NOMURA

ASIA PACIFIC

ASIA ECONOMIES

THE TIGERS RE-EMERGE

Macro Team

The tigers re-emerge

The Asian miracle is reviving. Asian savings and investment rates remain high. Asia dominates foreign direct investment (FDI) into emerging markets.

Investment funds are being used more efficiently. Labour is more mobile. Uncompetitive prestige projects are being starved of funds. Vast sums of money previously squandered on asset inflation now flow into real production. Asian economies are becoming more open, more competitive, and more receptive to foreign investment. Furthermore, investors have raised standards for profitability and transparency.

The Asian crisis of 1997-98 was short-lived, prompted by abuse of mechanisms that channelled vast amounts of funds into certain sectors (Thai real estate, South Korean chaebol), creating asset bubbles.

The Asian crisis also reflected political complacency, after economic urgency driven for decades by fear of communist aggression. Such fears are in the past, but pressure ushered in on the heels of globalisation will provide an impetus for decisive reform.

China is engaged in one of history's most ambitious reforms. Laying off 40m state enterprise workers and cutting the government in half should result in a vastly more efficient use of resources.

Meanwhile, in Japan the resource re-allocation process is progressing more slowly, but it is tangible.

The hi-tech revolution is transforming key Asian economies. Korea and Taiwan are becoming leaders in the global hi-tech revolution, Hong Kong is becoming the world's premier Internet economy, China is about to become a technology force, and Singapore has surpassed Japan as the world's second-largest recipient of FDI in technology.

Although South-east Asian economies perform well in a global perspective, North-east Asian economies are surpassing them.

A revival of high economic growth should mean a revival of high earnings growth — unlike the situation in the years leading up to the crisis, when investment was geared around asset inflation.

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William H. Overholt

The drivers of growth persist

The Asian miracle is reviving. Our analysis indicates that the principal long-term drivers of Asian growth remain vigorous, despite a painful crisis in the late-1990s. The false god of asset-price inflation has been banished as a growth source, but the traditional drivers of real growth persist and are being supplemented by corporate restructuring, bank restructuring, labour re-allocation, and a drive into the new world of hi-tech.

High savings and investment rates

High Asian savings rates will continue to provide a large pool of investable funds, and the available opportunities mean that these funds will continue to garner high rates of return. As the table below shows, these savings rates are deeply entrenched in Asian economies bar the Philippines. After the crisis, the practice of deliberately channelling exceptionally large amounts of capital, or inexpensive capital, into key sectors will diminish. Although this practice was fruitful at an early stage of growth, when the private sector lacked a critical mass of capital, over time it led to the creation of massive financial bubbles. For instance, in the early days of South Korea it was useful for the government to ensure that some companies had sufficient capital to become large-scale exporters. But three decades later, such practices just ensured the emergence of bloated chaebol (conglomerates) that over-invested in unproductive enterprises and paid their workers twice as much as international competition.

Gross domestic savings

	% of GDP
China	43
Hong Kong	31
Indonesia	31
South Korea	34
Malaysia	44
Philippines	15
Singapore	51
Taiwan	25
Thailand	36

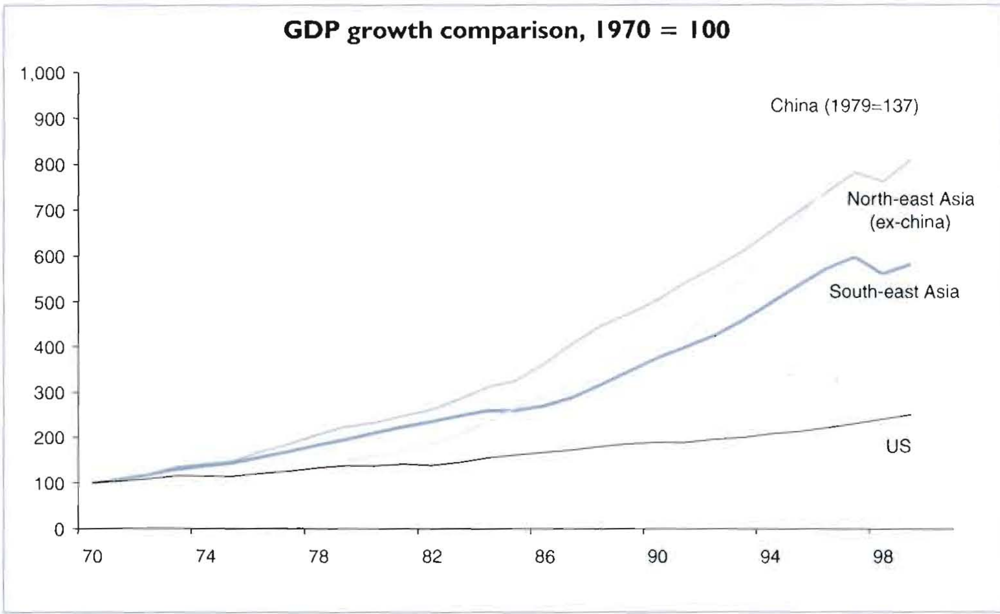
Source: UNDP

Efficiency of investment rising

In the absence of this discredited use of targeted and subsidised credit to spur growth, the efficiency with which capital and labour are used will rise. In the wake of the late-1990s crisis: company restructuring will spur more efficient capital usage; modernisation of banks will lead them to deploy capital with more concern for creditworthiness; and, with caveats for hi-tech stocks, most of the Asian business community has switched to focusing on real value creation as opposed to focusing on asset inflation.

Miracle growth exceeded 7%

In 1965-1995, the smaller Asian economies grew at around 7% per annum (pa), the first time in known world history that a group of economies with such diversity and large populations had grown so fast. This surging growth changed the course of Asia, not only defeating communism in the smaller countries but seducing China into moving from a strategy of suppressing the market and of revolutionary upheaval to a market-oriented strategy of joining the system. The chart over the page shows the differences in outcome between Asian and US GDP growth rates; over time, the differences compound spectacularly. The chart also shows that even if one includes the crisis years, average Asian growth rates have been robust. They are now in the process of rebounding to around their historical levels.



Source: IMF, International Financial Statistics

Average annual growth rates

1970-1999	(%)
China*	9.6
Hong Kong	6.8
Indonesia	5.9
South Korea	7.6
Malaysia	7.0
Philippines	3.5
Singapore	8.2
Taiwan	8.2
Thailand	6.7
US	3.1

Note: *China growth is for 1979-1999
Source: IMF, International Financial Statistics

China should lead

Our analysis suggests that China will lead the next phase of the Asian miracle. China's restructuring to make better use of its resources is unparalleled in world history. It is laying off 40m-plus people in state enterprises (around 40m), government (4m), and military (0.5m). More than 100m people have moved to more productive work in the cities from rural areas, and 250m extra will eventually follow. This forecast of China's growth hinges on China's ability to persist with reform over the next few years.

South Korea is restructuring and going more hi-tech

South Korea is restructuring its chaebol, introducing labour mobility, and transforming its banks from automatic teller machines (ATMs) directed by the government to real banks dancing to the tune of the market. The resources liberated by this widespread restructuring exercise are providing turbo power to its traditional industries and to the take-off of its world-class computer chip and telecoms industries. Samsung Electronics (0593 KS, W352,500, not covered) is now the world's largest DRAM maker. The government has also spurred a proliferation of entrepreneurship in this formerly bureaucratic economy, and as a result the Kosdaq has become South Korea's Nasdaq equivalent, making it one of the world's most exciting markets.

Taiwan is now a global hi-tech leader

Taiwan has become an economy that specialises in dissecting any industry's value chain, from shoes to computer chips, and reconstructing it in a more efficient way than any other economy. This island economy dominates whole hi-tech sectors, for instance making 90% of the world's computer scanners. It created the chip foundry business. Furthermore, the world's largest maker of laptop computers and its two largest PC-motherboard makers are both Taiwanese. Taiwan is the greatest beneficiary of outsourcing contracts from Japan and elsewhere, and conversely is the greatest outsourcer to China. But Taiwan has gone far beyond being the outsourcing recipient of Japanese technology; now it frequently will invent a range of laptops and then allow a top Japanese company to decide which of the Taiwan laptops will be marketed under the Japanese brand name.

Hong Kong: the world's premier Internet economy

Hong Kong may well become the world's leading Internet-based economy. In addition, the Hong Kong economy has emerged as more of an empire than an enclave. Hong Kong now employs well over 5m workers in China and several million elsewhere. It manages offshore trade worth well over HK$1trn a year. Added to this, 30,000-plus Hong Kong companies package complex services and have managed to get the time from imagination of a new fashion line to delivery down to five weeks from 11 months; exploiting the Internet should cut this to two weeks. The management of such functions, plus Hong Kong's regional financial function, can probably gain more from hi-tech communications and Internet business systems than any other economy in the world. Hong Kong's current Internet fever is making this transition happen quickly, and Hong Kong's fruitful alliance with the emerging Chinese hi-tech zones of neighbouring Shenzhen and the Beijing suburbs is adding to its hi-tech prowess. Since the onset of the crisis, Hong Kong's real estate prices have halved, and the government has committed to release enough land to break the traditional Hong Kong property inflation cycle. As a result, the money that used to go into asset inflation is being funnelled into hi-tech investment, a pattern visible in many Asian economies but one that is being implemented faster in Hong Kong.

Singapore: the world's leading hi-tech export platform...

Singapore, in addition to being a regional financial centre, has surpassed Japan and is second only to Germany as a destination for FDI in hi-tech manufacturing. In fact, Singapore is restructuring its whole society; banking, fund management, law, and many other industries are being liberalised. Beyond that, Singapore is freeing up the press, reforming its education system, and looking around the world to attract the best management education systems and most innovative people to Singapore. While not as radical as China's reform, Singapore's effort to remake the shape of its society is visionary and impressive. The result will be a more market-oriented economy and more efficient use of the nation's resources.

...with visionary liberalisation

South-east Asia lags

Not all Asian economies will do equally well. While North-east Asia is making a leap into the hi-tech arena, and is quickly becoming an innovative, leading-edge partner of first-world economies, in general South-east Asian economies are likely to underperform those of North-east Asia over the next five years. The gap between the two areas of East Asia will grow dramatically. North-east Asia is becoming largely part of the world's "new economy", while South-east Asia, Singapore aside, so far is largely entrenched in the "old economy".

Thailand: feeble banks, lacklustre education

Thailand has a diversified and competitive economy with a high savings rate, and still exports traditional products successfully. It is the logical assembly capital for goods like cars and white goods that do not require high education levels but do benefit from the country's level playing field that is less available in neighbouring countries. For instance, Thailand allows all auto companies to compete equally, whereas Indonesia, Malaysia, and South Korea have always heavily favoured domestic producers. Longer term, Thailand's agriculture and agriculture-based products could provide many years of growth. That said, the country faces challenges too. In the short term, Thailand has not fixed its banks as decisively as most of its peers. In the longer term, Thailand has not educated its people and will pay dearly for this failing. Thai wages have risen to a point where China can chip away at Thailand's market share in low-tech products, but with only 14% graduating from high school, Thailand cannot move up into hi-tech industries and services the way South Korea, Taiwan, Hong Kong, Singapore and even Malaysia have done. This is not to say that Thailand will perform poorly by world standards, but next to North-east Asian economies it looks poised slip further behind.

Malaysia: vigorous growth, but potential bubble

Meanwhile, Malaysia is growing vigorously. Its economy is diversified, and it has fixed its banks faster than Thailand and educated its people better too. Malaysia is a leading centre for hi-tech assembly and is the export platform of choice for industries that have come to find Singapore too costly. But Malaysia has its problems too. FDI is waning, concerned over rapid rules changes. Malaysia's large companies depend on political connections, and the market fears that political shifts will affect company performance. Research by our regional economist Paul Alapat shows that Malaysia's electronics business is head-to-head with China and that it remains competitive only by keeping a lid on the ringgit's appreciation. But suppression of the exchange rate may in time create financial bubbles that could prompt a reprise of the Asian crisis, but this time limited to Malaysia. Thus rapid economic growth and accumulation of reserves, in tandem with rapid equity market appreciation, are being purchased at what could become a high price in the future. This is a dilemma that Malaysia can eventually resolve only by vigorous industrial restructuring coupled with a willingness to let its exchange rate move to market levels.

Philippines: no reform, no miracle

Meanwhile, people in the Philippines benefit from high education standards and using English virtually as a native language, but their government fritters away this advantage. The virtues of vigorous economic reform have not caught on in the Philippines, where the local version of democracy entrenches a protected élite whose privileges reduce the efficiency of investment and limit the scale of desperately needed infrastructure investment. The courts, which are highly intrusive, are more instruments of socially powerful families than instruments of justice, and conservative judicial rulings often unnerve overseas investors. As indicated by the chart on long-term growth, the Philippines never participated in the Asian miracle and there is no prospect that the future will be any different from the past.

