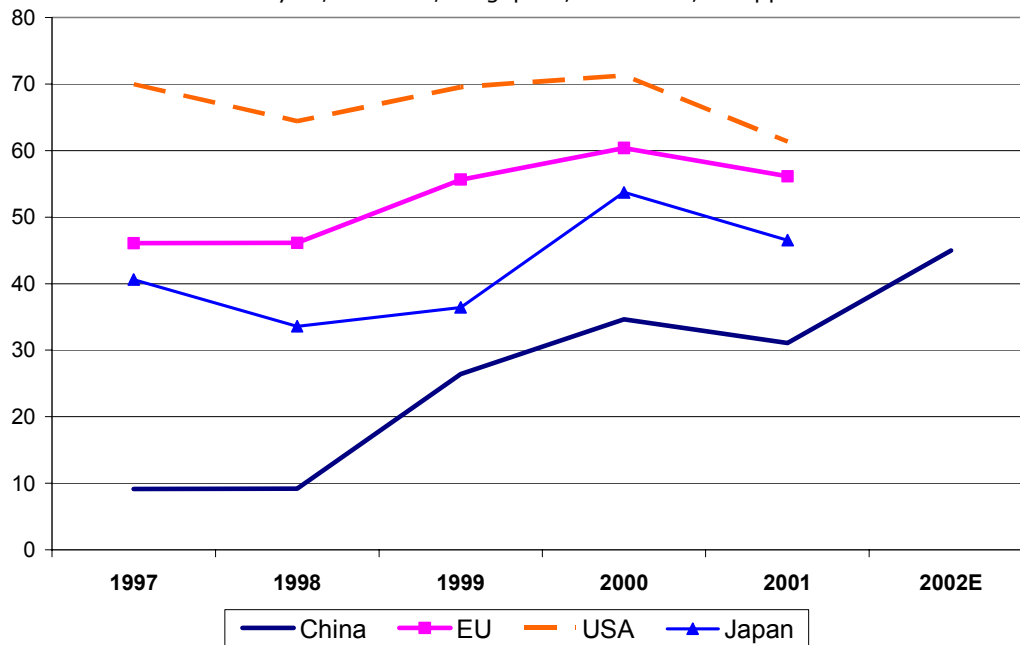


Source: The World Bank

Overall growth in East Asia is expected to be around 5.5 percent in 2002, up from a depressed level of 3.5 percent in 2001. The growth is quite broad based. A notable fact is the increase in intra-regional trade, and exports to China increased by 50 percent in the first half of 2002 (year on year). The growth and structural change in China have created strong export demand for other countries in East Asia. The growth in exports in China from other East Asian countries was two to three times as large as overall growth in exports, which means that the growth in exports to China more than offsets the decline in exports to other markets, in particular to Japan. The table below shows how rapidly China has become one of the main export markets for the other countries in the region. Note also the decline in exports to China in 2001. This decline is due to the fact that the other countries to a large extent are exporting products that are used as inputs in Chinese production.

### Exports from the ASEAN 5\* countries (in billion USD)

\* Malaysia, Thailand, Singapore, Indonesia, Philippines



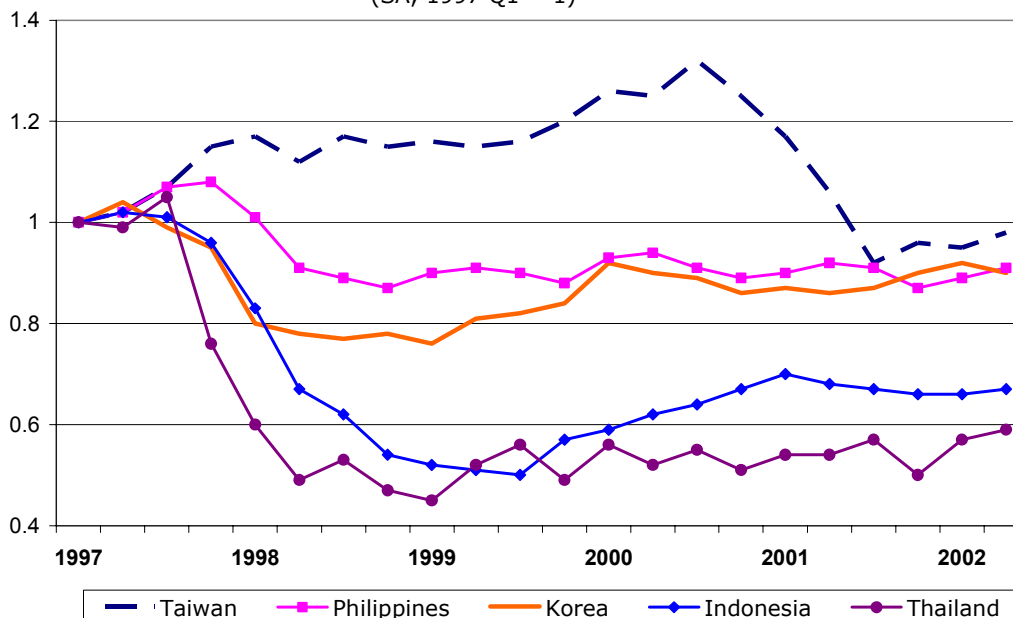
Source: ASEAN

Growth in the first half of 2002 was strongest in the economies that were hardest hit by the 2001 global slowdown. These countries include Korea, Taiwan, Singapore, Malaysia and Thailand. In the third quarter growth seemed to be slowing, and in Singapore there was a steep fall in industrial production. The lack of a strong global rebound will quite certainly restrain growth in the second half of 2002.

What is posing a problem for long-term sustainable growth, however, is the generally low level of private investment spending. In the crisis countries the levels of real fixed investment is in most cases below what they were prior to the crisis, reflecting the low level of private investment. There are signs of deteriorating infrastructure in some countries. There are several factors that might explain the low level of investment. First, the corporate sector of the region has still got high debt-equity ratios, and this hinders investment in a period of restructuring. Second, some sectors are still suffering from overcapacity that was built up during the boom in the 1990s. This is the case for the high-tech sectors and also to some extent in real estate. Third, the growth of China as both a strong competitor and a new enormous market is creating commercial uncertainty. It takes time for new production networks to settle, and as it seems likely that some of the countries will lose production to China, new products and opportunities must be developed before we can experience strong investment growth.

## East Asia - Real Fixed Investment (1997Q1-2002Q2)

(SA, 1997 Q1 = 1)



Source: The World Bank

Private fixed investment in the crisis economies is currently lower as a share of GDP than it was during the 1980s. Only in Korea, where private investment is at a level of 24 percent of GDP, has private investment revived. Another troubling element is the disappearance of inflows of FDI. FDI is important for both demand, for technology spillovers, and for the creation of linkages to domestic enterprises. It is therefore a concern that the net inflow of FDI to the five crisis countries only was at \$6 billion in 2001, down from \$12.6 billion in 2000 and \$19.6 billion in 1996. Parts of this fall can be explained by the overcapacity in high-tech sectors, but there are also reasons to believe that there is hard to find good investment opportunities in any country when a project must be evaluated against what one can achieve in China. The governments of the various countries might do some good by reducing investment barriers and providing good infrastructure facilities. Still, it seems like investment growth primarily will be driven by developing a healthy domestic corporate sector and providing the basis for efficient allocation of capital. This means that restructuring in the financial and corporate sectors still must be given top priority.

A lot has been done in the financial sector after the crisis. The amount of non-performing loans is reduced, and hence the ability of the sector to perform its role as an inter-mediator of allocating capital is improved. Further, the profitability of the financial sector is improving, and among the crisis countries, only the bank sector of Thailand is experiencing a negative return on assets.

The restructuring efforts in the corporate sector have not been as strong as in the financial sector. In Korea and Thailand the debt levels are down from their highs in the mid-90s, but they are still high by international standards. In Indonesia and the Philippines debt-equity ratios have actually increased since 1997, and in Indonesia the situation now looks quite troubling. When it comes to profitability we can see improvements, but the profit rates are still relatively low. The table below is quite illuminating.

<b>East Asia: Corporate Profitability</b>			
	1996	1998	2000-01
<b>Operating income to sales (%)</b>			
Indonesia	12.9	15.1	10.2
Korea	6	5.7	5.7
Malaysia	11.8	5.2	6.4
Philippines	11.3	6.2	6.6
Thailand	7.7	4.4	6.6
United States	12.8	13	12
<b>Interest expense to sales (%)</b>			
Indonesia	4.7	13.2	5.6
Korea	6.9	9.2	3.7
Malaysia	2.8	5.3	2.5
Philippines	1.9	5.8	6.4
Thailand	5.2	9.5	4
United States	1.3	1.5	1.7
<b>Ordinary income to sales (%)</b>			
Indonesia	11.1	-11.9	0.5
Korea	1.5	0.7	2.5
Malaysia	10.5	2.3	5.9
Philippines	14.8	0	4.3
Thailand	6.6	6.9	5.7
United States	11.8	11.5	10.8

Source: The World Bank (2002)

The decline in corporate leverage has been achieved mainly by shifting debt from corporations to households and the governments. The alternative way of reducing debt is through asset sales, but this has not been done extensively. Rising leverage among consumers and governments has increased demand, and allowed the corporations to reduce their borrowing. Thus, as long as funding is not obtained by issuing stocks, deleveraging can only continue if consumption and exports remain strong.

Korea provides us with a good example of how debt has been shifted, first through the government bailout of the banks, and then by a surge in household borrowing, which again has been stimulated by a booming property market. This has allowed the businesses to barely increase their borrowing during the past few years.

In China, on the other hand, the build up of government debt has helped sustaining growth. Huge infrastructure investments have contributed substantially to the high growth rates, but these investments have been funded by debt rather than taxes.