Indonesia: high risk, high potential gain

Indonesia's situation is both more risky and more full of potential. Investors in Indonesia fear a break-up of the country and show concern over the government's ability to collect enough revenue to cover its promises. Such concerns rarely arise in the Philippines. But we do not think that Indonesia will shatter, and there is a powerful reform movement in Indonesia that has no counterpart in the Philippines. So Indonesia's post-Suharto instability carries upside as well as downside. We are cautiously projecting that it will achieve much of its upside potential, notwithstanding the drag of political problems and debt on a scale unmatched elsewhere in the normally fast-growing parts of Asia.

While Asia will have relative losers (Thailand, Philippines, Indonesia) as well as relative winners (South Korea, Hong Kong, Taiwan, China, Singapore), even the relative losers are winners in an absolute sense. The growth rates we expect for these countries will far outperform their developed world and most developing world competitors. A 5% growth rate is high by historical standards and by comparison with most of today's world.

Other forces for high growth: young populations, globalisation

In addition to the forces of banking reform, corporate reform, accelerated flow of FDI, and the hi-tech revolution, Asian growth will be high for two other reasons. Outside of Japan, Hong Kong and Singapore, Asia's populations are young, and the tide of younger, better-educated people into the workforce will both expand the workforce and bolster productivity. Second, globalisation will boost competitive pressures and thus sweep in greater efficiency. The great risk of the crisis was that Asia would turn its back on globalisation, in accordance with the rhetoric of Malaysia's Prime Minister Mahathir and to a lesser extent the policy positions of China's former prime minister, Li Peng. Luckily, the result of the crisis has been the opposite, namely a firm dedication to open economies, symbolised by Asean commitments to a Asian Free Trade Area, by Thailand's and South Korea's increased opening to foreign direct investment, and by China efforts to join the World Trade Organization (WTO).

High growth does not equal high risk in this case

One of the surprising points to emerge from analysis of the Asian economies is that the return to high growth is not being purchased at the cost of high risk. As the table below shows, most Asian countries have high reserves expressed in months of import coverage and low debt-service ratios. The traditional standard for forex cover of imports is three months, and the traditional standard for debt-service ratios is 20% or below. For foreign debt as a percentage of GDP, 100% seems too high.

The least risky economies are Taiwan, Singapore, and Hong Kong, and the riskiest appears to be Indonesia. While not shown in these figures, China has the greatest risk of a domestic banking meltdown, and Malaysia the greatest risk of a financial bubble.

Risk data

1999	Reserves Import cover	% of GDP	Total foreign debt % of exports (G&S)	Debt-service ratio % of exports (G&S)
China	9.6	17.0	73.3	9.7
Indonesia	6.5	94.4	265.0	43.3
Hong Kong	5.5	32.4	23.4	3.3
South Korea	5.8	39.0	94.2	20.8
Malaysia	5.0	57.5	49.1	8.4
Philippines	3.8	66.9	105.9	10.1
Singapore	7.9	12.2	7.4	2.1
Thailand	7.3	65.2	114.0	19.9
Taiwan	10.2	12.1	24.6	2.3

Source: Datastream

High growth again means high earnings

In the past, high economic growth has generated exceptional corporate-earnings growth and stock-market performance. That said, this was not true in the lead-up to the Asian economic crisis, since during that period corporate efforts focused upon management of asset inflation and on investment in marginal projects with little regard for return. For instance, in Thailand during the several years leading up to the bubble bursting, corporate earnings growth virtually disappeared and the stock market faltered. Now that property inflation has stabilised and over-investment has been penalised, we anticipate a return to the normal strong correlation between high economic growth and rapid corporate earnings growth.

Crisis recovery: robust but uneven

William H. Overholt

Asia's recovery is robust but the post-crisis reform process must continue well into the future. The crisis began with a bubble and foreign-debt crises in key countries, most notably Indonesia, South Korea, and Thailand. When the bubbles popped, for instance when the Thai real estate market bloated by huge numbers of unsaleable apartments at unsustainable prices finally collapsed, foreign loans were called in and everyone with foreign debt needed dollars at the same time. For a while this short squeeze, the greatest short squeeze in modern history, more than doubled the local price of dollars.

The preconditions of crisis have vanished

Today, except for Indonesia, the foreign-debt crises are completely gone. And the vulnerability to currency crisis is gone since the currency crisis was simply an aspect of the foreign-debt crisis; there is no huge overhang of short-term debt to create a potential short squeeze today. When Brazil devalued nearly a year ago, it barely caused a ripple in Asia. Had China devalued any time in the past year, it would have caused only minor ripples elsewhere. In the absence of the vulnerabilities created by huge bubbles and overhang of short-term foreign debt, speculators are impotent to cause anything more than minor, local currency and interest-rate, pressures.

Broad-based recovery

Consumption and exports up

Consumer demand has perked up everywhere. More strongly, exports are rising everywhere, partly owing to domestic demand from neighbouring countries, partly from the extraordinary world boom in electronics, and partly from recovery in Europe and Japan. The weak US dollar has been particularly helpful to the weakest recoveries and it has aided all economies in the region bar Japan. The main source of risk is not in Asia, but rather US interest rates and stock prices.

Reform takes time...

Notwithstanding the breadth of the recovery, what Asia has accomplished so far is just the beginning. Throwing economies into reverse, and cutting imports while exports rebuilt forex reserves, was the easiest part. The reorganisation of the huge South Korean and Japanese conglomerates will take many years. Furthermore, the restructuring of 70,000 illiquid and insolvent Thai companies and the transformation of Thailand's banks will take a long time. Thus far, Hong Kong has done no structural adjustment at all, only counter-cyclical policies, so reform has only just begun.

...but it is tangible

Despite this, reform is tangible. By the time reform is over, China will have laid off at least 32.5m people, more than ten Singapores or around the entire working population of Japan. By the time this is over Thailand will have six relatively competitive banks instead of 15 traditional, lethargic ones. South Korea will have real banks instead of finance ministry ATMs. Corporate South Korea and Japan will have experienced revolutions. Everywhere globalisation and transparency are becoming more widespread — decisively in some places, while more gradually in others.

Enhanced political accountability

Public scrutiny enhanced

Every crisis country is seeing an increase in government accountability. Whether one looks at the enhanced democracies of South Korea, Taiwan and Indonesia, the new freedom of information laws in Thailand, the demands from all significant Hong Kong political parties for early direct election of the chief executive, or even the increased questioning of government in Malaysia, there is at least some increase in public scrutiny, and an increase in government concern about public reactions, in every country.

Asia has dodged a bullet...

Japanese bank stabilisation saved Asia

Since we already take recovery for granted, it is useful to remind ourselves that as recently as January 1999 it was still possible that the world was going to spiral into a vicious circle triggered by the Asian financial crisis. Looming over the entire world was the risk of Japanese financial meltdown. If Japan had not stabilised its banking system, the political impact of a Japanese banking collapse on China could well have led to dissipation of much of the momentum of Chinese reform. And very serious Japanese problems could well have tipped the balance between what has been a continuing boom in the US and what could have been a stock-market collapse followed by recession. Had such a scenario occurred, then all this momentum toward globalisation and transparency could well have gone into reverse. We could then have been seeing the region led by politicians saying we have to turn inward, that we have to take extreme measures to insulate ourselves from the nasty speculators, that the trend toward openness and market liberalisation have been a disaster, and that along with capital and market controls must come greater political control to insulate people from dastardly foreign and domestic plots.

Such as what happened in Latin America in the 1930s. As with Asia today, Latin America had experienced a generation of increasing openness, increasing marketisation and a tremendous prosperity in which those who moved the fastest in the direction of open markets prospered most. But then, with the onset of the depression in the US and Europe, those who had opened most suffered most. Latin Americans learned the lesson that they must protect themselves with high barriers and myriad controls, and that belief persisted for half a century, from the early 1930s through much of the 1980s. It could have happened again. We have been lucky to some extent, and we have had wise leadership from many sources, including the US Federal Reserve Board, the leaders of most Asian countries, and Asia's educated middle classes. In February 1999, the Japanese banking system stabilised, and around that time the global electronics recovery kicked in.

...and is moving forward decisively

High growth, low inflation, liberalisation

Instead of falling backward, every Asian economy is growing satisfactorily, experiencing low inflation, liberalising domestic markets, liberalising international economic relationships and reforming banks. These processes occur at different rates in different countries, for instance more slowly in Malaysia than in South Korea, but they are occurring throughout Asia.

Labour and capital more productive

Everywhere we are seeing more productive labour and capital. Asia had fallen into an era where the entire region was focused on managing asset inflation as the secret of generating rapid wealth. In particular, the overseas Chinese business community had evolved from a gigantic trading business into a gigantic asset inflation enterprise. Now the focus is again on production, moving goods and ideas. Moreover, Asia is reducing investments in unnecessary steel mills and petrochemical projects and bolstering investment in production of goods for which there is genuine world demand and genuine local competitive advantage. Asia is moving from property to production, from prestige to profit.

Growth this year already vigorous

To reinforce the positive news on the growth side, over the page is a table of 1999 growth estimates and 2000 growth forecasts. The 2000 figures are all positive, all vigorous, and mostly not so driven by low bases as the 1999 figures were. But this reform process is going to take a long time. For example, until a year ago in South Korea, none of the banks had any substantial ability to do what normal banks do, namely to assess creditworthiness and to allocate capital to the most productive uses. All they knew was how to obey orders from the finance ministry — or sometimes from wherever they received the biggest bribes. Similarly, Hong Kong, which prides itself on being one of the world's freest economies, if not the world's freest, is very free in tradable goods but in services and many other aspects is a network for third-world-style cartels. It will take at least a decade to dismantle them, if they manage to achieve it. Likewise, the liberalisation begun in Singapore will take a decade minimum to achieve.

GDP forecasts

(%)	1999	2000
Australia	4.3	4
China	7.1	7.8
Hong Kong	1.7	5.2
Indonesia	-0.2	4.3
South Korea	10.5	8.2
Malaysia	4.7	6.3
Philippines	3.0	4.0
Singapore	5.4	6.0
Taiwan	5.6	7.1
Thailand	4.3	4.9

Sources: CEIC, Nomura International (HK) estimates

Lengthy reforms mean long-term growth

When many overseas pundits comment on the region, they say the reforms are not real, that they have not gone far enough. But such a view is shortsighted. These reforms are a change in the way societies operate, and the process of going through these reforms will create growth, enhance productivity and add to the wealth of Asian peoples for at least a decade. The reforms are large and real, but they are so vast that they will take considerable time. Journalists and ideologues may ask whether black has suddenly turned into white, and answer negatively, but the discipline of economics always locates growth in improvements at the margin. Asia's margins are moving fast.

The politics of recovery

Politics crucial for Asia's recovery

While there has been commentary about the negative side of Asian politics, especially crony capitalism, little note has been taken of the dog that did not bark in this recovery: we have not seen populations revolting against painful reforms. You have not had leaders mobilising their populations to say that all this is just work of nasty foreign speculators and that the reforms are just a form of neo-colonial repression. There has been some such talk, of course, just as there was real speculation during the crisis, but mostly Asian political leaders have emphasised a different point: we have critical domestic problems that we have to fix, and we are going to fix them ourselves. Even those leaders who have found it convenient to overemphasise foreign speculators and minimise the impact domestic financial bubbles have in fact spent almost all of their efforts fixing domestic problems and have devoted negligible effort to castigating foreigners. This symbolises political maturity. In fact, it is probably reasonable to wonder whether, in similar circumstances, G-7 leaders would have provided such clear direction and whether G-7 interest groups would have accepted such rapid change and such huge short-term sacrifices.

Singapore: bonds of trust

Singapore's smooth adjustment to the crisis reflected a bond of trust between the people and the government, something unparalleled anywhere else in the region or probably in the world. After hearing a coherent explanation from their leaders, and watching them accept the first income cuts, the population willingly accepted wage cuts together with further large reductions in standards of living through deliberate currency depreciation. Having lived in Singapore during much the period, this writer can confirm that this acceptance resulted primarily from strong bonds of trust between government and people, not from authoritarian controls.

South Korea: middle-class consensus

In South Korea an extraordinary middle-class consensus enabled the reformist government to defy some of the most powerful enemies of reform in the world, namely the five chaebol that controlled well over half of the economy together with some of the world's most intransigent labour unions. In Hong Kong and Taiwan there has been solid support for doing the right things despite all the political noise you have around these different systems in Hong Kong and Taiwan. In Malaysia and Thailand, where there has not been the same degree of political trust, educated public opinion, and middle-class consensus, reforms have been somewhat less decisive but have nonetheless gone forward.

China: authoritarianism that delivers

China has followed the old Asian formula of the Park Chung Hee era in South Korea, imposing reforms on a largely peasant society but has obtained support since almost everyone has benefited from two decades of reform and since the educated class and most of the politically aware believe that in the current squeeze the government is doing its best in a trying situation. The degree of support in China's elite universities is remarkable for a third-word country. In contrast, Suharto's Indonesia, which lacked an educated workforce, a middle-class political structure, and trust between the government and people, could achieve little reform.