Quite a few economists have been calling for giving equity a more prominent place as a source of funding. In East Asia this has not happened, and there is a question why. One explanation could be the low degree of risk preference held by the households in East Asia. This could be a valid explanation, supported by the disproportionate large share of savings

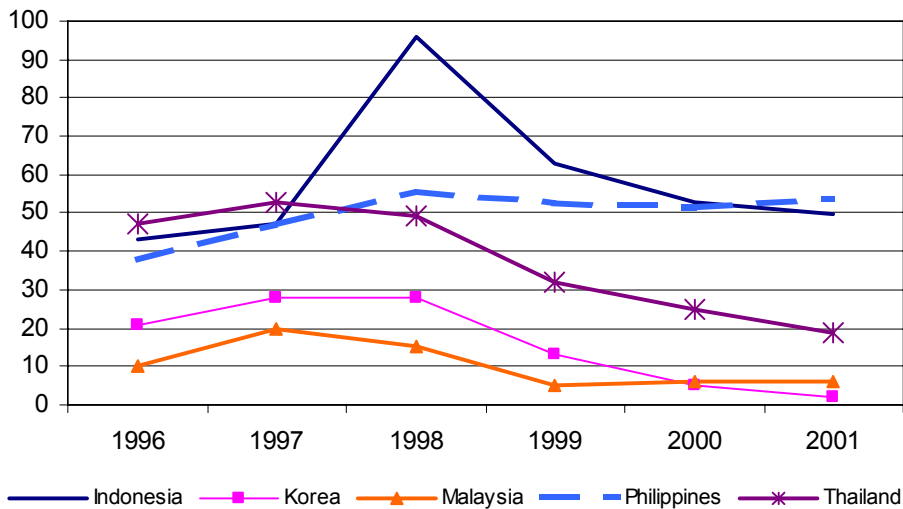
allocated to bank deposits. On the other hand, the gambling business in East Asia is a large and profitable one, and there seems to be nothing wrong with the entrepreneurial spirit. An important reason behind the lack of equity funding probably lies in the lack of relationship between corporate profits and economic growth. Companies have been unable to turn growth into profits, and hence the stock market does not reflect the health of the economy, but rather the anticipation of companies managing to make profits some day. As long as profits are low, the expected return of a stock is the same, so why buy the risks while getting nothing in return? So instead of investing in the stock market, investors have turned to property markets, where the booms and busts are more in line with economic activity. The swings are just slightly more violent.

There are currently several factors that are making the growth prospects of the East Asian region uncertain. First, the rebound in the global economy will not be as strong as previously anticipated. The growth prospects in both the US and Europe have been revised downwards several times, and as these are major export markets for East Asian countries growth prospects have been revised downwards here as well. The lack of a strong rebound in the high-tech sector is especially damaging to the region. It is worrying that North American semiconductor equipment bookings plunged during the early fall of 2002. Second, the region is a significant net importer of oil, and the current high oil prices worsen the terms of trade for the regions as a whole, and erode income. Third, the terrorist attacks in Bali and elsewhere have depressed tourism and business confidence. As several of the economies are highly dependent upon the revenues from tourism, and increases in investment are dependent upon business confidence, these attacks will have negative in the short and potentially also in the long run. The East Asian region have managed well during the turmoil in several Latin-American markets. Most currencies have appreciated and the stock markets have done better relative to those in developed countries.

It is noteworthy how well the region has fared when one take the negative external shocks into consideration. Emerging market turmoil, 2001's export slowdown, terrorist attacks, high oil prices, and still robust growth. Factors that explain this might include adaptive macroeconomic policies and better macroeconomic conditions, the restructuring and reduction of foreign debt, record levels of foreign reserves, and improved operations in the financial and corporate sectors. It seems like the region has regained some of the confidence that was lost so suddenly in 1997. Eurobond spreads have declined during the latter part of 2001 and the first half of 2002. They remain close to their lowest levels in three years, and have overcome potential contagious spillovers from the troubled emerging markets like those of Argentina and Brazil. This resilience has allowed low interest rates, which has been driving growth in consumption and credit.

The region's external macroeconomic vulnerability has declined considerably over the past few years. The crisis countries have run current account surpluses continuously since 1997, and this has strengthened the national balance sheets. The source of these surpluses has been the decline in private investment combined with high and stable saving rates. Still, the trend is lower current account surpluses as a consumption boom lowers the saving rates and investment spending gradually gets back on track.

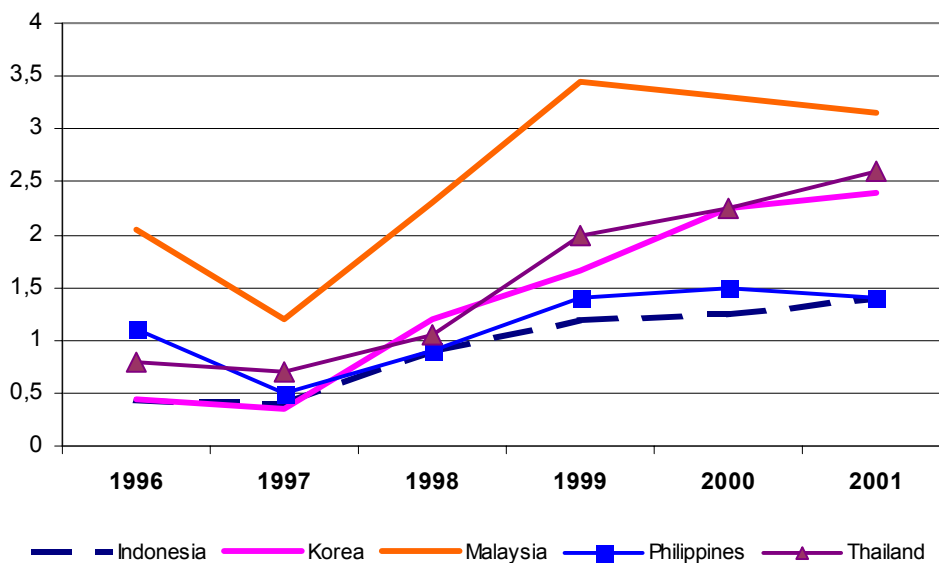
### Net External Debt As % of GDP



Source: The World Bank

The reduction in foreign debt in the period after the crisis combined with the substantially larger amount of foreign reserves, are making the countries less vulnerable should the current account surpluses turn into deficits, and the international capital move back into Asia.

### Ratio of Foreign Reserves to Short Term Debt



Source: The World Bank

#### 4.2) Country by country:

What follows is a brief report on the recent development in some of the countries in the region. I have only included some of the countries, but I think the issues facing those that have been included illustrate the underlying development in the region quite well.



#### **4.2.1) China**

Two main shocks have affected China over the past five years, that is the Asian economic crisis and the global economic slowdown. Still, the Chinese economy has managed to sustain an average growth rate of 7.8 percent over the period 1997-2001. Partly, this has been accomplished through expansionary fiscal and monetary policies. Both heavy investments in infrastructure and pay rises for civil servants have contributed to maintaining aggregate demand. During the latter part of 2002, however, the underlying growth has been strong, primarily due to strong exports and an expansion in foreign direct investment.

The growth in GDP is primarily driven by growth in industry and manufacturing. Manufacturing output has been growing by over 12 percent in 2002, and the same has the output of foreign funded companies. The service sector is not growing as rapidly, and growth has slowed from 7.4% in 2001 to a bit below 7% in 2002. Agricultural output growth has been between 2 and 4% over the past couple of years.

Fixed asset investment has been particularly strong during 2002, rising from 12,8% of GDP in 2001 to 21.8% during the first three quarters of 2002. This growth has been driven by investments made by state owned enterprises and by foreign funded enterprises. The linkages to other economic activity have been substantial.

There have been some signs of a property bubble developing in some regions, for instance in Shanghai, where speculative demand has been estimated to account for over 20 percent of the purchases. In Shanghai property prices have been increasing by 30-50 percent over the past year. Government officials have been concerned about the risks of a property market bubble, and some ministers have jointly intervened to restrict the supply of land and also by controlling new property projects. The rural-urban income gap is quite disturbing in China. In urban areas, incomes have been growing by 17 percent in 2002, while the growth in rural areas has only been 5 percent, up from just 2 percent in 2000.

The deflationary trend is still not leaving the Chinese economy. Consumer and producer prices have been falling by around 1 and 2 percent respectively in 2002. The deflation is partly a result of rising productivity in the industrial sector. However, a significant contributory factor has been the effect of excess supply. The Chinese government is still propping up inefficient state owned enterprises (SOEs) that are contributing to the excess supply. However, the importance of the SOEs is diminishing, and job growth is found within the non-state owned sectors of the economy.

After having reduced the corporate income tax in 2001 and also after having reduced tariffs upon joining the WTO, the public revenue growth has slowed down. The fiscal deficit will be considerable in 2002, and it will be difficult to maintain the fiscal deficit below 3 percent of GDP. The government will have to reduce tax evasion and also probably increase personal income taxation in order to balance the public budget. In the short run, it seems likely that public investments will have to fall in order to reduce the deficit. The public debt service ratio is currently at tolerable levels at 7.3 percent, but potential problems in the banking sector could worsen the situation as the government is expected to step in in order to rescue the banks.

The government has been anxious about strengthening the financial sector over the past few years. The control of financial risk been strengthened, and the effect has been that the growth of credit has slowed down. As the growth of deposits is still strong, the ratio of loans to deposits has fallen from 80 percent to 76 percent. Especially the state commercial banks have been cautious about lending, and they are especially unwilling to extend credit to the

corporate sector. There is some disagreement on how bad the condition in the Chinese banking system really is.<sup>2</sup> Nobody would disagree when presented with a statement saying that the amount of bad debt is huge, the questions are rather just how great it is, and how vulnerable the economy is with respect to the banking sector. Goldman Sachs has estimated the amount of bad debt to \$500-600 billion, which is about 50 percent of GDP. The state banks have been extending loans to SOEs in a reckless manner, a result of government policies. One could say that the government simply has placed its costs in the banks' balance sheets instead of issuing government bonds. Below there will be a discussion on the high Chinese saving rate. For the banking sector this is a blessing, as liquidity is coming into the banks in large amounts, and this gives the banks an opportunity to start acting like banks. With respect to how the banking sector may influence the growth rate, one should note that China for a long while has been growing rapidly with a terribly distorted banking system. Reforms are now (seemingly) around the corner, and the short-term costs will be substantial. However, an improved financial sector is already about to develop, and the underlying strengths and advantages of the country will not disappear.

The central bank, The People's Bank of China (PBC), has been concerned about the deflationary trend, and hence the PBC earlier this year cut interest rates (to 5.3 percent) and increased the target growth rate for M2 (from 13 to 14 percent). It should also be noted that China has yet to liberalize the interest market, but this set as a priority by some influential reformers.

The development in the Chinese stock market has been driven by the expectations of what the government is going to do with the state-owned shares, which compose 70 percent of the value of China's stock markets. In 2001 a plan was presented that aimed at reducing the state share while using the proceeds to fund the social security system. In June 2002 it was announced that the state share reduction scheme was terminated, and this gave this shored up stock prices in the short run. This is due to the fact that China's stock market is regarded as 'Policy Markets', which means that with a high state-owned share, prices are propped up in expectation of government policies that will prop up stock prices.