Reform fatigue occurs, but offset by opposition disarray

We can see that most Asian countries have had responsible and forward-looking leadership, together with more public support than most observers expected. Having said that, political fatigue is setting in. The popularity of South Korea's Kim Dae Jung, the leading reformer among the smaller countries, is down to dangerous levels of 30-35% support from 60-65%. For the first time Thailand's Chuan Leekpai, also a forward-looking leader, is at risk in the next election. China's Zhu Rongji received a pummelling in 1999, with reform opponents taking advantage of the US initial rebuff on WTO plus the bombing of China's embassy in Belgrade. So even the best reformers have suffered. But in every case so far, the reformers have been saved by the political and intellectual incoherence of the opposition. Whether it is Chavalit in Thailand, Li Peng in China, or the near-faceless opposition leadership in South Korea, oppositions have come across as divided, backward-looking, and controlled by reactionary interest groups. In most cases this is saving the reformers and giving them a chance to complete their tasks.

Geopolitical evolution of the Asian miracle

Let us now shift to a broader view of the politics of Asian economic management. What were the political origins of the Asian miracle in the first place? What has changed? This writer has argued for many years that the Asian miracle originated out of geopolitical fear. Economics is mostly about greed and fear, but economists define fear too narrowly.

Miracle Asia was dominated by fear

During 1950-80, Asia was driven by fear. Every country bar the Philippines was scared. South Korea feared a North Korea that was economically and militarily superior in the 1950s and 1960s and still had an overwhelming surprise-attack threat through much of the 1980s.[1] Meanwhile, Taiwan and Hong Kong were afraid of China, Thailand was afraid of Vietnam, Malaysia was concerned about Indonesia, and Singapore was afraid of just about everyone.

Desperate to overcome the threats from their neighbours, Asian countries tried various strategies. For instance, in the 1950s South Korea tried pouring all its resources into the military, and in 1960-61 it entrusted its fate to what turned out to be a premature and unstable democratisation. Eventually, Asians learned from each other that if they became fixated on economic performance, and if they chose the right economic strategy of gradual liberalisation, then they could pull together dispirited, fragmented societies at home and outperform communist foes abroad. As recently as the early-1980s it was conventional wisdom that the more open societies were always vulnerable to political upheaval but that communist systems were virtually invulnerable to overthrow. It was the Asian obsession with economic hyper-performance, together with communist economic failure, that overcame such "wisdom." The countries that did not discover that formula, namely Laos, Vietnam and Cambodia, basically

[1] The configurations of South Korean and North Korean forces are quite different. For many years, South Korean forces would have been superior in a long war but North Korea had an exceptional ability to launch a shattering surprise attack.

disappeared in their previous forms. Burma was geopolitically lucky but has become a hapless, starving economy and a polity that in recent decades has never had fewer than a dozen civil wars raging on its territory. However, the ones who did, led by Japan, South Korea, Taiwan and Singapore, have triumphed.

Fear forced ongoing reform

One consequence of that fear was a process of continual reform, of rapid implementation of reforms. Another part of it was that, if problems were appearing, Asian governments dealt with them quickly. Park Chung Hee in South Korea or Chiang Ching Kuo in Taiwan just did not let any financial or economic problem get too far out of control, since if they did the communists were going to get them. That knowledge and fear pervaded their approach to every problem. In politics, it made them less tolerant and more dictatorial. In economics it made them more centralised, more decisive, and underpinned their reformist zeal.

1990s: complacency emerged...

In the 1990s two things happened. One was that fear receded. The Soviet Union was gone. China basically changed sides, driving toward a market economy and seeking to join the system rather than to disrupt it. Geopolitically, Asians felt they were home free.

...and so did bubbles

Second, Asian governments' centralist allocation of credit, intended to accelerate growth and to enhance certain sectors, created financial bubbles. In earlier years, for instance, the South Korean government's allocation of huge volumes of cheap credit to the chaebol had served its intended purpose of stimulating rapid growth and of building up precisely those heavy industries that were most important for military defence against North Korea. But in the 1990s the same policies produced bloated conglomerates, burdened with overcapacity, incapable of making a profit, offering employees lifetime employment, and paying their workers more than twice what their peers elsewhere earned. Economists saw this, but nobody wanted to address it. The Kim Young Sam government tried to cover up the problems, and when it did, finally, make feeble efforts to address just one issue, namely the country's labour immobility, it was overwhelmed by opposition. Similarly, by 1995-96 Thai officials knew there was a real estate bubble emerging. Senior officials mentioned it in speeches, but in the mode of, well, some day somebody ought to think about doing something about that. Almost the entire political class was making money from the bubble, and there was so much feeling that everything would be all right no matter what they did, that the real estate and finance company bubble was allowed to spiral out of control. In short, Asia was plagued both by the bubbles that resulted from obsolete anti-communist economic policies and by the lack of communists to scare politicians into dealing with the imbalances.

New reform driver: globalisation replaces fear

Fortunately, Asia is unlikely to return to the kind of geopolitical fear that we had in the past. Communist aggression is gone and the greatest menace to Asian prosperity would appear to be "Greenies and Sweenies" (American for anti-globalist forces). But now globalisation has progressed to a degree that makes everyone vulnerable. Any economy that stops reforming for two or three years will find competitors taking away its markets. Of course, the existence of competition, the need to improve competitiveness by liberalising, has been an Asian reality for decades. Taiwan and South Korea chased Japan up-market, out of cheap shoes and shirts. Then Thailand and Malaysia chased South Korea and Taiwan up-market. But the process is accelerating. China is a giant new competitor, and it enters the competition not just on the level of cheap shirts but rather on many levels: enough shirts to clothe the entire human population and enough computers from Legend Holdings (992 HK, HK$14.20, OUTPERFORM) to make Compaq number two in Asia this year. India and Latin America are becoming serious competitors for the first time, and new combinations of technology, marketing, and fashion are prompting the US back into the garment business.

This more dynamic global economy is appealing in a more balanced way to greed and fear than did the communist threat. The "new economy" creates more pressure for openness, accountability, and freer markets, whereas the old geopolitics provided justification for the decisiveness that seemed to come from dictatorship and financial controls, but globalisation provides enough adrenaline that the mid-1990s era of complacency will likely be seen by historians as a blip.

Revival of political priorities?

Political risks to renewed miracle: Taiwan and South Korea

Two to five years from now we are unlikely to be much concerned about economic vulnerabilities. We are going to be back to major political issues. China is going to be the most dynamic force. Japan will remain a far larger economy, but the force that is accelerating, changing, and challenging, will be China. Managing the rise of China is the great issue of this generation. Among the smaller countries, the headlines on the front pages of the newspapers will probably concern a North Korea collapse. And the eventual outcome in the Koreas may well be decided during the next two or three months in Taiwan. If the recent Taiwan election reinforces the drive toward incremental independence, then we are going to have a crisis among China, Taiwan and the US. Then, when North Korea implodes, China will say, we are not going to let an ally of America's with all those US troops get close to our Yalu River border. If on the contrary the Taiwan-China issue heads back toward rapprochement and stability, then when the Korean debacle comes the Chinese are going to say, well, it is embarrassing but inevitable, let it happen.[2] Which of these two outcomes will occur, not economic recovery questions, is the great issue of Asia in the two-to-five-year future.

Let us now focus on what is happening in the two big economies, Japan and China. Then we will assess one success story and one less successful story among the smaller economies.

The big economy drivers I: Japan's slow reform

Two myths about Japan

What is going on in Japan? The Western view is that Japan in the 1990s is the US in the 1930s; if they just stimulate demand by running larger deficits, then the problem of inadequate demand will be resolved and everything will be fine. The story one hears from much of the Japanese establishment is that Japan is involved in a financial asset adjustment and the only thing to do is to wait until people have saved enough to offset the financial imbalances cause by the collapse of asset prices a decade ago. But these images of the Japanese economy are too abstract to describe the reality of a Japanese economy that is in chronic trouble not owing to macro-financial imbalances but rather structural weaknesses that the government has been slow to address. Both the Western and Japanese establishment images of Japan are far of the mark since they ignore the possibility of massive structural change of the kind that is occurring elsewhere in Asia. Other countries do far-reaching reforms of their industrial structure and become far more competitive, with much higher growth. Japan does not have to remain passive about corporate structure while fiddling with the money supply or waiting for accounts to refill with savings.

Japan as a structural adjustment case

One can liken Japan to a human. This person has, first of all, a tennis player's right arm consisting of car and consumer electronics industries that are so competitive that under any conditions this right arm will win. High yen, low yen, weak world economy, strong world economy, this right arm is always going to win. Then you have the body of the Japanese economy; property, retailing, construction and so forth. This is a gourmand's body after eating bankers' lunches for 30 years. Domestically, this body is divided into cartels, internationally it is protected, and it has all the same problems the US midwest had in the early to mid-1980s when economists

[2] These comments are based on reports from meetings between unofficial but very senior delegations of Chinese and South Koreans.

called it the Rust Belt. The US steel companies and auto companies had not faced international competition before and had become complacent and uncompetitive. When the South Koreans and the Japanese showed up, the US firms nearly collapsed. However, ten years of vigorous international exercise competition took the rust out of the Rust Belt, and after great pain these companies became globally competitive. Today companies like Ford are world class and in some cases are acquiring their Japanese and South Korean counterparts. Japan has begun that process but it is not very far into it. Much of the core of the Japanese economy still has that Rust Belt quality, that banker-gourmand's stomach that needs a decade of vigorous competitive exercise.

And then you have the cancerous lungs, Japan's financial system. As the Japanese banks descended into crisis, instead of performing surgery to remove the worst banks and allow redeployment of their capital to stronger institutions, the Japanese government let the cancer flourish until there was no healthy tissue, until there was not one commercial bank in Japan that was sound. Today, reform is occurring but the extent of the cancer is still so great that normal surgery remains impossible. For instance, if the government did not guarantee 100% of all bank deposits, the financial system might collapse, but with such guarantees an unhealthy degree of moral hazard persists and incentives to reform remain inadequate.

This problem is not primarily cyclical, not one which government stimulation by itself could provide cure. It is not just a matter of waiting for savings to repair balance sheets. The only full cure is vigorous international competition for domestic industry and revolutionary changes of management and redeployment of capital for the banking system.

Japan is adjusting and recovering, albeit slowly

While progress has been slow, Japan has finally started down that road and made considerable headway. Until January of last year, every security in Asia was simply an option on an unstable Japanese banking system. Then, in February 1999, the Japanese banks became so scared by collapse of the bond market, and the consequent collapse of bank capital, that the owners agreed to take government money and to dilute their equity. As a result, all of Asia was financially stabilised.

Japanese financial drag on Asia has lifted; contribution is accelerating

Until then, capital adequacy problems had required the Japanese banks to pare down their assets in Asia, for instance pulling over US$200bn out of Asia through the two financial hubs, Hong Kong and Singapore. Faced with depletion of their capital by bad loans at home, Japanese banks had to contract their assets by selling or reducing their good loans abroad in one of the great liquidations of financial history. This deprived the rest of Asia of growth capital, raised interest rates, and threatened currency regimes. That process has now ceased. We expect it to reverse and go the other way shortly. As mentioned earlier, the process of outsourcing from Japan is accelerating again. Outsourcing pushes capital into the smaller economies and pulls imports back from them. Separately, trade recovery started with the smaller Asian countries stimulating the large Japanese producers, increasing orders from the Japanese electronics companies and thereby reviving them, but now Japanese imports from the smaller Asian countries have grown more than 20%, so the process is mutual.

Portfolio flows from Japan to the rest of Asia have yet to revive. We expect that to begin next quarter. So this process of Japanese recovery, slow as it has been, is starting to underpin Asian recovery.

The big economy drivers II: China's heroic reform

China has the old Asia fear

China has been the opposite story from Japan. By 1994, China's leaders foresaw a crisis if they did not undertake radical reforms. From the beginning, despite contrary ideological predilections, they saw the state enterprises as the core of the problem and understood that state-enterprise losses, if not stemmed, would lead to a banking collapse. They were determined to prevent such a crisis. To do so, instead of following politics as usual, they installed a tough anti-politician, Zhu Rongji, as prime minister — the rough equivalent of making Paul Volcker US president. This is what South Korea did in 1961 when it accepted Park Chung Hee; fear of collapse created a public mood in which, rather than choose a leader by garnering the support of a majority of interest groups, support coalesced around a leader who would step on the toes of all interest groups. The Soviet Union's collapse, and the superior performance of all of China's ideological adversaries, created an analogue of the geopolitical fear that had driven the smaller countries from the 1960s through the 1980s. This process began with the rise of Deng Xiaoping in the late 1970s, but it rose to a new threshold post-1989.

China's problem parallels South Korea's...

China's crisis is structurally identical to South Korea's, but the response to problems has been radically different. Like the South Koreans, the Chinese told their banks to give all their funds to favourite firms — state enterprises in China, chaebol in South Korea. The favoured firms accepted the cheap money and invested it in lifetime employment and about 30% overcapacity in almost every industry. In both cases, such misallocation was financially unsustainable and endangered the banking system. The difference is the Chinese saw it coming and acted before the banking system collapsed.

...but the response is more proactive

Never in modern Asian history has there been a reform like that the Chinese are trying to do. They're trying to cut their government in half. (Imagine any other government trying to cut itself in half in three years.) They got their military largely out of business in one year. (Imagine trying to get the Indonesian or Thai military out of business in one year.) They are reforming the banks, reforming state enterprises, and in the process laying off the equivalent of two-thirds of the entire working population of Japan in only three years. The result of this, one would expect, would be a tremendous upheaval. The actual result has been exactly the opposite.