The Chinese economy seems to have benefited strongly from the accession to the WTO. The confidence of foreign investors has been rising, contributing to the relocation of manufacturing production from the US, Japan, and the EU to China. The importance of finding cost-based advantages during a time of margin squeeze on most manufactured products has contributed to the extent to which this relocation has been taking place. The consequence is that Chinese exports are growing at a double digit rate. The boost in exports has also been helped by a real depreciation of the Chinese currency, the Renminbi.

The growth in Chinese exports has been tremendous over the past two decades, averaging a 14.3 percent annual growth. Currently China accounts for one-fifth of global trade growth, and China's exports are now equal to 79 percent of Japan's, up from 22 percent in 1990 and 14 percent in 1980. In per-capita terms, however, China's exports are among the lowest in the world. If each Chinese worker should produce for the global economy in the same way as Americans and Japanese do, there is no reason why the growth should slow substantially down. The location of production of mass-manufactured products is taking advantage of the wage differentials that exist, and low-skilled production is to some extent moving inland where the wage rates are lower, while the eastern seaboard is moving into an higher degree of value added production such as automobiles, semiconductors, telecoms, and pharmaceuticals. Some have attributed the great competitiveness of China to its currency

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<sup>2</sup> See The Economist, Volume 366, Number 8307

peg to the USD. There could be some truth to this, but, as Andy Xie of Morgan Stanley notes, during the relative appreciation of the Chinese currency during the Asian crisis, the price level in China fell significantly. This indicates that the price flexibility is quite high in China, and that competitiveness was restored in this manner. If this is true, the currency peg cannot explain why China is so competitive.

*Outlook:*

Presently the key drivers to growth are public sector fixed investment and external demand (export growth and FDI inflows). Currently the economy can not rely on private investment and consumption as the sole drivers of growth, and it also seems likely that the growth in public fixed investment will slow down in order to reduce the public deficit. Further, the consolidation of the state-owned enterprise sector will increase the burden on the private sector when it comes to creating jobs. The SOEs are likely to decline further over the coming period, especially as the banks are becoming tougher and more unwilling to give loans to non-viable enterprises. The problems of the SOEs are illustrated by the fact that their profits are falling while the profits of the private-sector enterprises are increasing quite robustly. The growth in export demand is likely to continue, but the strength is of course dependent upon the growth in the rest of the global economy. Still, the outsourcing of operations to China is likely to continue, due to the both cheap and relatively skilled stock of labor.

The WTO membership implies that China has to allow the entry of foreign financial institutions. Some Western institutions have already established joint ventures with Chinese firms. Hopefully, the presence of Western institutions will increase the efficiency and prudence of Chinese financial institutions, and reduce the probability that mismanagement in the financial sector will hinder the overall prospects of growth.

There have been some worries that the slowdown in credit growth has been too strong, and that it can no longer support the current rate of economic growth. In my opinion, the slowdown in credit growth is a positive sign, even though it might reduce the rate of economic growth by a percentage point or two. The long-term benefit of developing a prudent financial sector with professional risk management system must be what determines legislation and regulation, not the policies' short-term (and medium-term) effect on growth. Finally, the government faces considerable challenges on the social front. The income gap is widening considerably, and there is also the question of how to develop sustainable pension and social security programs.

The IMF predicts that China's growth will be around 7-8 percent in 2003, a growth rate which has been more or less the norm over the past years. There is no doubt that China will face huge challenges ahead, not least on the social policy front. A reduction in the enormous amount of unemployed, in addition to an improved safety net for the old must be given priority. Further, a sound banking system must be developed, and an end must come to the propping up of inefficient SOEs.

However, even though there are risks on the downside for the Chinese economy, there seems to be stronger reason why robust growth shall continue. The economy will benefit from the WTO-membership and the increased confidence of foreign investors and companies, and as the respect for entrepreneurs and industrialists is growing among the official China, a further move toward a market economy should provide a good basis for growth.

#### **4.2.2) A note on Hong Kong**

The effects of increased integration with mainland China is the all important factor driving the economic development in Hong Kong. China started its economic reforms by establishing a special economic zone next to Hong Kong. As Hong Kong needed labor to increase production, it took advantage of the cheap labor next door, and moved production there. In the beginning profit margins soared, and a property market bubble developed. Over time other also started to take advantage of the low Chinese wage rates, and Hong Kong's export margins contracted.

Presently, the deflationary impulses stemming from the mainland are enormous, and Hong Kong has suffered from deflation for four years now. What is going on seems to be like the arbitrage-induced border-trade that is happening between Norway and Sweden. As Hong Kong residents are traveling to other Chinese provinces to take advantage of the low prices found there, Hong Kong retailers must effectively compete with their counterparts in low-priced Chinese provinces, with deflation in Hong Kong as the result. Policy makers in Hong Kong have tried to prevent this from happening by introducing barriers to the movement of factors and goods, and they have also tried to prevent deflation from taking a hold by running expansionary fiscal policies. Consumption and investment have remained weak since the outset of deflation four years ago, and this has left Hong Kong dependent on and vulnerable to the global business cycle. The real GDP growth was low (-0.5 to 0.8 percent) during 2001 and in the first two quarters of 2002, but improved a bit in the third quarter. Public consumption and net exports of services contributed to a 3.3 growth rate in 3Q, but investment and consumption growth are still negative. Hong Kong will soon have to tighten the fiscal policy in order to restore the budget balance, and this indicates downward pressure on the economy in the short to medium term. However, the external sector should benefit from an improved global economic climate in 2003.

#### **4.2.3) South Korea**

Given the global economic environment, the Korean economy has performed unusually well over the past year. There was a sharp slowdown in the first half of 2001, but since the end of 2001 growth has picked up and accelerated. The annualized growth rates year on year in the first and second quarters of 2002 were 5.1 and 6.2 percent respectively.

Private consumption has been the underlying growth motor over the past couple of years, driving growth both in 2001 and 2002. Private consumption contributed about half of the growth in final demand in the first half of 2002, and the growth rate in private consumption has been 7-8 percent in both 2001 and 2002. This growth has been stimulated and sustained by growth in household income, easy access to credit, and low real interest rates. The unemployment rate has fallen from 4.8 percent in early 2001 to 3.1 percent in August 2002. A tight labor market has provided the basis for strong wage increases. Real wages grew by 6.9 percent in the first half of 2002. Real wages for urban workers are now finally exceeding the 1997 level. There has been some upward pressure on consumer prices, and consumer price inflation reached 3.1 percent in September 2002. This is still comfortably within the Bank of Korea target range of 2-4 percent.

Growth in gross fixed investment has picked up as well, supported by increased investment in both equipment and construction. The latter started growing in 2001 after three years of decline. Equipment investment contracted during 2000 and 2001 with the bust in the high-tech sector, but in the first and second quarter it was growing by 2.1 and almost 8 percent, respectively.

Growth in exports has contributed to GDP growth as well in 2002. Led by growth in the high-tech sector, year on year growth in the second reached a robust 12 percent. Still, Korea's export structure is quite diverse, and it is not just the high-tech sector that has contributed to the growth. Even though imports of consumer goods are growing quickly, the trade balance and the current account still remain strong. Also the capital account is recording large surpluses, and this implies that Korea continues to accumulate foreign reserves. Total external assets exceed total external liabilities, and the official reserves are almost twice the short-term external liabilities. The vulnerability experienced during the 1997-98-crisis is reduced substantially.

The Won has appreciated by 8 percent in nominal terms during 2002 (due to the weak USD and the relative attractive Korean bonds). In real terms, however, the appreciation has been stronger, about 15 percent during the first half of 2002. The tradable goods sector is expected to suffer from this real appreciation. Indeed, there are some signs that the growth in the external sector is slowing.

The services sector has been growing steadily due to the consumption growth. Consumer optimism and rapid growth in credit, and contributed to strong growth particularly in the wholesale, retail and the finance and insurance sectors. These have been growing at 7-8 percent year on year in the first half of 2002.

There have been some concerns over the strong growth in credit to households. This grew by about 34 percent year on year in the second quarter of 2002, and credit to households has increased from about 16 percent of GDP in 1999 to 28 percent in mid-2002. Credit card lending is surging, and a worrying signal is the growth in the delinquency rates on credit cards, which grew from 8.4 percent in March to 11.2 percent in September. Only uncertainties in the external sector have discouraged to Bank of Korea from raising the call rate (currently at 4 percent).

Fiscal policy, which has been expansive over the past period, is now focusing on maintaining economic stability.

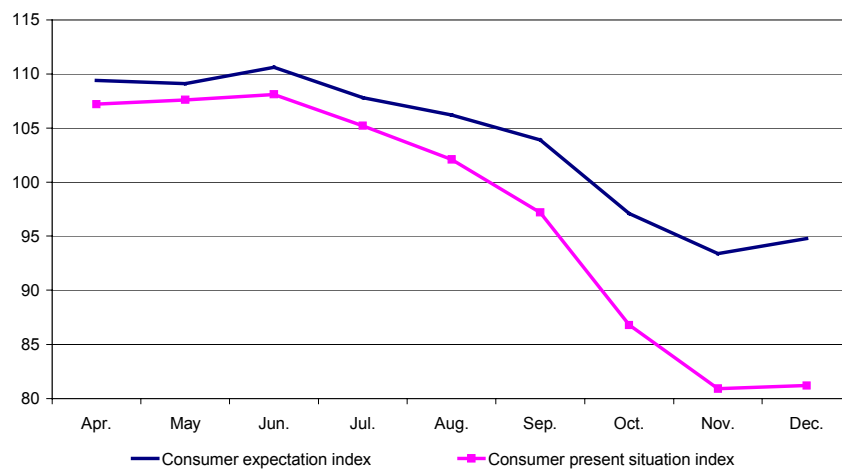
The financial sector seems stronger than it has been for a long time. The amount of non-performing loans has been declining rapidly, and the average profitability of the Korean banking system has increased. An important issue in the financial sector is the privatization of the banks that were nationalized during the crisis. After experiencing increased profitability in these banks, the government is committed to complete bank privatization over the next three years.

The vulnerability of the corporate sector has also been reduced. Average debt/equity ratios for manufacturing firms have declined, from 3.96 in 1997 to 1.82 at the end of 2001. The trend has continued in 2002. However, these ratios are high compared to OECD norms. Average debt/equity ratios in, for instance, the US, the UK and Germany are 1.2, 0.4, and 0.8 respectively. Further, the improvement in the corporate sector strength is not a general phenomenon. The weakest half of the corporations hold on to a large proportion of the debt, and those with interest coverage less than 1 hold around 29 percent of the total corporate debt (this number is based on a sample of listed non-financial firms). It is important to continue the process of removing the non-viable corporations, and to restructure those that are distressed but solvent.

**Outlook:**

Currently there are signs that the Korean economy is slowing down. Consumption growth based on a boom in the property market is slowing down. In 3Q2002 consumer spending grew 6.1 percent year on year (down from 8.4 percent in 1Q and 7.6 percent in 2q) , while the growth in construction spending also slowed down. The main change that has occurred in the Korean economy over the past quarter is the steep decline in consumer confidence. Even though growth in consumer spending is still strong, it is slowing down. As Korean growth has been bolstered by strong domestic demand, this does not bode too well for the future, and growth might well slow down in 2003. Still, as the credit growth comes down, chances are that the economy will avoid the hard landing many have feared.

**Korea - Consumer sentiment (Apr. - Dec. 2002)**



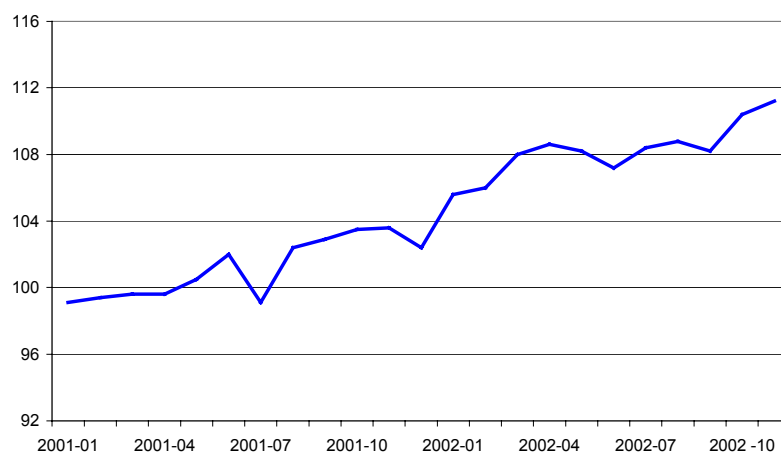
Source: Korea National Statistical Office

Aggregate domestic demand growth was down from 7.3 percent in 2Q to 4.2 percent in 3Q (both year on year). Still, strong growth in exports is supporting growth, but weak pricing power is making the volume growth larger than the growth in won terms (16 percent volume growth year on year vs. 8 percent growth in won terms). A deflation of the credit bubble has been expected for some time, and it is expected that the Bank of Korea will meet softer demand with quite large interest rate reductions. Credit growth was down to W2 trillion in November, down from W6.1 trillion in October, and an average of W9.1 trillion over the first three quarters of 2002. The government has enacted several measures to prevent the credit bubble to inflate further. These measures include a higher capital requirement for property loans, a tighter limit on credit card debt, and higher capital gains tax on property sales. The measures the government has enacted in order to preserve the stability of house prices seem to pay off somewhat, as the house prices were stable in the final part of 2002. Prices declined marginally in Seoul. Apartment prices increased by 30 percent in 2002 alone, however, and there is a danger that another Asian property bubble could burst. The political unrest on the Korean peninsula is not exactly improving the situation with respect to consumer and business confidence, and might increase this risk.

Still, there seems to be reasonable to hope for a soft landing. It is expected that this can be achieved through numerous interest rate reductions, expansionary fiscal policy (the budget is currently balanced), and strong(er) external demand, both from China and the developed world. Still, the risk is that a plunging consumer sentiment and a credit squeeze will be stronger forces than the former.

Industrial production showed positive signs in the latter part of 2002. Driven by strong growth in production of semiconductors, audio communications equipment and automobiles, all-important export industries. In addition, the growth in these sectors has contributed to a pick-up in investment. Growth in the service sector is slowing down a bit, however, due to the slowdown in consumer spending.

**Korea - Industrial production, sa, 2001 - 2002**



Source: Korea National Statistical Office

Early in January 2003, the Bank of Korea left interest rates unchanged at 4,25 percent. The dilemma for the central bank is that it does not want consumer spending to slow down too rapidly, but it must on the other hand make sure that the credit and real estate imbalances that have developed will be corrected. Further, with strong exports and industrial production, the demand side seems quite strong at the moment.

#### **4.2.4) Thailand**

Thailand was the first goose to be shot down during the Asian economic crisis. The economy was already in decline prior to the crisis, mainly due to the bursting of a massive property market bubble. Thailand has still not fully recovered from the crisis, but substantial progress has been made. Real GDP per capita is expected to remain below the pre-crisis level in 2002, and poverty is a greater problem than it was five years ago. Private investment has revived from depressed levels, and private consumption growth has been high over the past period. Thailand has maintained an average real GDP growth rate of around 3.5 percent per annum during 1999-2001, after contracting by more than 10 percent in 1998. A decline in growth during 2001 has been followed by a 4.5 percent growth in the first half of 2002, with growth driven by consumption growth, expansionary fiscal policy and current account surpluses. There is some doubt that this recovery based on consumption based asset reflation can be sustained.

Below you can find a table over the core economic indicators of Thailand. This illustrates the dramatic consequences of the combined effect of the bursting of a real estate bubble and a currency crisis. Take, for instance, a look at the gross fixed capital formation.

Core Economic Indicators of Thailand					
Item	1997	1998	1999	2000	2001
<b>Gross Domestic Product (GDP)</b>					
<b>GDP at current market prices (Billion baht)</b>	<b>4,732.6</b>	<b>4,626.4</b>	<b>4,632.1</b>	<b>4,904.7</b>	<b>5,099.6</b>
<b>Real GDP (Billion baht)</b>	<b>3,072.6</b>	<b>2,749.7</b>	<b>2,871.5</b>	<b>3,004.7</b>	<b>3,059.1</b>
<b>Growth rate of Real GDP (%)</b>	<b>-1.4</b>	<b>-10.5</b>	<b>4.4</b>	<b>4.6</b>	<b>1.8</b>
<b>Production approach</b>					
Agriculture	-0.9	-1.5	2.0	4.9	...
Manufacturing	1.6	-11.2	12.3	6.0	...
Construction	-25.6	-38.2	-6.8	-9.4	...
Services and others	-0.3	-9.4	0.8	4.4	...
<b>Expenditure approach</b>					
Consumption	-1.6	-9.5	4.1	4.6	3.2
- Private sector	-1.4	-11.5	4.3	4.9	3.4
- Public sector	-2.8	3.9	3.2	2.6	1.9
Gross fixed capital formation	-20.5	-44.3	-3.2	5.5	0.8
- Private sector	-30.4	-52.3	-3.2	17.2	5.1
- Public sector	10.2	-28.7	-3.1	-9.9	-6.6
<b>Degree of openness (%)</b>	<b>94.6</b>	<b>101.9</b>	<b>104.1</b>	<b>125.4</b>	<b>126.5</b>
<b>Inflation rate (%)</b>					
Growth rate of consumer price index	5.5	8.1	0.3	1.6	1.6
Growth rate of GDP deflator	4.0	9.2	-4.1	1.2	2.1
<b>Unemployment rate (%)</b>	<b>1.5</b>	<b>4.4</b>	<b>4.2</b>	<b>3.6</b>	<b>3.3</b>

Source: National Statistical Office, Thailand

After the crisis Thailand has reduced its external vulnerability substantially. In 2002, external debt is expected to be less than one-third of what it was in 1997. Further, the country has adopted a flexible exchange rate policy, while also diversifying its export base, which has helped the country cushion the shock of the IT slowdown.

Since 1997, public debt has surged from 14 percent of GDP to 59 percent of GDP in 2001, as a consequence of fiscal stimulus packages, the costs of restructuring the financial sector, and the effect of the currency devaluation on the costs of servicing foreign exchange liabilities. Further shocks to the economy will make the public debt situation problematic. The corporate sector is still highly leveraged, even though the ability of firms to pay interest is slowly recovering. Progress has been made in the banking sector, but there are still significant unrealized losses that make the sector fragile. Improvements in corporate governance have been significant, with improved accounting and auditing standards and enhanced securities regulations.

A main problem for the economy is the sluggish investment. The crisis was caused by over - investment, and a substantial recovery is yet to be seen. Private investment collapsed from about 31 percent of GDP in 1996 to less than 11 percent in 1998, while it is currently at about 14%. This is well below the level that one considers can support long-term high growth. However, the saving rate is high (about 30%), and when the allocation of capital is improving and the credibility in the corporate sector is regained, there seems to be no reason why investment should not come back closer to the levels of the past. Productivity is currently increasing in all sectors except in the service sector, and this is a sign that the process of allocating capital is improving.

The Thai government has actively been trying to develop a new development strategy for the country, a strategy that should preserve the export-oriented thoughts of the past while also emphasizing the development of the lagging regions. More on this below.



#### **4.2.5) Malaysia**

Economic activity has recovered in Malaysia in 2002. Growth in real GDP is expected to be about 3.5 percent in 2002, up from a lackluster 0.5 percent in 2001. Growth is driven by buoyant consumer spending, which has been growing by 6 percent in 2002. This growth has been supported by expansionary fiscal policy, low interest rates, and better access to financing. Further, there has been a recovery in exports, and the importance of intra-regional trade has increased. Exports to other ASEAN countries increased by 12 percent in the first half of 2002, while exports to China surged by 48%.

During the period 1999-2001 the federal government has run an average fiscal deficit of about 5 percent of GDP. As a result, total public debt had increased to 70 percent of GDP by the end of 2001. Policymakers are now trying to limit the growth in public spending.

The financial and corporate sectors have restructured their operations. The banks are to a lesser degree relying on short-term external borrowing. The term structure of corporate debt is improved with an increased share of domestic bond financing biased toward medium- and long term bonds.

Private investment has been hit in Malaysia like it has been in other crisis countries. Private investment is now only around 10 percent of GDP, down from a level of 30 percent before the crisis. For growth to be sustainable there is a need for a larger share of investment. Another troubling fact is the lack of foreign direct investment. FDI was flowing in to Malaysia at a rate of 4 percent of GDP prior to the crisis, but currently there is hardly any foreign enterprises investing at all. FDI as a percentage of GDP was below 1 percent in 2001.