Signs of recovery

China's recovery began with exports and consumers have begun to follow. The majority of layoffs are now behind it, growth is expected to be higher this year than in the past, exports are rising fast, consumption is recovering, imports are recovering, and consumer confidence is riding high. If you saw consumer confidence extremely high in Japan one would say, ah, we are home free. In China it is present now. Most significantly, the character of China's growth is changing. Through the third quarter of 1999, the economy was growing almost exclusively on the heels of government deficits, and the government was spending RMB3 for every RMB1 of growth; clearly that could not be sustained for more than a few years. Fortunately, that focus on government-stimulated fixed-asset investment is now waning, even while growth is accelerating. Thus, the green shoots of a Chinese recovery are appearing.

Reforms accelerating

Even before recovery began, the Chinese started accelerating their reforms, accelerating housing liberalisation, promising interest-rate liberalisation, letting foreign banks and companies into renminbi markets faster, opening their insurance markets, joining the WTO, enhancing their securities markets in a wide variety of ways, upgrading their constitutional status of private enterprise, giving private enterprises status for banking, tax treatment, and land allocation, and so on. So while everyone else is tiring, the Chinese are stepping up their reforms.

Residual problems are daunting

China must work itself out from under a huge burden. The government's debt burden plus the debts of its banks and state enterprises may amount to 100% of GDP. But China's reforms appear to be leading to a recovery that will sustain growth at Asian-miracle rates and will strongly support the growth of other Asian economies, particularly Hong Kong and Taiwan.

Winners and losers

Havens of trust: Hong Kong and Singapore; and bastions of technology, Taiwan and South Korea

Among the smaller countries, there are two categories of big winners. Singapore and Hong Kong provide havens of honesty, trust, skill and market flexibility. In the post-crisis environment such qualities are valued more than ever, and there is a "flight to quality". Put another way, the two city states are the regional financial centres and regional corporate headquarters and all their competitors have just died. So they are the financial winners. South Korea and Taiwan are the technological winners, whose leap into the hi-tech world makes them first-class global players rather than just consumers of the crumbs thrown away by Japan. We are out of the era when Japanese companies shed their obsolete technologies to Taiwan and into the era when a Taiwan company invents five new laptops and asks the Japanese company which of the five it should manufacture under the Japanese brand.

The relative losers, who are not going to do badly if you compare them with Latin Americans, Africans, and Eastern Europeans, are those that have not reformed fast enough to remain at the forefront and those who have not invested sufficiently in their people to have a shot at the financial or technological first team. Most noteworthy among these are the Philippines and Thailand.

The Philippines: insufficient fear

The Philippines has always been a country that was not scared. People in the Philippines were not scared since they had US bases, so they have always operated like a Latin American country. More precisely, the Philippines had some reformist drive for exactly one presidential term, the term of President Ramos after the US bases were expelled, but reformism was limited then and has dissipated now.

We highlight the contrasts between the winners, mostly North-east Asian, and the relative (we stress relative) losers, mostly South-east Asian, by focusing on the details of one of each.

One key winner: Hong Kong

A winner that initially appears a loser

At first glance, Hong Kong appears a clear loser. In GDP growth its economy was the worst performer of 1999 other than Indonesia. Hong Kong's direct exports are declining and its re-exports are relatively stagnant. Its government was so preoccupied with the transition to Chinese sovereignty, and so divided between hostile legislature and executive, that it undertook virtually no structural reform. This situation presented the sharpest imaginable contrast with Singapore, where the government immediately saw the necessity for wide-ranging structural reforms and committed itself to an inspiring plan to liberalise and upgrade the Singapore economy. To make the situation worse, Hong Kong's economy has been known as a property-based economy, and now property prices have plummeted by half and the government says it will use its ability to release land to ensure that the old asset inflation cycle does not recur. Have we seen the last of dynamic Hong Kong?

A great manufacturing empire

Quite the opposite. The end of an obsession with asset inflation will release money and executive time for expansion of the real economy. And that real economy is quite different from the conventional wisdom surrounding it. Part of the conventional wisdom is that Hong Kong has no manufacturing. In fact, it is more focused on manufacturing than any other wealthy economy in the world. While a breakdown of Hong Kong's GDP shows that it is some 84% services, the majority of those services consist of managing manufacturing enterprises with factories that happen to be located outside Hong Kong. In all, 46% of Hong Kong's economy concerns manufacturing, with more than 5m workers employed by Hong Kong companies in China and millions more employed throughout the rest of Asia plus countries like Mauritius and Jamaica. In light of this, Hong Kong is more leveraged into the Asian recovery, and particularly into the Chinese recovery, than any other economy.

Profitable offshore trade

Closely connected to this offshore manufacturing are two other key facets of the Hong Kong economy. One is the rise in offshore trade. Hong Kong's lacklustre exports and re-export figures reflect the fact that direct manufacture and export of, for instance, blue jeans, was a 1960s business, while making them in Guangdong and re-exporting them through Hong Kong was a 1980s business. The new business, growing fast, is making them in places like Mauritius and Jamaica and exporting them directly to markets like the US. That business was worth more than HK$1trn in 1997 and growing fast, with 9.2%, or just under US$2,000 per capita, coming back to Hong Kong as profit.

Packager of complex services

Second, the rise of Hong Kong as the world's pre-eminent packager of complex services is accelerating. Currently a company like Li & Fung (494 HK, HK$31.40, OUTPERFORM) can take an order for a new line of garments from a European store, make prototypes, get them approved, buy yarn in South Korea, dye it in Taiwan, manufacture the garments in five factories in Thailand, arrange all the financing, insurance, and shipping, and have them on the shelves in Europe five weeks from receipt of the initial order. A few years ago, this process took 11 months, and soon it will take just three weeks. Hong Kong has no peers in this area; a Hong Kong Trade Development Council project will give all 30,000 Hong Kong companies engaged in this business the opportunity to do their business through an advanced Internet-trading system, and there is hope of cutting the time from order to delivery down to just two weeks.

Traditional roles too

Hong Kong's traditional roles as a regional financial centre and regional headquarters are also expanding fast. Hong Kong and Singapore are more pre-eminent in these areas than ever before, since the competition has collapsed and there is a regional "flight to quality".

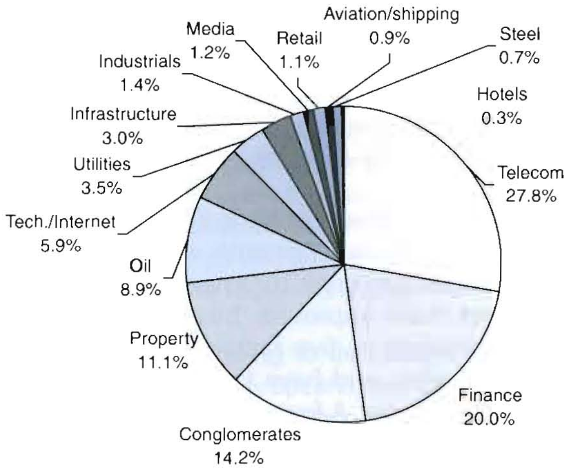
Hong Kong's private sector appears to be compensating for the government's inadequate response to the need for change. In autumn 1999, Hong Kong's Business and Professionals Federation published a plan for *Hong Kong As A World City*, and the government has endorsed the concept. Meanwhile, Hong Kong's private sector has developed a mania for hi-tech and electronic commerce, and Hong Kong's close ties to similar manias in Beijing and neighbouring Shenzhen promise that this business, particularly in Chinese-language forms, will develop on a huge scale. The rise of business-to-business (B2B) e-commerce should enhance Hong Kong's already great advantages in logistics, offshore manufacturing, offshore trade, and packaging of complex services.

More productive use of resources

The financial resources that used to be focused on property inflation are now available for investment in these sectors of real economic activity. The result is a rapid transformation of Hong Kong's economy. Three examples of this transformation can make this point. First, the signature business of Hong Kong, namely the family empire of Hong Kong tycoon Li Ka-shing, has been shifting from a concentration on property into the creation of a global port-management empire, with effective control of key aspects of the ports of Hong Kong, neighbouring Guangdong, Shanghai, Rotterdam, and the Panama Canal; a global telecommunications business through tie-ups with Mannesmann/Vodafone AirTouch and Global Crossing; and an Internet/hi-tech thrust through Pacific Century Cyberworks (1186 HK, HK$20.45, not covered). Second, Compaq is being surpassed as the leading manufacturer of personal computers by the Chinese company, Legend, which is listed in Hong Kong. Third, as indicated in the chart over the page by our head of Hong Kong research Mark Simpson, by end-2000 the Hong Kong stock market, previously known as a market dominated by property stocks, is expected to be a diversified market with the property sector little bigger than the previously non-existent oil sector.

This shows how rapidly an economy with a highly educated population and a responsiveness to the market can transform itself even in the absence of strong government support.

Projected end-2000 HSI constituents plus companies with US$1bn-cap (adjusted for upcoming IPOs)



Source: Nomura International (HK)

One relative loser: Thailand

Thailand has made tangible progress...

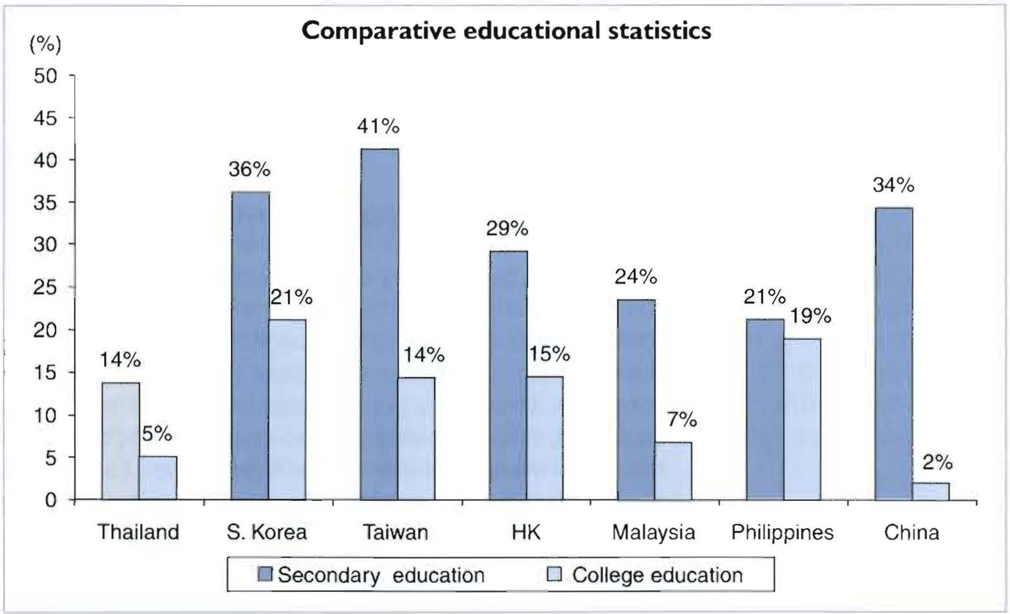
Thailand is coming up a relative loser. To be fair, the Thai government has accomplished a great deal, and some of its accomplishments are profound. It has stabilised the baht, resolved its debt crisis, restored its forex reserves, and in the process restored economic growth with low inflation. It has closed 58 defunct finance companies and set in motion processes that will change 15 troubled banks into what will probably be six better banks. The government has changed the constitution in ways that should cut political corruption. The military has a new dedication to professionalism, as indicated by the resignation of its top officer from the Senate when he was promoted to his new position. New freedom of information laws are opening up everything from government bureaucracy to political parities to police to university admissions. Changed attitudes are improving the way banks make loans and the way accountants audit companies. All this is most impressive.

...but key reforms are inadequate

That said, Thailand has both a serious short-term problem and serious long-term issues to fix. The short-term problem results from a reluctance to address decisively the most critical reforms. The Thais did not properly fix their banks. They did not change many of the old managements and they recapitalised their banks using complex instruments called SLIPs (stapled limited interest preferred shares) and CAPs (capital augmented preferred shares) that cost so much that they mostly just defer the real recapitalisation to a future date. While Thais nominally have been restructuring 70,000 corporations, in most cases they have just been reducing loan payments to the current cashflow of the companies; since most of the companies are not changing their structures, and since their banks are not taking needed write-offs, here again the problems are mostly just being deferred rather than solved. Closely related, Thailand has not allowed its real estate market to clear. Almost three years after the dawning of the crisis, there are few large property transactions and the government continues to base policy on property value indices that are pure fiction. Contrast this with Shanghai, where property prices have in many cases fallen 80% and the government allows the market to clear. Finally, with much fanfare, Thailand replaced a bad bankruptcy law, which allowed a defaulting debtor to stall for nine years, with a new bankruptcy law ostensibly intended to restore creditors' rights. But then lawyers discovered that the new law allows a debtor to stall for 11 years. Few potential creditors will find such a situation appealing.