Among what is called the MTIP economies (that is South East Asia; Malaysia, Thailand, Indonesia, and the Philippines), Malaysia is the most dependent on FDI, manufacturing, and exports. Hence, the country is troubled by the disappearing FDI, and it is also hurt by the slowdown in the IT-sector. There are some signs that the country is moving towards a similar kind of economic plan as the one advocated by the prime minister of Thailand. In order to strengthen the domestic sector, some government resources have been channeled from projects that attract foreign capital, to projects that favor SMEs and the rural sector of the economy. Still, the country is aggressively trying to lure businesses away from other places in the region, through heavy subsidies.

#### **4.2.6) Indonesia**

Indonesia has enjoyed increased political stability after Megawati came to power in July 2001. Of course, the setback due to the terrorist attacks on Bali in October 2002 was big. Still, the long-term benefits of a strong government that can clean up the mess after decades of bad governance are far greater than the short- to medium term losses stemming from this attack.

Indonesia was the country that was hardest hit during the Asian crisis, and it has taken time for robust growth to resume. Growth has been relatively slow even after Megawati came to power. The real GDP of Indonesia grew by 4.8 percent in 2000, 3.3 percent in 2001, and it grew by 2.9 percent in the first half of 2002.

Robust consumer spending has, like in many other East Asian economies, been the engine of growth. Consumption has been growing by between 6 and 10 percent over the past

quarters, bolstered by increased stability, growth in consumer credit (which expanded by 46 percent in 2Q 2002), and rapidly rising formal wages. There are now signs that this consumption boom might be slowing down.

Growth in fixed investment has been negative for quite some time now, however. The investment growth rates have been negative since 3Q 2001, and the level of investment fell considerably late in 2001 and during the first half of 2002. Due to the Bali attacks one should not expect this trend to be reversed too quickly. Foreign investors seem to have been scared away from Indonesia, too. Net FDI has been negative since 1998.

With an appreciating currency and tight monetary policy, the inflationary pressures are fading, and the CPI inflation rate are not down from 15 percent in February 2002 to 9 percent in September.

The exports of Indonesia was hard hit by the global slowdown, and due to an appreciating real exchange rate (the rupiah has appreciated by almost 25 percent since the mid-2001), it has taken time for growth in exports to resume. Still, the trade balance has been in positive territory, especially due to strong growth in exports to China, and, up until now, low imports. It is expected that The Bali attack will have considerable negative consequences on the balance of payments. However, revenues from tourism only amount to some 2 percent of GDP, so the impact from reduced tourism alone will probably not amount to too much for the aggregate economy. Still, resumption of political stability and improved law and order is of paramount importance for Indonesia in the long run.

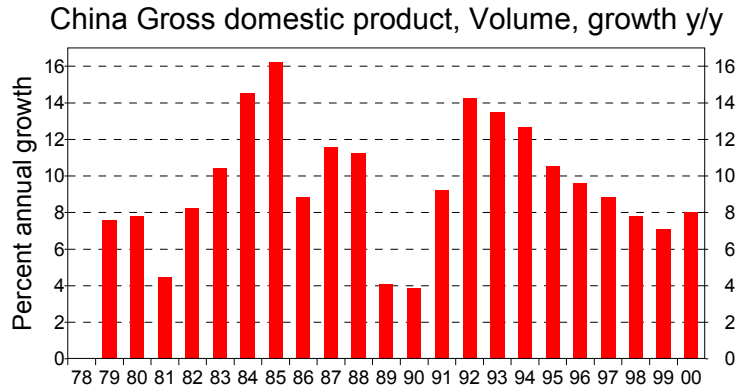
Since president Suharto was ousted in 1998, it has been debated how to get the large amount of exile capital back to Indonesia, and how to treat the businessmen who are holding this largely illegally appropriated capital. On the one hand, it seems proper that these cronies of the Suharto-regime should get their punishment. On the other hand, the threat of a strict punishment will not get the capital back to Indonesia, and hence exile capital amounting to some \$25-30 billion will be out of reach for an economy that badly needs it. The question is whether it is advisable to allow the return of these businessmen and their capital, and through an improved economic system with enhanced regulation and monitoring to use their entrepreneurial knowledge and let them go on unpunished.

Indonesia's amount of external debt still makes the situation vulnerable. The ratio of short-term debt to gross reserves is around 70 percent, more or less twice the amount one can find in Thailand, Korea, and Malaysia. The rating on government bonds was raised in September by S&P from Selective Default to CCC+. This rating is below that of comparable economies like Thailand (BBB-), the Philippines (BB+), and Vietnam (BB-). S&P's upgrade reflects the decline in the ratio of public debt to GDP, which currently is at 80 percent, down from its peak of 98 percent in 2000.

## **5) How Chinese growth is affecting the region**

China's growth has been dramatic ever since Deng Xiaoping started his gradual reforms towards a more liberal economic system. The Chinese economy is becoming one of the world's largest economies. In US dollar terms the Chinese economy is currently just ten percent the size of the US economy. However, the Chinese currency (which since 1995 has

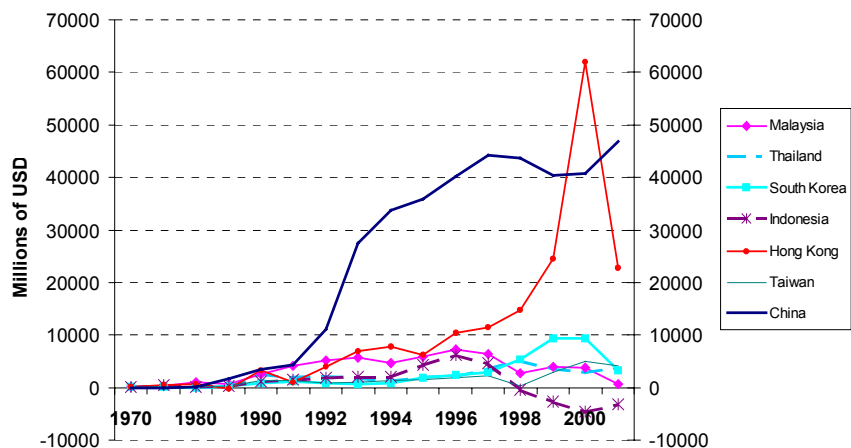
been pegged to the US dollar) seems to be dramatically undervalued in PPP-terms, and hence the real value of the Chinese economy is probably much greater.



Source: Ecwin

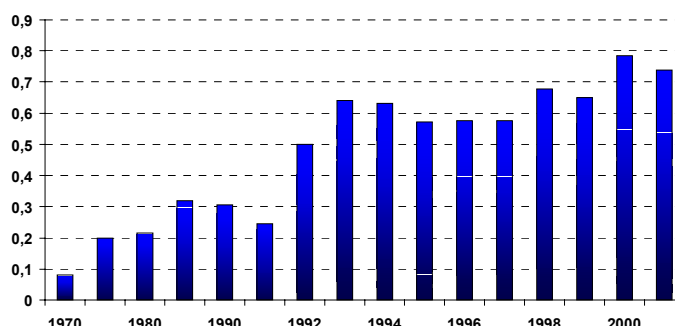
China's growth has been driven by strong growth in exports and, especially over the past few years, by a strong inflow of foreign direct investment. There has been a general trend that China has been receiving ever-larger inflows of FDI, while other East Asian countries, except Hong Kong, have been struggling to attract FDI. In some instances, notably Indonesia, other countries have even had a hard time holding on to the foreign capital stock they already have. The graph below illustrates this point. While Hong Kong benefits from Chinese growth as a big portion of Chinese trade passes through the ports of Hong Kong, there seems to be a declining trend for the rest of the sample countries. China and Hong Kong's share of aggregate FDI inflows in South, East and South East Asia is currently above 70 percent.

**FDI inflows to various Asian countries**



Source: UNCTAD's World Investment Report

**China and Hong Kong's share of South, East and South East Asia's FDI inflows**

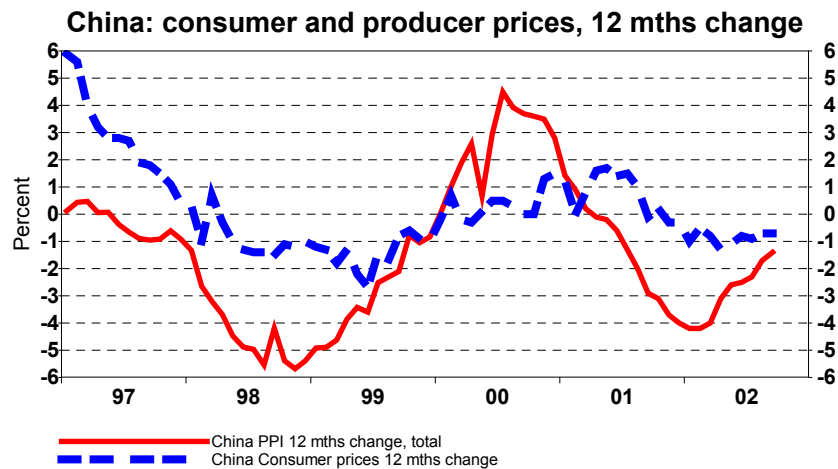


Source: UNCTAD's World Investment Report

While Chinese growth in external trade is strong, consumption growth is relatively moderate.<sup>3</sup> This stems to some degree from the differing income levels of different age groups. Older workers who leave the labor force are generally far poorer than the population as a whole. Most of them have worked either as farmers or in state owned enterprises. Both groups are lacking pension plans with substantial benefits, and this means that the retirees do not have much savings or resources to draw down. At the same time, the saving rate of people in the labor force is high, as they are building up resources for retirement. What we have is therefore an older part of the population that does not have 'any' resources' to spend, while the younger generations who have the means to consume have a low propensity to consume. The saving rate of the economy as a whole is therefore high. This is a natural consequence of the transition from a socialist system (where nobody needs to accumulate resources for the retirement, which means that household wealth will be low) to a capitalist system (where you to varying extents must be able to provide for yourself in the event of illness, unemployment or during retirement). Net household wealth should in equilibrium be several times GDP. This implies that in the transition phase the rate of asset accumulation must outpace the rate of income growth, which again implies that the rate of consumption growth must be lower than the rate of income growth. As we shall see, these developments have powerful influences on the entire Asian region.