Politics causes the inadequacies

These critical issues result from an elitist system where the financial leadership, the political leadership, and the corporate leadership overlap so much that decisive financial reform is politically impossible. For instance, the draft bankruptcy law was amended by the Senate, where some of the country's biggest debtors were able to rewrite the law in such a way as to protect most of their own interests at the expense of the country's need for ongoing access to credit. These financial problems are so deep-rooted that they will delay Thailand's full recovery well beyond that of Asian neighbours who have taken stronger action to fix their banks and restructure insolvent companies.



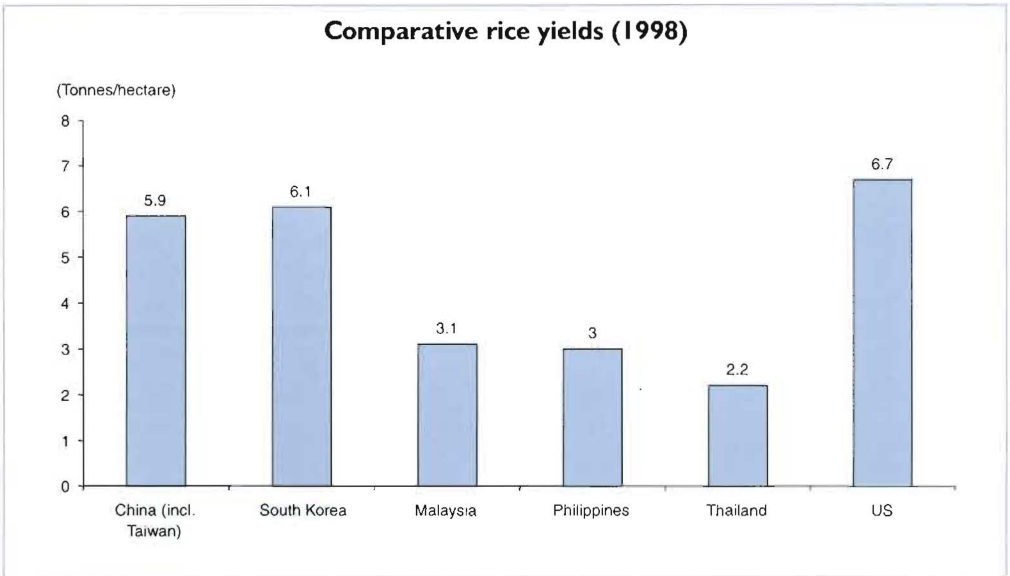
Source: UNDP

Elitist education the greatest drag

Thailand's long-run problem is an elitist educational system that has failed to provide Thai people with the skills to move up into a higher-technology world along with their Asian neighbours. In Thailand, as the chart above indicates, only 14% of the population completes secondary school. Everyone else does better, including China at 34%. Thus, China will gradually nibble away at Thailand's ability to produce cheap shirts and shoes competitively, and in the meantime Thailand will be hobbled in moving up into electronics and other hi-tech sectors à la Singapore and Malaysia.

Even rice production suffers from low education levels

The consequences are not confined to manufacturing. Thailand is the greatest rice exporter in the world, but as the chart below indicates, those yields are among the lowest in the world.



Source: UNDP

Trapped between China and Singapore

Thus Thailand is now trapped between China coming up at the bottom and other Asian economies above it and beside it moving into the higher-technology era. Thailand is not a loser in any absolute sense. It will emerge from the crisis more efficient than it was before. It will continue to benefit from high savings rates, an extremely diverse and competitive economy, and a government budget less saddled with recurrent deficits and interest group benefits than most Latin American and East European economies. In the medium term, it has considerable opportunity to expand in medium-tech areas, and it remains the Asian centre of choice for manufacturing products like vehicles and white goods. So it is not a loser in a global sense, but it is losing ground to Asian competition in the short run and it faces a long-term imperative: educate the population or become an absolute loser.

A serious but surmountable crisis

Post-crisis Asia will be leaner and fitter

Asia has not been fatally damaged by the regional financial crisis and in fact has been strengthened by it. It retains key traditional virtues, notably high savings rates, ability to discipline government budgets, responsiveness to the need for continued liberalisation, and awareness that the pace of globalisation must be measured. It continues to have a young population and a low dependency ratio. Although it stumbled, it has avoided the anti-globalist reaction of Latin America in the 1930s and the social irresponsibility of the Russian/East European spasmodic liberalisation. Like the US after the onset of the Depression, it is addressing the weaknesses of banking supervision and crony capitalism that created the financial bubbles. As with the US, it will take many years to move away from traditional business practices (note: not Asian values, but traditional business practices that were no different from early 20th-century US habits), but financial and competitive forces strongly under way are likely to ensure continued improvement.

In all of this, the big winners have connected with the market, fixed their banks, changed their managements, taken their losses, and educated their people. The relative losers have done some reform, but have protected their failed managements, coddled their banks, failed to allow their markets to clear, and above all have insufficiently educated their people.

We turn now to an estimate of Asia's growth after the crisis. Using the method described in the following section, and the detailed findings of the country analyses below, we arrive at the following forecasts for Asian economies in the years 2001-2005.

GDP growth projections

(%)	2001-2005
China	8.0
South Korea	6.2
Taiwan	6.8
Hong Kong	6.0
Singapore	5.9
Malaysia	7.0
Thailand	5.0
Indonesia	6.0
Philippines	4.7

Source: Nomura International (HK)

Quantifying growth prospects

Paul Alapat

Economic growth is the product of increases in the stock of capital and labour, factor productivity changes and technological progress. For an empirical assessment of historical growth, and as a guide to five-year growth projections for the nine Asian countries that follow, we adopt the incremental capital output ratio (ICOR) as our yardstick. This measure decomposes economic growth into the product of the gross fixed-capital formation share of gross domestic product and the inverse of the ICOR.

ICOR: the productivity of investment

Specifically, ICOR is measured as the gross fixed-capital formation in constant prices, divided by the change in gross domestic product in constant prices in the following year. In short, ICOR summarises how many units of capital are needed to generate an additional unit of output. It is a crude and simple tool, but it provides a quantifiable framework to launch our medium-term growth forecasts. In a continent with a generous supply of national savings ICOR gives a quick read on how productively those resources are being applied to generate economic growth. It provides an understanding of how much growth is being driven by capital accumulation and how much by all the other drivers of economic growth.

ICOR projections vs Solow growth model

ICOR more practical than Solow model

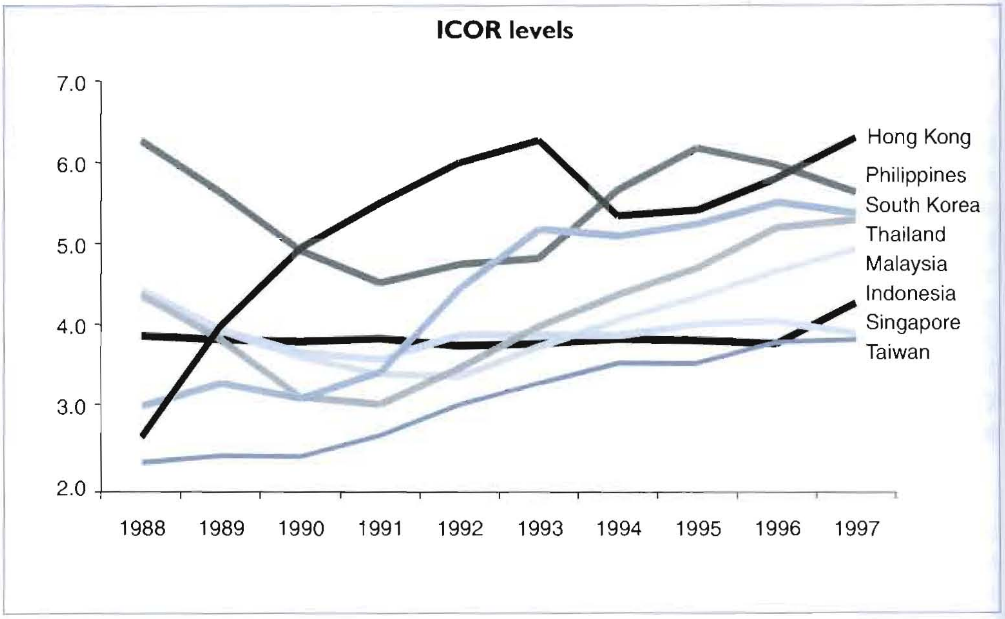
We have chosen to use the ICOR over the more-detailed Solow growth model to estimate future growth prospects for reasons of simplicity and reliability. The Solow model decomposes GDP growth into its constituents and then projects the sustainable GDP growth trend as a product of the trajectories of the different components. The neo-classical production function is used to allocate total national income to the shares of capital and labour. The consequent residual value, or the Solow residual, has variously been described as the total factor productivity growth and the "measure of our ignorance".

Though the Solow model provides the most detail on growth components, it makes challenging demands on data. Critically, it calls for data on educational attainment of the workforce and an estimate of the accumulated stock of capital within the country. Further, problems on the aggregation of labour inputs differentiated by age, gender, education and sectors have to be surmounted by recourse to heroic assumptions. Aggregating different types of physical capital is no less formidable.

In contrast, ICOR decomposes growth into only two components — capital accumulation (gross fixed investment) and capital productivity (the inverse of ICOR). The returns to workforce growth and technology changes are all captured within the ICOR variable. So while ICOR sacrifices detailed decomposition, it depends on a more solid foundation — the investment share of GDP and its productivity.

The tale of the tape — historical parameters

Using GDP data at constant prices from 1980, we decompose economic growth for the eight economies (Chinese data are available only in nominal terms and so ICOR for China is not presented here) to establish historical parameters for ICOR levels and changes. ICOR ratios are the net result of institutional arrangements, sectoral allocation of resources, workforce growth and technological changes, all of which change gradually over time. To capture the direction of this gradual change, we use five-year ICOR moving averages. Further, we drop out years with negative GDP growth or years with stagnant national income growth, which would distort the ICOR measures considerably.

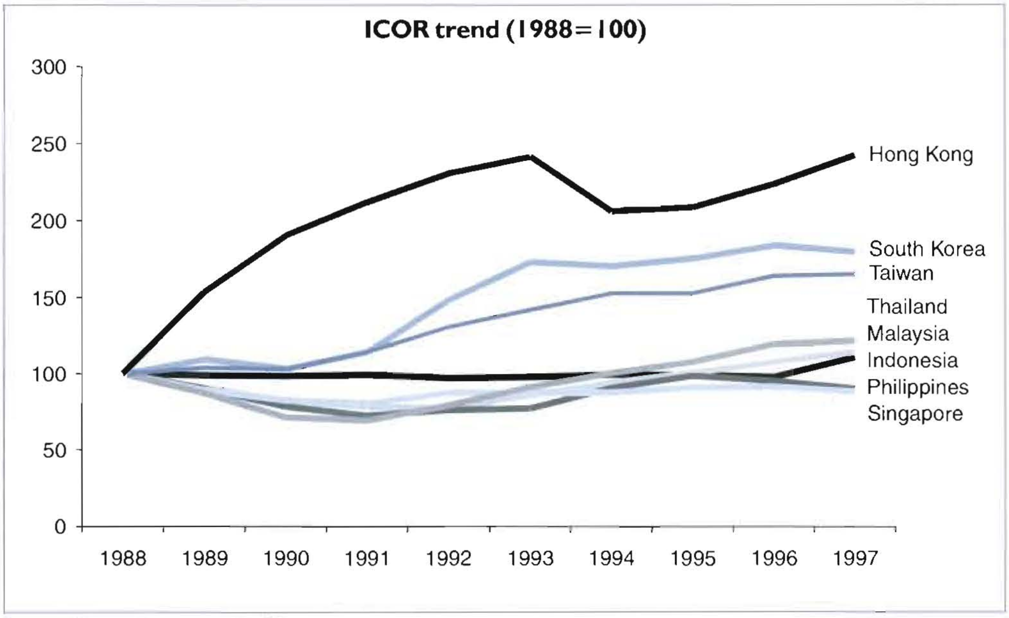


Source: Nomura International (HK)

Taiwan the most productive, the Philippines the least

ICOR level. In absolute ICOR measures, Taiwan comes out as the most productive over the period under study. Although Taiwan's ICOR has trended higher over the past decade, it still averages below that of all the economies in our study. South Korea and Hong Kong, which started 1988 with low ICOR values, have climbed above those of all others bar the Philippines. The South-east Asian economies began as relatively less efficient users of capital, but have been able to contain the deterioration in ICOR throughout the 1990s — most notably, Singapore and Indonesia. Of the South-east Asian economies, Thailand and Malaysia have been less successful in containing the increase in their respective ICOR. The Philippines started the decade with the worst ICOR and ended it no better; with the least productive use of its capital resources. A ranking of the levels of ICOR yields the following list: Taiwan, Singapore, Indonesia, Malaysia, South Korea, Thailand, Hong Kong and the Philippines.

These rankings must not be over-interpreted. They reflect much more than just the relative efficiency of capital usage. Taiwan undoubtedly is the most efficient user of capital. South Korea ranks relatively low, partly since the chaebol were using capital poorly but also since South Korea has focused on capital-intensive sectors such as cars, DRAMs, ships, and the like. Meanwhile, much of Hong Kong's investment is not allocated to Hong Kong and thus may not be incorporated its growth numbers. Thus, while the ratio of investment to growth in the past is a useful guide to what is likely to happen, comparisons between countries must only be done with care.