Strong growth in production capacity and productivity combined with a propensity to accumulate assets rather than to consume make the goods market deflationary and the asset markets inflationary. The graph below shows the deflationary pressure in the goods market. The assets markets on the other hand has been more inflationary, especially the property market. Stocks are not doing as well, as falling prices is detrimental to profits and hence stock prices. One might also regard the market for education as an asset market, an asset market for human capital, that is. Chinese parents are investing heavily in the brains of their children, and prices in the educational sector have been surging.

<sup>3</sup> For more on this, see Morgan Stanley GEF, Oct 15, 2002



The deflation in the goods market is primarily driven by increases in productivity. The results of productivity gains are threefold; they can lead to higher wages, increased profits and to lower prices. Whether some factor of production will gain or whether the increases in productivity will benefit the consumers through lower prices depends on the relative scarcity of labour, capital and final demand, respectively. That China has a huge pool of available labour should not come as a surprise. Chinese firms are in a situation where there is no reason to increase wages in response to productivity increases due to the huge pool of unemployed labour that is more than willing to replace the existing workers at the current wage rate. That capital, too, is plentiful in China might be a bit more of a surprise. But we have already explained the origins of the high saving rates, and the large amount of savings makes capital inexpensive, as the price demanded for postponing consumption is low. The propensity to save rather than to consume also makes demand price elastic. All this points in the direction of consumers benefiting from productivity increases through falling prices.

An abundant pool of educated labor as well as low costs of capital are two factors making China an extremely important player. Productivity increases have already depressed world prices of the products that China exports. Up until now China's export growth has been concentrated within mass manufacturing and assembly. However, there seems to be no reason why things will stop there. The supply of skill and capital makes it possible to produce investment goods locally. This is not the case for most other developing countries, where investment goods must be imported at high prices based on Western world wages. So, in contrast to many other developing countries, China is in the position to take advantage of its enormous amount of inexpensive labor. And that labor can be used in both labor-intensive and capital-intensive industries.

Other factors are also giving China, but potentially also other Asian economies, advantages. Developing Asia has already emerged as the dominant producer of technology products, with 32 percent of global technology exports. The case for strengthening this position seems quite strong. In the first place multinational companies are to an increasing extent seeking locations of production that will give them cost-based advantages. Productivity adjusted wages in Asia, and especially in China, are extremely low compared to the levels in the West. It does not stop here, however. China and other Asian countries do not only have an inexpensive labor force, they also have a *skilled and inexpensive* labor force. According to the US National Science Foundation, in 1999 universities in Asia produced more graduates with engineering degrees than the US, Japan and the EU combined. Two thirds of the

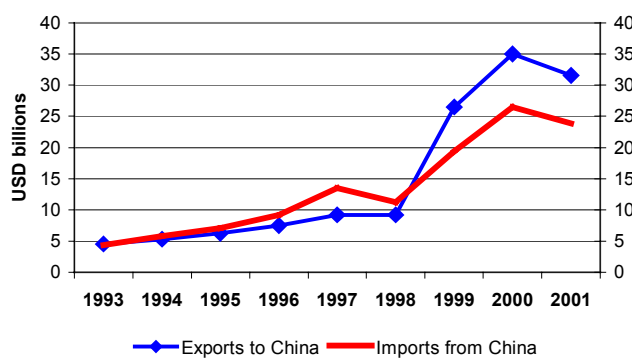
engineering students in Asia graduate from Chinese universities. Further, the Asian countries are strongly focusing on producing science graduates. While science and engineering degrees represented thirty percent of the total number of bachelor's degrees awarded in the US in 1999, the corresponding number in China was an astonishing 73 percent, In South Korea the number was 45 percent, and in Taiwan it was 40 percent. No wonder that some of the powerful technology companies have decided to locate R&D-divisions in especially China. One should not look blindly at the sheer number by themselves, however. Especially for the countries surrounding China, what will be important is not just educated people who can perform the tasks given to them, but people with an entrepreneurial drive. If one takes a look at the education system in several of the East Asian countries, it seems like more room for individualism must be allowed if one is to take full advantage of human creativity.

### 5.1) Will powerful Chinese growth spill over to all of East Asia?

Publicly the leaders of the ASEAN countries seem to think that their countries will benefit from the strong growth in the Chinese economy. China provides these countries with an enormous market, which they should be able to exploit through trade. Rapidly growing Sino-Southeast Asia trade seems to support this belief. There certainly are some benefits from Chinese growth and intra-regional trade. First, increased production in China gives lower prices on imports, and leaves more demand for domestic use. Second, Chinese growth increases demand for the products of ASEAN countries (For instance, Korea (not a member of the ASEAN), ran a USD 14 billion surplus with China in 2001 primarily due to Chinese demand for micro chips). However, Chinese growth is not just a blessing for the neighboring countries, whose leaders' awareness about this fact seems to be growing.

The graph below shows the growth in trade between China and the ASEAN member countries.

**ASEAN trade with China**

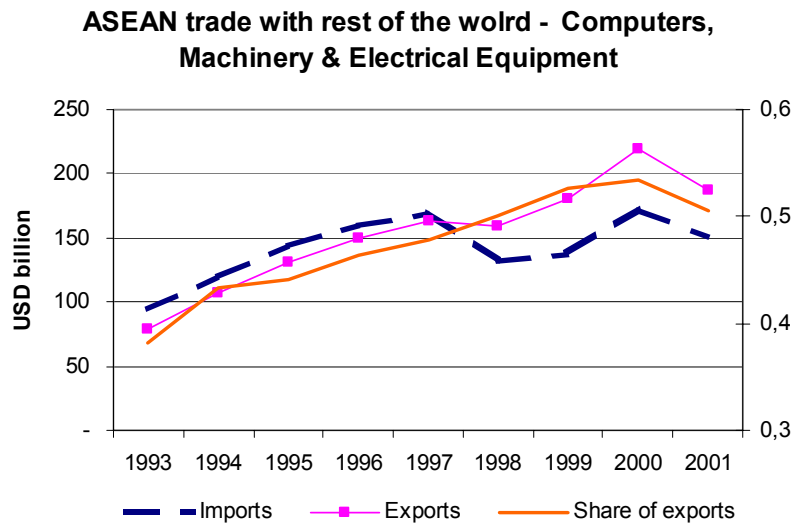


Source: ASEAN

The growth in exports to China has been remarkable, and the trade surplus with China amounts to more than one percent of ASEAN GDP alone. Beneath the surface things are not looking so bright. The trouble seems to be that China's imports consist mainly of mass-manufacturing and primary products. Neither of these seems to be the type of industries that will provide the ASEAN countries with a solid basis for long-term growth. First, China's manufacturing imports from the neighboring countries are to a large extent used as inputs in its own manufacturing. There is no reason to believe that China over time will not be able to produce these components by themselves, especially as the cost of labor is far lower in

China. In that way a large export market will be taken away from the ASEAN countries. Second, to rely on growth through the export of primary products like agricultural products and scarce non-renewable resources (for instance mineral products) hardly seems to be the sole way these countries would want to go. However, as China develops its manufacturing sectors, the demand for agricultural products and natural resources will increase. Resource rich Southeast Asia can to some extent supply China with these products. But again, on the other hand, investment in these sectors has been low, and it will take time before the production level and - efficiency will be at a high level.

The ASEAN countries are currently to a large extent relying on production of machinery and electrical appliances for their exports. The share of these products in total exports is about fifty percent (see graph below, export share is on the right axis), making the countries vulnerable both to external demand shocks and especially to China taking over the markets by exploiting its low-cost and well-educated stock of labor.



Source: ASEAN

The growth in manufacturing exports to China could prove to be a temporary phenomenon. China is expanding its production capacity rapidly through inflows of foreign direct investment by multinational companies. Currently China primarily occupies the assembly part of the value chain, but later on production capacity in the upstream steps of the production chain is likely to be developed. This will take away the market for ASEAN countries' manufacturing exports, which now compose fifty percent of the total exports to China.

The trouble seems to be that China can do it all. Wages are extremely low (only Indonesia has lower wages in the region) and the work force is quite well educated (there are about three million students graduating from Chinese universities annually, and this number is growing fast). The spread of knowledge is exponential in nature, and when you combine this with a workforce that is able to receive and understand new knowledge, continued growth in both labor intensive and relatively skill intensive industries seems inevitable. Because of this there seems to be no reason to expect that China will not continue to be the main recipient of foreign direct investment, at the cost of its smaller Asian neighbors.

So what should the ASEAN countries do to get out of what looks like huge troubles ahead?

## **6) New vs. Old Economic Models: Prime minister Thaksin's economic development plan**

During the 1970s and 1980s the majority of Asia Pacific embraced an economic model that was based on two premises; i) high investment rates, and ii) export-orientated industrialization. Within the Asia Pacific countries, there were largely two groups. The first one developed large domestic enterprises with a great extent of interaction between the companies, banks and the government. Korea, with its chaebols, and Taiwan are the prime example of this group. The second group based its industrialization on multinational companies and foreign direct investment, making the countries vulnerable if the tide were to turn. Many countries (Singapore, Hong Kong and South East Asia) in the Asia Pacific region fall into this category. Since the 1970s, this has been a successful strategy due to the high degree of outsourcing by MNCs, and the steadily increasing amounts of FDI. What the countries have not managed is to develop a self-sufficient domestic economy. As the MNCs and FDI have lost their appetite for East Asian countries ex. China, the countries must now reorient their economic models.

Another facet of the East Asian Economic Model was the tight interaction between the companies, banks and the governments. This led to rent seeking activities and excessive investments caused by cheap credit and distorted incentives. As profitable investments in the industries that were promoted eventually were exhausted, and profitable investment opportunities in other sectors were ignored, the return to capital was low (remember the table on corporate profitability). These were some of the main factors contributing to the Asian economic crisis. Still, the crisis did not immediately make the countries reorient their development policies. The tight linkages between the government and the Asian companies with their complex family ownership structure were not broken. The crisis years of 1997 and 1998 does not seem to have been harsh enough for this to happen, as both the government and private agents were unwilling to change the status quo as long as they still had private gains from the interaction and no other alternative plan was presented.

Currently, however, there are signs that several countries are about to reorient their models of economic development. Primarily three factors are making this necessary. First, the current vulnerability of aggregate economic activity to quite narrow drops in global demand is not desirable. Second, in the presence of a growing China, it will be difficult to continue the strong growth based on mass manufacturing. Third, the strength of the domestic private sector must be strengthened in order to reduce the reliance upon foreign capital and technology.