Source: Nomura International (HK)

Singapore best at controlling cost rises, Hong Kong the least

ICOR slope. The second dimension of ICOR is the speed of its change over the course of the 1990s. The North-east Asian economies witnessed the fastest ICOR deterioration, led by Hong Kong, and followed by South Korea and Taiwan. This appears to reflect the real estate bubble in Hong Kong, rising chaebol overcapacity in South Korea, and Taiwan's shift into more capital-intensive electronics production. By contrast, the South-east Asian economies saw limited ICOR increase, thanks partly to the early 1990s surge in exports and growth in that part of the world. Of these South-east Asian economies, Singapore has been the most successful in curbing the deterioration in its capital productivity, followed by Indonesia. From the slope of the ICOR curves, we gain the following ranking: Singapore, Indonesia, Philippines, Malaysia, Thailand, Taiwan, South Korea and Hong Kong.

Korea

Paul Alapat

Explosive growth for more than two deacdes

One of the greatest economic miracles in history catapulted South Korea into the ranks of the Organisation of Economic Co-operation and Development (OECD) from one of the poorest countries in the world in the 1960s. Driven by insecurity, fostered by government leadership, subsidised by bank credit, and fuelled by an educated labour force, GDP grew at an annual rate of 7.8% over the 20 years from 1975. This pace of growth is unrivalled among the high-income countries, and second only to China over this period. Notwithstanding the banking crisis and the regulatory shortcomings that stalled the Korean growth machine in 1998, the ingredients for strong growth remain. Growth in the initial years was powered by a sectoral shift from less productive to more efficient sectors; in the latter years, growth depended on increased application of physical capital. Looking ahead, we expect that the drivers of growth will come increasingly from productivity enhancements, anchored by human capital — as opposed to the physical-capital accumulation of the past decades.

Engines of growth

Among Asia's most qualified labour forces

Over the next five years, we expect the large pool of technically qualified manpower to be central to Korean growth. With 39% of those enrolled for tertiary education in science sectors, Korea possesses the key ingredient to keep it at the forefront of the information technology (IT) revolution, particularly in the telecoms and semiconductor sectors. Over time, this will underwrite Korea's entry into knowledge-intensive service sectors and help expand services' share of GDP from 50% currently closer to the 60% averaged in high-income economies. The increased application of "knowledge capital" to the production process should help raise overall factor productivity.

More discriminating resource allocation

One important by-product of the financial crisis has been the shift away from bank credit into bonds, equities and venture capital. Following the financial crisis and the policy-dictated ceiling of a debt-to-equity ratio of two for the top corporates, companies have rapidly reduced their traditional reliance on bank credit. The shift away from bank loans should promote gradual change in industrial ownership and greater discrimination in project selection; areas that have been the biggest barriers to productivity improvement in Korea.

Leadership in some frontier technologies...

Over the past few years, Korean companies have become world leaders in several frontier technology sectors. They are now the world's largest manufacturer of DRAM semiconductors, of mobile handsets, video recorders and Asia-ex Japan's largest producer of telecoms equipment. Korean companies occupy leading positions in digital television, MP3 machines, TFT-LCD, and appear well positioned to leverage off the global opportunities that technological change is throwing open in the information, communications and technology sectors. Korea has steadfastly shadowed Japan in promoting its domestic industry, and is finally closing the gap with Japanese producers in semiconductors, shipbuilding, automobiles and a range of electronics.

...should boost FDI and exports

The rich industrial base and the technically qualified labour pool will pull in more foreign capital and technology in the coming years — an added catalyst to growth. In 1998, Korea averaged FDI as a share of GDP of 1.5%, among the lowest in Asia. In the years ahead we expect that FDI/GDP ratio should climb closer to the Asian average of 4%.

Since the government embarked on trade liberalisation and export promotion in the 1970s, exports have expanded at close to 13% in constant prices — the driver of aggregate demand expansion in Korea. Exports are about 40% of GDP, and have been the critical engine to growth over the past decade and a half. As Korean companies complete their huge investments into information, communications and technology sectors and upgrade their quality, they will necessarily have to target global markets outside of Korea, given the limited size of the domestic market. More and more, we expect external demand to pace the growth in GDP.

Five-year growth projections

(5 years ending)	1997	2005F	2010F
GDP growth (% y-y)	7.1	6.2	7.2
Savings rate/GDP	35	33	34
Investment/GDP	38	33	36
ICOR average	5.4	5.3	5.0
Labour force growth (%)	1.9	1.8	1.7
Debt service/exports (%)	6.7	9.5	8.0
External debt/GDP (%)	28.3	26	24
External debt/exports (%)	90.5	65	60
Central govt budget/GDP (%)	0.1	-1	1
	1999 end	**2005 end**	**2010 end**
Public debt/GDP (%)	30	20	10

Source: Nomura International (HK)

Economic growth in Korea over the past 30 years has been backed by steady accumulation of physical capital. Gross fixed investment to GDP ratio has climbed by 10 percentage points in every decade — from 18% in the 1970s to 28% in the 1980s to 38% in the 1990s — until the economic crisis in 1998 brought a sharp cutback in investment. Going forward, we expect national savings to be the overriding constraint on domestic investment, given that the current account will have to be largely balanced in the post-crisis years.

Meanwhile, the diversion of public funds to support the financial system and servicing of that public debt will demand that the budget stays in deficit over the coming years. The increased government dis-saving is estimated to deduct 2% of GDP on an average from national savings in the next five years. Moreover, the gradually increasing dependency ratios will preclude household savings from increasing significantly.

Investment ratios will be constrained...

Declining savings and the need to generate modest current account surpluses to service the expected capital account outflows (external debt repayments) will decrease investment to GDP ratios five percentage points from the pre-crisis levels. This will be the primary drag on economic growth in the coming five years.

...growth will lean on productivity upgrades

Admittedly, the increased application of human capital, the technological changes underway, increased FDI participation and more discriminating financing sources will raise factor productivity in Korea. However, we expect the full impact of these productivity-enhancing changes only after 2005. In the next five years, we only look for a modest decline in ICOR, which will not be sufficient to offset the decrease in the investment ratio and the consequent slowdown in the sustainable growth trajectory to 6.2% from its pre-crisis 7.2% level. With unemployment rates above historical averages, the labour force is not seen as a constraint on growth over the coming decade. Neither is the availability of skilled labour. We estimate that the labour force will grow by 1.75% in the next decade.

Foreign reserves and fiscal position comfortable

Although Korea had to resort to IMF assistance for balance-of-payments (BOP) support during 1998 and 1999, the strong recovery in exports and the current account surplus has allowed the country to reinforce its external balances rapidly. External debt to GDP has been quickly scaled down from a peak of 46% in 1998 to 34% in 1999 and is seen to be brought back to pre-crisis levels over the next five years. Further, the huge base of exports looks comfortably placed to service the debt stock in the years ahead. The strong build-up of foreign exchange reserves provides an additional degree of comfort, with reserves at a healthy six months of imports and improving end-1999.

Meanwhile, the bailout of the financial sector and ongoing draw on public resour for recapitalising the investment trust companies (ITCs) is expected to raise total pul debt to 35% of GDP. However, given that Korea's public revenue to GDP is in excess 20%, the country has the fiscal resources and slippage into a debt trap is not a conce The issue is more about undermining the efficient use of resources considering government's enthusiasm for bailing out the private sector.

Key risks

Reform stalls

For now, the government has been pro-active in assisting the troubled banks a ITCs with public funds, provided they were big enough. While the planned reducti in deposit insurance coverage and the "hands off" promise will, theoretically, redu the problem of moral hazard, implementation is yet to be seen. Financial and corpor restructuring is not complete and a sharp economic recovery may undermine commitment to reform. The restructuring may remain mired in financial reschedul and fail to extend to 'operational' restructuring of corporates. Improvement corporate governance is not entrenched as yet and leaves the corporate, and banking system open to many of the same risks in the event of another econor slowdown and drop in confidence. Further, risk remains that the insolvent ITCs co be merged with the banking system and taxpayer funds called in for several m rounds of recapitalisation; the public debt and deficits are left unchecked and ch off funding for more productive sectors.

Chaebol dominance continued

Conglomerates could continue to dominate the corporate and financial landsca Though there is evidence of a shift of funding away from bank loans, there are a concerns that the chaebol have come to dominate the new sources of funding throu ownership of securities houses. In short, the chaebol continue to control the acc to funds and could subvert the process to more efficient allocation of resources.

Defending a niche between China and Japan

Korea stands out among the newly industrialised economies (NIEs) with its continu heavy reliance on industry as a share of GDP. From a 38% share of GDP in 19 manufacturing has expanded to 43% by 1998. The continued dependence manufacturing and its proximity to China make Korea particularly vulnerable to growing manufacturing base in China — more so once WTO entry adds to FDI inflo and Chinese production prowess. At the upper end of the manufacturing sec superior Japanese research and development could potentially outcompete Korea frontier technologies.

The North Korean threat

Growing poverty and domestic discontent could provoke North Korea into m border clashes and developing nuclear missile capability. Increased border tensi could then turn off FDI flows, and retard the shift to greater political and econor freedom. Essentially, the move to a market economy gets arrested and Korea mo back to a national security-dominated economy.

Weaknesses

- Small domestic market and language barriers limit ability to promote high-value services sector.
- History of government-directed industrial development.
- Heavy industry vulnerability to dollar/yen fluctuations.
- Proximity to China keeps lower-value manufacturing under constant threat.
- Banks exercise little discipline on capacity addition and cheap credit spurs over-investment.
- North Korean frictions need constant monitoring.
- Militant, overpaid labour force.
- Barriers to foreign ownership, technology primarily home-grown.
- Poor cousins to Japan, though quality gap narrowing.

Strengths

- Among the largest pools of technically qualified professionals in Asia — human capital works for it.
- Diversified industrial base, second only to Japan.
- Several world-class companies in the information, communications and technology sectors.
- Healthier mix of funding sources, shift away from reliance on bank loans.
- Comfortable fiscal balances, with public revenue to GDP ratio close to OECD levels.
- Property bubble limited and overcapacity confined mainly to manufacturing.
- Hyper-competition in the domestic market hones Korean companies for the world markets.

Taiwan

Paul Alapat

Since 1964 not a single recession

Among the nimblest economies in Asia, Taiwan has been able to adapt and adjust rapidly to changes in external opportunities and technological shifts. Testimony to this remarkable agility of the Taiwanese economic machine is that in all the years since 1964 to and including 1998, Taiwan had not experienced a single year of economic contraction.

Engines of growth

The dynamic small and medium firms...

The dynamism of Taiwan has traditionally come from the amalgam of small, focused, family-controlled firms. The 1m-plus small and medium-size enterprises, which employ close to 80% of the workforce and produce more than half of all exports, have made Taiwan a little bit of Silicon Valley, a little of Hong Kong. It is expected that this fleet-footed industrial core is perfectly suited for the rapid changes being pushed forward by the information, communication and technology revolution under way and will be among the prime beneficiaries of this restructuring. Above all, it is the flexible industrial structure of Taiwan that we see as continuing to be the most important driver of economic growth in Taiwan in the coming decade. Sectorally, integrated circuit foundry services, integrated circuits (ICs), wafer fabs, DRAMs, PC monitors and motherboards, LCDs, scanners, mobile phones and other telecommunications equipment will continue to be leading drivers of growth.

Over the medium term, it is widely believed that the mainland's entry into the WTO will be closely followed by Taiwan's accession into the WTO. Following WTO entry, remaining barriers on trade and capital flows will be lifted. This should spur closer integration between Taiwan's capital and management and the mainland's labour and resources, bolstering Taiwan's competitiveness in a range of manufacturing sectors. Exploiting the synergies between the resources of the mainland and Taiwan has been one of the mainstays of growth since the mid-1980s.

...plus Japanese outsourcing...

Meantime, Taiwan should be one of the prime beneficiaries of Japanese outsourcing. The efforts of Japanese companies to cut costs and regain profitability will result in a massive wave of outsourcing in the coming years. Taiwanese companies, with their impeccable process management expertise and mainland production base, should be uniquely positioned to capitalise on this, introducing an additional growth catalyst in the coming decade.

...combine with a technically educated workforce

Much like the rest of its East Asian neighbours, Taiwan has long emphasised the importance of education. More importantly, it fostered tertiary education in science and achieved one of the highest tertiary enrolment levels in the world (45% of tertiary enrolment in sciences). The deep pool of well-trained engineers and scientists will play a crucial role in boosting technological and process innovations. We expect this will have a significant impact on boosting factor productivity and growth in the coming decade.

Five-year projections

(5 years ending)	1997	2005F	2010F
GDP growth (% y-y)	6.3	6.8	7.8
Savings rate/GDP	25	25	27
Investment/GDP	23	23	25
ICOR average	3.7	3.4	3.2
Labour force growth	1.3	1	1
Central govt budget/GDP (%)	-3.5	-3	-2

Source: Nomura International (HK)

Taiwan has been fortunate in being able to combine the complementary strengths of the mainland with its capital and enterprise to drive economic growth. In doing so it has been able to temper the diminishing returns to increased capital accumulation much more effectively than Korea and Singapore.

Domestic savings will cap investment

The ever-present threat of border tensions with China and significant country risk will compel the economy to fund its domestic investment outlays from the domestic savings it is able to muster, with limited reliance on foreign savings. Just as it has lived since 1980, with a current account surplus every year, so will it have to manage in the years ahead.

National savings will be constrained by an average 3% of fiscal deficit as public housing projects and market stabilisation funds are serviced. As public infrastructure projects are completed, a decrease in government dis-saving should support a modest improvement in national savings into the latter half of the coming decade.

Technological progress, human capital will raise capital productivity

In the interim, the marginal productivity of capital, ICOR, should improve as technological change, funding diversification and infrastructure improvement combine with Taiwan's superior human capital. Large public projects should be the only negative on factor productivity improvement, but these should have diminishing impact with each passing year. With unemployment rates above historical averages, the labour force is not seen as a constraint over the first five years. It is expected to grow about 1% each year, but increasingly, blue-collar worker availability will be an issue.

Key risks

The ever-present danger from China

A formal incorporation of Taiwan into a US-Japan theatre missile defence (TMD) would institute a regional military alliance of the major forces hostile to China and could provoke a strong reaction. The risks are compounded by frosty Sino-US relations, which have been marred by the scandal over alleged Chinese spying, the exploding US trade deficit with China and political posturing ahead of the US elections.

Taiwan's manufacturing and banking sectors are hugely leveraged to the economy on the mainland, with more than US$40bn of capital invested by more than 10,000 Taiwanese companies. Meanwhile, China is entering a critical stage in its two decade-long reform process. A failure at this stage could seriously derail economic momentum in China, with disastrous consequences for Taiwan's troubled financial system.

Growth slowdown and financial crisis

The Achilles' heel of "Taiwan Inc" is its financial system. In marked contrast to its dynamic industrial sector, the financial sector is backward, politicised and overbanked. Taiwan's network of 40 local banks, 46 foreign banks and more than 300 rural credit co-operatives lack economies of scale, lack professionalism and lack adequate risk-management procedures. The financial sector is heavily exposed to the stock market through its own stock positions, through loans collateralised by stock and margin credit to customers. And the entire problem is compounded by lack of exposure. Any slowdown in economic growth could spiral into a banking crisis and there onto a vicious downward spiral.

Weaknesses

- Political uncertainty and isolation.
- Inefficient, and politically controlled financial system.
- Comparatively poor physical infrastructure.
- Limited domestic market size.
- Financial markets, instruments sophistication hampered by lack of Taipei's stature as regional financial centre.
- As component suppliers, vulnerable to shifts by OEMs.

Strengths

- Flexible, fleet-footed small and medium-sized companies.
- Technically well-qualified labour force and shrewd business leadership.
- Synergy with the mainland.
- Innovation bred from insecurity.
- Huge foreign reserves and capital account controls provide insulation against currency turbulence.
- Low public debt at 24% of GDP and healthy public revenue at 22% of GDP permit fiscal flexibility.

China

Kevin Chan

Capable of 8% annual GDP growth

China's long-term growth prospects hinge on structural reforms. China is capable of producing 8% pa real GDP growth in the next five years, provided structural reforms progress smoothly.

Engines of growth

In the past two decades, China's economic growth has been driven by reform. In the period since reforms began, China has been the world's fastest-growing economy. Annual GDP in China is now about US$1tn. Since 1979, annual exports have increased 11-fold to US$194bn. If re-exports via Hong Kong are included, China is now the fifth-largest exporter in the world. Beijing has made all this possible by continuing with bold reform steps in the past two decades.

Structural reform the key

In the next five years, structural reforms look set to remain the fundamental driver for growth. The pace of reform and deregulation should accelerate. Under the Sino-US agreement for China's WTO entry, China has pledged to open its fast-growing telecoms, Internet, banking, insurance, agriculture and retail distribution sectors in the next two to five years. Domestically, China is undergoing major reforms in its banking, state-owned enterprises (SOEs), housing and health care, with an aim to improving economic and operational efficiency. About 30m SOE workers have been laid off in the past three years. An additional 5-10m are earmarked to leave the SOE system in 2000. By the end of this year, employment by SOEs is expected to fall to 70m — about 40% fewer workers than in 1996, with a resulting increase in efficiency and profits. By end-1999, half of the 6,599 loss-making SOEs in 1997 had either returned to profit or broken even. Although the achievements to date have been impressive, the lion's share of the economic benefits should come through later.

Investment productivity likely to improve

To further quantify the improvement in efficiency, our analysis suggests that the ICOR in China has been improving throughout the past two decades. The fact that five-year moving average ICOR fell from 2.8 in 1983 to 1.4 in 1996 suggests China is using capital much more efficiently[3]. In other words, one unit of investment now may now produce twice as much as in 1981. Looking forward, though the need to invest heavily into infrastructure may limit the improvement in ICOR in the next five years, we believe China's ICOR should continue to fall steadily. SOE reforms have already reduced 'blind investments' into unproductive projects and 'blind production' of goods for which there is no demand — freeing up valuable resources into higher value-added activities. Township and private enterprises, which use capital much more efficiently than the SOEs, are expected to grow that much faster. In the next five years, rapid developments in telecoms and IT are not only productivity enhancing, but also help build the base for a take-off in the services sector.

The shift to the non-SOE sector

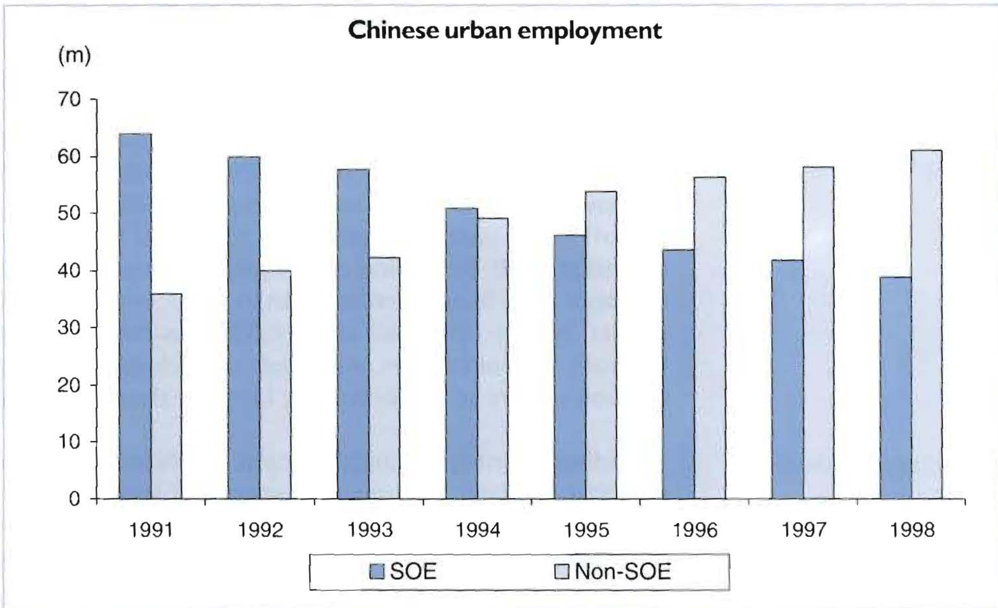
The growth in the non-state-owned sector has been impressive. In 1991, the SOEs produced more than 60% of the industrial output. In 1998, the ratio dropped to 35%. Around 20m township enterprises have been created. As at end-1998, around 55% of the urban labour force was employed by non-SOEs, and this ratio is expected to rise markedly in the next five years.

[3] The calculations of ICOR, savings and investment ratios for China are based on nominal figures. A breakdown of GDP by demand components in real terms is not available. It is more meaningful to study the trends rather than absolute values of the data.

Growth at township enterprises looks to have stalled

However, the growth of township enterprises has slowed in the past two years. Employment by township enterprises has stuck at around 120-130m and is believed to have fallen slightly in 1999. The economic downturn in recent years has dampened the growth in township enterprises. Exports and domestic consumption are township enterprises' key sources of demand. The fact that economic growth in China since 1997 has been driven by central government infrastructure investments has no benefit to township enterprises. The lack of funding has also restrained growth, as credit co-operatives, the bankers for rural enterprises, have been in trouble.

The worst may have passed. Since 2H99, exports have regained momentum, expanding by 20% y-y. Continued G-7 and regional demand in 2000 should help ease the pressures on township enterprises, while consumption is expected to witness gradual structural improvements. Restrictions on exports are expected to be eased in 2000, allowing more small township enterprises to participate in the export boom. As far as funding is concerned, Beijing's pledge to allow private firms to list on the local stock markets and the proposed establishment of a second board should provide new sources of funding for the private sector in the next five years.



Source: *China Statistical Yearbook 1991-99*

Rapid growth of e-commerce

As in other North-east Asian economies, the development of technology will surge in the next five years. Although China lags the US in e-commerce and IT by many years, growth is rapid. China's IT market grew 26% in 1999 to US$15bn. Legend Holdings, the largest PC assembler in China, has already surpassed Compaq in terms of PC sales in Asia. In the next five years, growth of IT sector is projected to increase further. PC sales growth has been rapid, averaging 30% pa between 1998 and 1999. Despite this growth, PC penetration is just 2.8%. The same can be said for Internet users, with the urban penetration rate at 2.3%.

Services to lead

The services sectors are booming after 50 years of being denied funds and labelled "illegitimate". From insurance to babysitting to food delivery, services will explode in coming years.

Significant stock of FDI

Since 1979, China has attracted more than US$260bn worth of FDI. More than 60% of the FDI into China was sourced from Asia. In 1998, 56% of FDI used by China went to the manufacturing sector. The proportion of merchandise exports produced by foreign-funded operations rose from 20.4% in 1992 to 41.5% in 1998. This shows China is still internationally competitive, despite the sharp depreciation of regional exchange rates in 1997-98.

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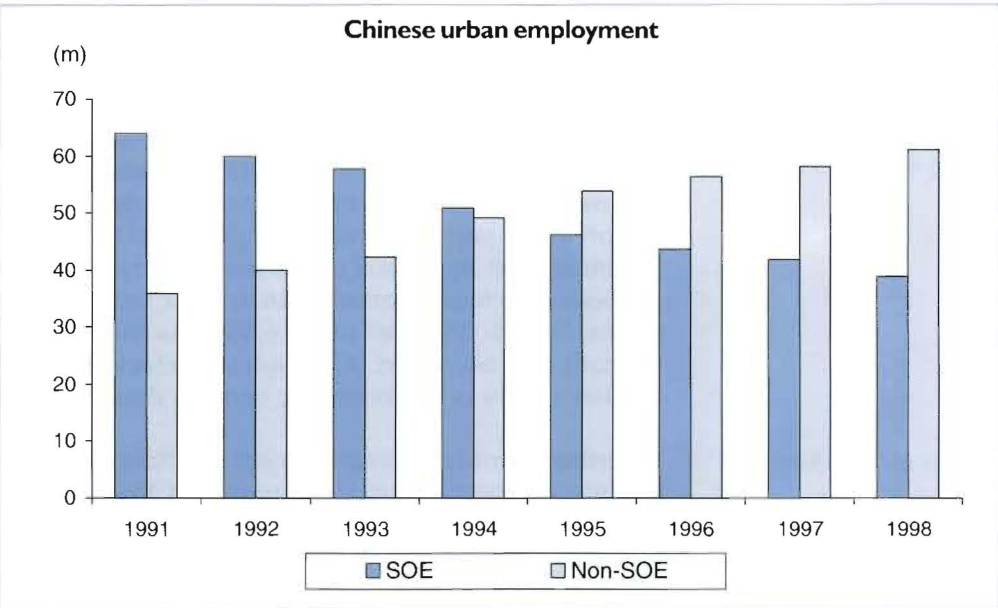

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China's pending admission to the WTO should boost FDI inflows further. Nevertheless, the composition of FDI inflows is likely to shift from manufacturing to telecoms, IT and services. On the heels of the opening of insurance sector, a number of international insurance giants have been licensed to operate in China. The local banking sector is earmarked for full opening in the next two to five years. Besides, foreign firms will be granted distribution rights in China's local market. For the rapidly growing telecoms sector, foreign firms will be allowed up to 49% ownership (including Internet-related business). All this suggests that service, telecoms and financial sectors may become the key area for FDI and growth.

Funding shift away from bank loans

In addition to foreign capital, China's economic activities have been financed by bank loans, with the state-owned banking sector being the cashier of local government and SOEs. The State Council is determined to deepen local equity and bond markets to channel savings to investment more efficiently, but these attempts have had limited success so far. Liberalisation of local interest rates is a prerequisite for bond market development. The local equity market has developed at a much faster rate. The combined market capitalisation of the Shanghai and Shenzhen A-share markets has grown eight-fold since mid-1995, and turnover on the two exchanges has increased 3.5x. Still, the market capitalisation to GDP ratio is only around 36% (39% including H-shares and red chips), less than India's 45% and the Philippines' 65%. At present, only SOEs are allowed to apply for listing, although private companies are expected to be listed soon.