In response to a slowdown in global demand for manufacturing products and to the growing Chinese economy, the Prime Minister of Thailand, Thaksin Shinawatra, in 2001 presented a new plan for promoting economic growth. This plan is gradually becoming a model for economic development that the governments of other countries in the region are endorsing, so it should be worthwhile to present its main points. Thaksin's starting point is the fight for what he calls quality growth. This means i) stability of the economy, ii) equality of distribution of growth, and iii) a high performance, knowledge-based, and creative economy. It is recognized that the Thai economy has relied excessively on foreign capital and technologies, and low wages of the unskilled labor. Productivity growth has been relatively slow, and in the presence of a Chinese economy that supplies equally skilled labor at a lower cost, it seems clear that growth based on the exports of mass manufactured products cannot continue. It is further recognized that the amount of bad debt in the banking system was stifling credit creation. At the same time foreign investors had lost their appetite for



investing in the country. Hence it seemed clear that it was important to make improvements in the capital markets, especially the equity markets.

The main point of Thaksin's plan is to implement what has been called a dual-track development strategy. The first element of this strategy is a continuation of the export of mass manufactured products, but the production processes will have to be rationalized in order to be able to compete with China. The second and new element is a domestic skill-driven SME (small and medium-sized enterprises) model, which represents a shift from this predominantly manufactured export-driven model to one that leverages the underutilized domestic resources and sectors. The government largely takes the role as a coordinator (for instance by setting up intra-industry coordinating organizations, and by providing incentives for raising capital for SMEs through the equity market rather than through banks). This means that the plan will not imply a too heavy fiscal burden. One of the underlying motives of the plan is to discover and develop industries with inherent comparative advantages, as for instance tourism, which now composes seven percent of Thailand's GDP. This reflects the importance of striving for developing goods and services that can complement the goods and services that Chinese growth is based on.

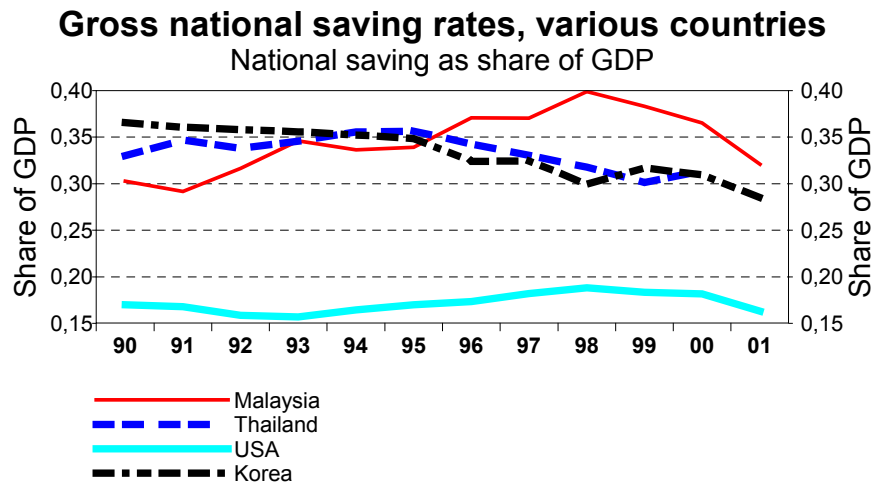
Up until now East Asia has supplied the world with mainly electronics, agricultural products and some primary commodities. One of the problems with this strategy, however, is the lack of pricing power. Asia has been supplying products for which the elasticity of demand is high while at the same time excess capacity has made the supply inelastic, as a drop in demand still makes supply abundant as long as the price is above marginal cost of production. The degree of export orientation and the sensitivity of prices of their products in response to drops in demand make the economies vulnerable. The products of the economies are homogeneous which makes it impossible to charge higher prices due to monopoly power stemming from for instance product differentiation. As drops in demand are hitting prices rather than the quantity supplied, the rewards to the factors of production are suffering directly. The return to capital will be weak, and the wages workers receive will be falling. With China entering the markets that other East Asian economies have been large players in, supply will again increase substantially, depressing prices further.

The bottom line is that the traditional development strategy embraced by almost all countries of East Asia makes the countries vulnerable to worsening terms of trade and price wars stemming from the overcapacity of supply. China's growth in mass manufacturing is only making matters worse, and has already made the other countries in the region trying to divert exports of components and raw materials toward China, while the traditional exports to Japan, the US and the EU is declining in relative importance.

Traditionally most East Asian countries have been classified as relatively labor rich and capital poor. Hence the promotion of labor-intensive production has been natural. The problem seems to be that Thailand and other East and Southeast Asian countries are quite capital rich and labor poor relative to China. When comparative advantages are classified in these broad manners one eventually runs into trouble when a country is squeezed from both sides - Thailand, for instance, is capital poor relative to the West, and at least labor poor relative to China. What then should Thailand do? It seems natural to dig deeper to find the true comparative advantages of a country. In a world where there are relatively few and small export oriented countries basing their growth on the same general comparative advantage, things are all right; there is more or less enough demand to satisfy the aggregate supply without the price charged being too low. When a new giant producer steps into the arena overtaking the traditional comparative advantage of the smaller countries, new growth momentum must be found elsewhere.

## 7) Excess saving

A predominant feature of the Asian economies has been their extraordinary high saving rates. The graph below shows the gross national saving rates as a share of GDP for various East Asian countries and the USA. The difference between the Asian countries and the US is remarkable.



The savings have been used to finance large-scale domestic investment, and to some extent to finance the saving deficit in other regions of the world, notably the US. While Krugman points to what he claims is low growth in total factor productivity and hence that the Asian miracle is no miracle at all, Dani Rodrik points out that to have such high saving rates and such a degree of mobilization of capital is quite a miracle by itself. When East Asia embarked on its export-oriented strategy, high investment in production capacity was a prerequisite. The countries were successful in providing incentives for saving, making the population postpone consumption. What they effectively were doing was to build up capacity that would satisfy external demand, while leaving internal demand weak. Hence the domestic economies were not developed to a great extent. With domestic demand low, there was no demand for building up capacity in what Western countries regard as essential service industries. This left the economies without a domestic economy that could assist growth if external demand were to weaken.

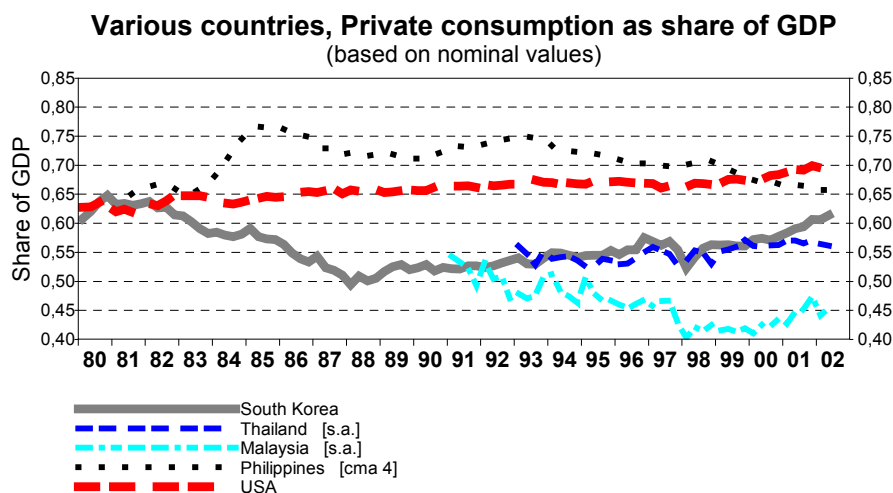
The excessive saving in Asia has played an important role for many years. While the US is the only significant net buyer in the world, running current account deficits of about five percent of GDP, Asian economies are and have been dependent upon just this strong demand from the US. American consumers have responded to this by spending more than they earn, which is possible only through capital inflows, which again to a great extent have been financed by savings in Asia. This is hardly a long-term solution, as the US net international investment position is weakening rapidly and this will eventually make it harder to attract foreign capital. Profitable investment opportunities are not so much greater in the US than elsewhere.

This story seems to indicate that high saving rates have been necessary for Asia to be successful in pursuing its pure export-oriented industrialization strategy. The savings have been assisting external demand, helping the export industries of the Asian countries. While

multinational companies in many East Asian countries have been providing the capital for productive investments through foreign direct investments, domestic saving has not always been put to efficient uses. The capital systems in many of these countries are underdeveloped, and saving takes primarily the form of saving in bank deposits. With bank systems that are not known for their efficient allocation of capital to loan applicants, there seems to be room for increased efficiency in the use of domestic saving through improved capital markets.

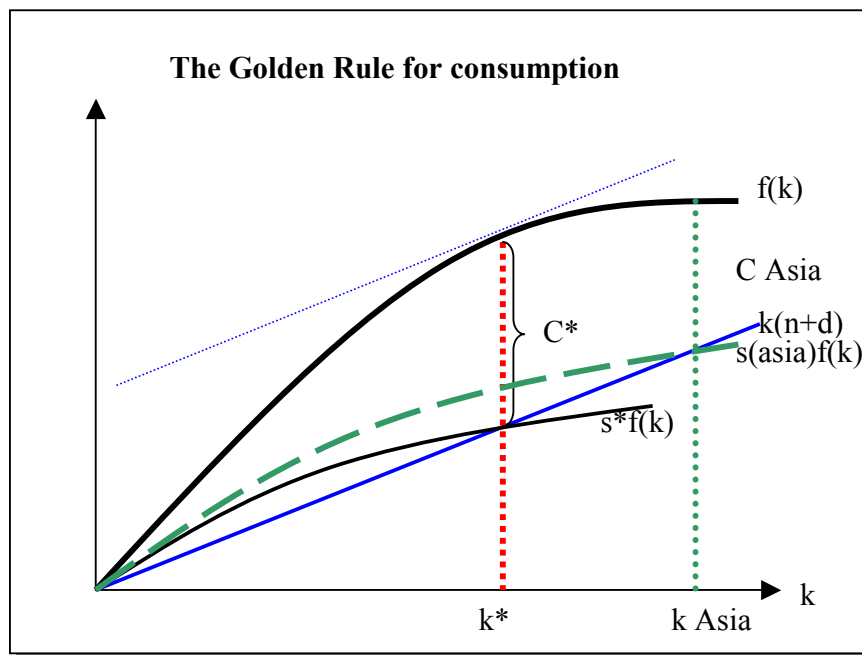
## 7.1) Excess saving allowing interim consumption based asset reflation

For most of the newly industrialized Asian economies private consumption as a share of GDP is low relative to what we see in the West. During a period where a country is moving towards a steady state by investing massively in production capacity it is just natural that this ratio is falling. However, when the desired level of capital per worker is reached, the investment momentum should abate, so that one finally can take part in the postponed consumption. The graph below shows private consumption as a share of GDP for various Asian countries, in addition to the US.

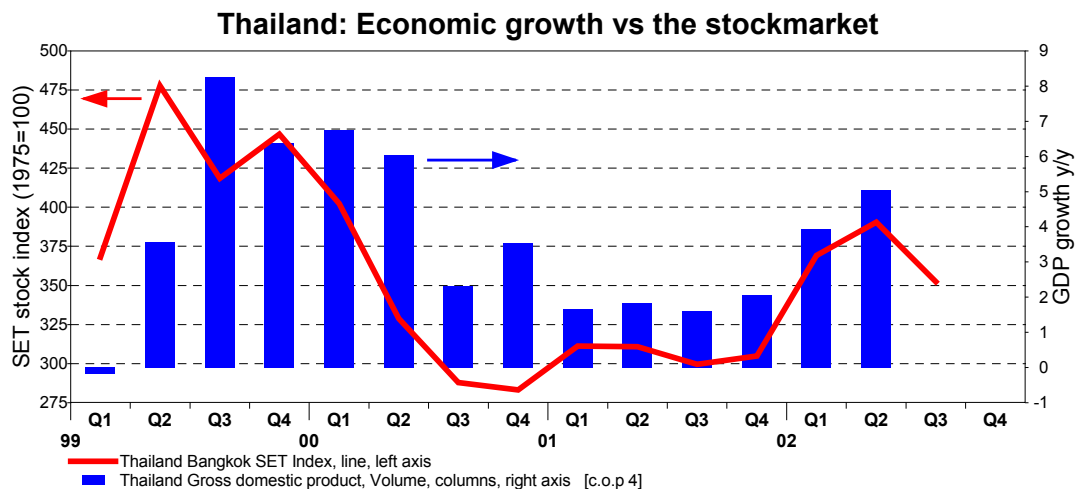


Due to the generally high saving rates in the East Asian region there has been room for a structural growth in consumption over and above the growth in GDP. I say 'has been', for as we will see, this elbowroom has been exploited in some of the countries under consideration. According to the golden rule in the Solow model, consumption is optimally chosen so as to equalize the marginal product of capital with the rate of depreciation plus population growth. Implied here is that the optimal saving rate is equal to the elasticity of production per capita with respect to capital. Asian saving rates seem to be so high that they cannot be optimal. After all, an individual's welfare must be based on the goods and services he consumes, not on how much he lets the economy produce without he himself getting a share of the output. This point is illustrated in the figure below. This is a standard Solow model, where  $f(k)$  denotes production per worker,  $s$  denotes the saving rate,  $k$  is capital per worker,  $n$  is population growth, and  $d$  denotes the rate of depreciation of capital. A steady state is defined as where capital per worker is stable, that is, where the  $sf(k) = k(n+d)$ . What is left for consumption in steady state is the difference between production and saving, that is, the vertical distance between  $f(k)$  and the

point where  $sf(k) = k(n+d)$ . There is only one saving rate that is optimal if consumption is to be maximized. This optimal saving rate  $s^*$  gives the capital per worker  $k^*$ . If the saving rate is higher, however, even though production per worker is higher, consumption will be lower as more saving is demanded to make sure that the amount of capital available per worker is constant. With respect to the Asian countries it is hard to avoid the conclusion that the saving rate is too high, that is, that the marginal productivity of capital is lower than the combined rate of population growth and the rate of depreciation. Hence, it would be rational for the Asian countries to reduce their saving rates and to increase current consumption.



Quite a few commentators have argued that this is what should be done in Asia. One part of Thai Prime Minister Thaksin's economic plan involves a temporary increase in consumption growth. Several factors indicate that East Asian economies will be dependent upon strong domestic demand. The deflationary pressures stemming from China, and slow growth in traditional manufacturing industries both point in this direction. In addition it will take time before new winners in new industries are identified (if this is possible at all), and also to set up a regime that provides the correct incentives for new winners to emerge. Therefore Thaksin has pursued a strategy that has been named Thaksinomics. Thailand's economy has been troubled by strong deflationary pressures, industries struggling with excess capacity, and with banks troubled by bad loans. This is hardly the best environment for a solid supply of credit or general business investment. But instead of going through the harsh remedy where banks the banks are writing off bad debts and businesses letting excess capacity fade away, Thaksin has promoted a strategy with low interest rates, easy credit and high public spending. Thaksinomics has also got another name, that is, consumption-based asset reflation. Through a variety of measures seeking to bolster domestic demand, the Thai economy has been experiencing relatively rapid growth over the past few quarters. During the period of Thaksinomics, Thailand's stock market has outperformed most of the other stock exchanges in the region (see graph below). There has been a general reflation of asset prices, both stocks and property, and consumer confidence has gone up too. The latest development in the stock market does not bode to well, however.



This is of course not sustainable in the long run. But as a temporary remedy for lackluster global demand for its export products, it could be a successful strategy. The public deficit this year is running at about 3,8 percent of GDP, while the budget of next year projects a considerable fiscal tightening (if the budget is not tightened, increasing public debt could cause a rise in interest rates, and trouble the economy). Hence, it seems that in the short run, continued growth in Thailand's economy is dependent upon reviving global demand. If not, the strong growth during the past couple of quarters will be reversed.

## 8) Plans and substance of regional cooperation and integration

The development strategy of East Asian nations has traditionally been based on export-oriented industrialization, and multilateralism was the principle guiding trade arrangements. In 1997, Japan, China, and South Korea were the only major economies of the world that had yet to conclude a free trade agreement. ASEAN (The Association of Southeast Asian Nations) was the only agreement that had been concluded within the region, and the impact of this organization has been negligible up until now (it has existed for more than thirty years). Recently, however, there has been a shift towards bilateral and regional trade agreements. There are plans to establish a free trade area involving the economies of ASEAN and China, and also Japan, Korea, and China are discussing the possibilities of forming a free trade agreement. Given the challenges and opportunities facing the countries in the region as China continues to transform itself into an economic behemoth, there seems to be a strong rationale for reducing trade barriers within the region.

Several factors can explain this recent development. First, progress toward free trade within the WTO is slow, and faster progress can be made if one is willing form bilateral and regional agreements. Second, there is a global trend towards regionalism, with NAFTA and the EU as the major economic players. This might create a bandwagon-effect, as uncertainties rises with respect to the easy of access to the markets of the other trading blocs. This fear seems valid, due to protectionist trends in both the US and in the EU. Recently, for instance, the EU

imposed a 5 percent market share quota on Chinese TVs. Third, the Asian financial/economic crisis seemed to demonstrate that the market regards the countries of the region as one market. The attempts to create common defenses against the mood swings of the market can explain why the extent of regional cooperation has increased. Fourth, the economies of the region are to an increasing extent trying to take advantages of the competitive advantages of the various countries, and the corporations are outsourcing production accordingly. The reduction of barriers to the mobility of factors and goods therefore seems quite rational.

The question remains whether something substantial will develop from all these grand regional plans. If we take a look at what has happened with ASEAN we might suspect that nothing much will happen. Daniel Lan of Morgan Stanley states bluntly that ASEAN has been a colossal failure when it comes to the speed and degree of economic integration among its ten member countries. What hinders progress towards integration seems to be that the member states to a considerable extent are competitors on the global arena, and the member states are unilaterally imposing trade restrictions in order to protect domestic industry. The growth of Intra-ASEAN trade has been fairly low and it composes only 15-20 percent of total trade. In a Global Economic Forum (GEF)-article called *Asia Pacific: Don't Count on an Imminent Revival of Asean*, Daniel Lan provides several examples of how economic warfare rather than economic integration is characteristic of the development of ASEAN. Here are some of them:

- First, the member are competing fiercely for manufacturing FDI, throwing money at MNCs by granting them generous fiscal incentives and other kinds of subsidies.
- Second, countries like Singapore and Malaysia are also competing to attract and keep operational headquarters. As production gradually moves to China, the headquarters are likely to follow suit, and a continuation of the subsidy competition will waste resources.
- Third, in order to cushion the effect of a declining manufacturing sector, several countries would like to build strength on tourism. The countries are to a large extent fighting for the same tourists, and subsidy competition is not an unlikely scenario here either.
- Fourth, in the transport and logistics sectors especially Thailand and Malaysia are subsidizing domestic industry in order to attract activity at the cost of especially Singapore. To a large extent this competition seems to be based on desire and will, rather than on the process of rational allocation of resources and production. The countries in East Asia have succeeded once through (or despite of?) heavy intervention by the government, but there seems to be a danger that inefficient rent seeking activities could be the result this time. As for increased integration among the ASEAN members, this does not seem very likely as long as the members are involved in fierce competition of this kind. A high degree of integration will probably not develop until a new map of the division of labor has been drawn. This demands the development of new economic strategies that draws on the countries' latent comparative advantages, such that one profits from indigenous skills and resource endowments. With China doing the mass manufacturing, the other countries will have to do some thinking and become a bit more refined.

## 9) Conclusion

Three main factors have been contributing to growth in East Asia in 2002. These are i) strong consumption growth, ii) a rebound in exports to the developed world, and iii) a large increase in exports to China. While the contribution of the first factor seems to fade away, and the importance of the second factor might increase in 2003, it is the third factor and, in general, China's influence on the region that seems to be the most important factor.

While it seems quite clear that growth in China will continue to be strong, there is no guarantee that the Chinese success will spill over on other East Asian economies. Chinese production will gradually expand into the more value-added parts of the production process, threatening the livelihood of for instance South Korea and Taiwan. Increases in productivity and large economies of scale will depress export prices further, and profit margins in the production of goods in direct competition with Chinese producers will probably be low. While exports to China of the products other East Asian countries produce might continue to grow substantially for some time to come, it seems clear that other Asian nations will have to develop expertise in new areas. Developing differentiated products and intellectual property gives pricing power and profits. It will also be important to be able to supply differentiated products to the Chinese market when demand there picks up further. To some extent Chinese demand will be directed towards commodities, and some of the resource rich countries in the region can benefit from this. However, strong growth will probably be based on finding and developing true and subtler comparative advantages. Nobody would like to be in direct competition with China in the coming years, and the entire value chain of the products China is currently involved in producing might be threatened by Chinese expansion. A smart strategy will probably be to look at what the Chinese are not good at, and what they can't possibly become good at.

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