Five-year forecasts

(5 years ending)	1997	2005F
ICOR	1.4	1.8
I Ratio	34.5	31.0
S Ratio	41.1	38.0
Labour	1.3	1.2
GDP	12.1	8.0
	1997	**2005F**
Debt service	9.5	7.9
Ex debt/GDP	18.8	17.1
Ex debt/exports	82.9	79.1

Note: Data used in this table are nominal except for GDP.
Source: Nomura International (HK)

Restructuring demands will divert resources

In the next five years, the expected recovery of private consumption should limit the growth in household savings. Meanwhile, accelerated SOE and banking reforms should limit scope for corporate savings. The expected pick-up in consumption and improvement in productivity should underpin economic growth in the next five years.

Meanwhile, ongoing reform of the financial sector will continue to demand public resources and divert public spending away from capital spending over the medium term. Though WTO accession should support increased domestic investment, we expect the full impact will only be seen in the second half of the coming decade.

With decades of budget deficits, China's national domestic debt outstanding is estimated at around RMB2tn (US$245bn), roughly 25% of GDP. The rate of growth of the domestic debt has picked up in recent years, owing to large-scale fiscal stimulus since the Asian crisis. The need to restructure the banking system will require substantial financial resources to clean up non-performing loans (NPLs) in the banking system. Assuming an NPL ratio of 30% of total loans and a recovery ratio of 30%, the total cost to bail out the banking system is estimated at RMB1.97tn. Besides, estimates from reliable international organisations suggest total debt from SOEs and other hidden debts should be close to 40% of GDP. Adding all these to the current level of national domestic debt, domestic debt could be as high as RMB8tn (US$960bn), almost 100% of GDP. This would mean China's domestic debt burden is as high as Japan's. In the next five years, the need to deploy financial resources to banking reform should imply a lower savings and investment ratio.

Productivity should be a pillar for next five years

Accordingly, over the next five years we forecast GDP growth in China will be anchored by improvements to capital productivity, which more than offsets the anticipated dip in capital accumulation. We look for GDP growth to stay high, at an average 8% pa in the years to 2005, though below the 9.7% growth in the past decade.

Strengths of the economy

Huge domestic market and pool of cheap labour

The obvious strength of China's economy is the huge potential of its labour force and domestic market, with a population of 1.25bn (720m of whom are defined as "economically active") and 420m households. Since the urban population accounts for around 30% of the total population, 70% of China's domestic market is pretty much undeveloped. To put this argument into perspective, 90% of rural households still do not own a refrigerator. Even among urban households, there are only 8.6 buses for every 10,000 city dwellers. Rapid rural electrification and road development should rapidly increase participation in the modern economy. This is one of the key reasons for the "Go-West" strategy, aimed at shifting development away from the coast, that was central to the economic policy of the National People's Congress meeting concluded in Beijing in March 2000.

Reformist administration

The commitment to structural reform in Beijing is a key strength. What helped China avoid the "Asian contagion" of the 1997-98 financial crisis was not simply the closed capital account. China spotted, acknowledged and started to address structural economic problems well ahead of the rest of region. Even in the face of the financial crisis that swept the emerging markets, the administration did not let up on reform.

Manageable level of external debt and strong FX reserves

Various estimates suggest China's total external debts range at US$140-210bn. Our estimates suggest that the debt-service ratio should be around 7-10%. Relative to the US$154.7bn China holds in forex reserves (second only to Japan), the external debt looks manageable. Forex reserves cover more than 11 months of merchandise imports, among the highest such ratios in the world.

More importantly, only 13% of the debt is short-term debt and most of the long-term debt is low-rate lending from supernational bodies, such as the World Bank, the IMF, and G-7 governments. Given the high level of reserves, strong balance of payments and the low level of short-term debt, external debt is not a problem.

Weaknesses of the economy

Few college graduates, poor English-language skills

The proportion of college graduates to population is low and almost unchanged (from 0.2% to 0.3%) from 1985-98. The literacy rate, which official statistics put at 70-80%, is not poor by emerging market standards, with an almost 100% enrolment rate of school-age children. The language barrier is a major weakness — English language training remains a luxury.

Weak infrastructure

Despite 20 years of rapid development, infrastructure remains poor. Fixed-line telephone penetration is still at the single-digit level. While there are 13 bicycles per 100 persons, there are only 8.6 buses per 10,000 persons. Waterworks are still poor, with frequent flooding around the Yellow River but drought in the northern provinces.

Poor transparency and corporate governance

Transparency is poor at all levels. The National People's Congress is a rubber stamp. Freedom of speech and press are wanting: local and foreign media are subject to strict controls. Transparency at the corporate level is no better. Disclosure is set at the minimum level and accounting standards adopted by listed firms are not fully comparable to international standards. The judicial system is heavily influenced by politicians.

The other major weakness of China's economy is its nascent-capitalist characteristics. The undesirable by-product of this "socialist-market economy" is that business managers are tied up with conflicting objectives — profit and welfare maximisation. The fact that the state remains the majority shareholder of most businesses and the concept that Chinese assets must not be sold to foreigners on the cheap are key obstacles to corporate reforms.

Weakness of China's banking system

China's banks are technically insolvent. With NPLs estimated at 20-30%, the large state-owned banks are almost certainly running on negative equity. The root of the banking system's problem is the requirement to lend to SOEs. This is being addressed but remains a drag.

Key risks

Although our central view is that structural reform should progress reasonably smoothly, the key risk is that reform may fail. In broad terms, there are two areas of risk — political and economic.

Unemployment

So far, unemployment has not generated social unrest or political backlash, but there is always the risk of a political misstep creating a backlash, or of some unseen threshold of pain being passed. It is estimated that China needs to generate 10m jobs pa to absorb the natural increase in labour force (1m), those displaced from SOEs (4m) and steady annual migration from rural areas (5m).

Bad-debt burdened banks

High NPLs (20-30%), the possibility that NPLs are even higher than estimated, and the reluctance of the government to auction off non-performing assets quickly may lead to a deeper banking crisis than we anticipate.

Political succession

While the Jiang-Li-Zhu administration has been firmly in power and the roots of structural reforms are deeply planted, the *troika* is approaching retirement in the next five years. The succession issue may be a source of risk. Judging from the present situation, a smooth transition of power seems more likely. With most of the old guard dead, reformers dominate in almost all ranks in the political pyramid. The most important factor is that the present generation benefits enormously from the reforms of the past two decades. Nonetheless, the succession may become the moment when frustrations over unemployment and SOE downsizing show.

Taiwan relations

Finally, stability in China critically depends on political developments in Taiwan. Should Taiwan declare independence, a military reaction from the mainland cannot be ruled out. Should this unlikely scenario occur, trade and investment sanctions could result in a complete halt to structural reforms.

Hong Kong

Kevin Chan

GDP growth of 4-5% looks sustainable

Statistically, Hong Kong is capable of producing a long-term economic growth rate of 4-5%, gauged by real GDP. However, measuring Hong Kong's growth by real GDP is bound to underestimate the SAR's growth potential. Since more and more Hong Kong citizens and corporations will derive earnings from operations outside Hong Kong, GNP data is a better accurate gauge of Hong Kong's economic growth. We believe Hong Kong's economic growth could be as high as 6-7% pa in the next five years in terms of real GNP. A much lower cost base, good infrastructure and continued strong economic growth in China suggest Hong Kong should be able to strengthen its role as the regional finance and communication centre.

Rule of law, business-friendly policies

From a fishing village to one of the major global financial centres, the foundation of the success of Hong Kong is built upon natural resources and demand, economic efficiency, the rule of law and a business-friendly policy backed by an ample supply of cheap Chinese labour. Between 1986 and 1999, real GDP doubled. Per capita GDP is now US$23,550, which exceeds that of most industrialised economies. Twenty-five years ago, the Hong Kong economy was dominated by garments, textiles, plastics and toy manufacturing. Now, more than 85% of GDP derives from services, with banking and finance accounting for a quarter of GDP. Hong Kong is now the seventh-largest forex trading centre, the eighth-largest banking centre and the ninth-largest trading economy in the world. In 1999, 840 international firms had regional headquarters in the SAR. Hong Kong also operates the second-busiest container port in the world and the market capitalisation of the equity market is the second largest in Asia after Japan.

As much as 46% of GDP from manufacturing

But it would be unfair to say Hong Kong does not have a sound manufacturing sector. While most of the GDP produced locally consists of services, Hong Kong derives significant income from offshore manufacturing. Since the late 1980s, most of the manufacturing base has been relocated to China and, in recent years, South-east Asia, the Indian subcontinent and Indo-China. More than 5m workers in China now work for Hong Kong-invested factories, compared with a labour force of only 3.5m million in the SAR itself. Traditionally, the manufactured goods are shipped back to Hong Kong for re-export to final destinations, producing re-exports equal to 90% of GDP. About 46% of the Hong Kong economy relates to manufacturing.

Engines of growth

China

Hong Kong is the primary gateway to mainland China. China is not only the major source of demand for Hong Kong's products and services, but also provides a pool of cheap labour, vast natural resources and investment opportunities for Hong Kong. More than 85% of Hong Kong's exports are re-exports and at least 60% of the re-exports originate from China. China related re-exports account for about 55% of Hong Kong's GDP. Approximately 30% of the tourist arrivals and a fifth of the revenue from tourism are from China. Given that China is likely to produce real GDP growth of up to 9% in the next five years, China looks set to remain the most important driving force for Hong Kong's economy.

There have been some concerns over Hong Kong's role once China accedes to the WTO. As China is increasingly able to service its own trade, one concern is that Hong Kong's ports may lose business. However, most of the highways and ports in the Mainland are either financed or managed by Hong Kong companies. As mentioned above, Hong Kong already has a substantial interest in China's manufacturing sector.

Hong Kong's banking and finance industry should also be a net beneficiary, as China opens its doors. The fact that Hong Kong has the best banking system in the region, first-class infrastructure, world-class legal and accounting systems, and fluid mobility of funds, should enable the SAR to beat competitors across the border for international fund raising. In the next five years in particular, when China's capital account is unlikely to be fully opened and bank restructuring continues, China's WTO admission should bring more opportunities than threats to Hong Kong.

While the SAR will further develop its role as the gateway to China, Hong Kong aims to develop itself into a first-world city. Two particular industries have been earmarked to go global — finance and technology.

Regional financial hub

The objective of the government is to develop Hong Kong as the regional hub of globalised finance markets. The merger and the listing of the stock and futures exchanges, the Hong Kong Exchanges and Clearing Ltd, will provide the platform for this development. The proposed formation of a global alliance with the Chicago and Frankfurt futures exchanges, approval from the US Federal Reserve to form an offshore US dollar clearing centre in Hong Kong and the adoption of a common computerised trading system from Germany and the US will give Hong Kong the infrastructure to develop a 24-hour, non-stop globalised trading system. As a direct result of these policies, major US companies such as Microsoft, Intel, Cisco, Dell and Starbucks are expected to have a secondary listing on Hong Kong's main board in 2000. All these developments should raise Hong Kong's profile as the Asian hub of a global trading system.

And communication centre

In the past two years, it has become clear that Hong Kong is developing into a regional hi-tech service and e-commerce centre, rather than a hi-tech manufacturer or a hi-tech R&D centre. One year ago, only seven out of the 33 Hang Seng Index constituent companies invested in "dot-coms" and telecoms. At present, the number is 20. Hong Kong's largest Internet company, Pacific Century Cyberworks, was non-existent only nine months ago. But now, it is the third-largest Internet company in Asia and has a market capitalisation larger than that of Amazon.com.

Bursting of the property bubble boosts competitiveness

The best-known problems to affect Hong Kong in the past decade are sky-high property prices and double-digit inflation. While the property sector was the main engine of growth for most of the 1990s, cost competitiveness deteriorated markedly given the property bubble. But the bursting of the property bubble in 1997 has seen property prices and rentals fall by about 50%. The sharp fall in property prices not only makes the SAR more competitive, it frees up the resources and entrepreneurial skill to develop real businesses.

Five-year forecasts

(5 years ending)	1997	2005F
ICOR	5.8	5.0
I Ratio	30.5	35.0
S Ratio	30.8	33.0
Labour force	2.2	3.0
GDP	5.2	6.0

Source: Nomura International (HK)

In national account terms, investment has been a key driver for growth. The investment ratio rose by 500 basis points (bps) to around 30% from 1987-91 to 1992-96, mainly owing to infrastructure investments, while the ratio of private consumption to GDP has been fluctuating narrowly around 60%. The main capital expenditures during the period were the US$20bn New Airport Core Programme, telecommunications, and extensions to the underground railway system.

Chinese reform, rationalised asset prices should raise factor productivity

In the next five years, we believe Hong Kong's ICOR is likely to fall to 4.0-5.0. As we concluded in our discussion on China, China's ICOR is expected to improve following the structural reforms and further market opening. Therefore, the manufacturing business and investments owned by corporate Hong Kong should bear fruit.

The structural shift from property development to technology will result in better use of capital. The financial resources that were once focused on property inflation are now available for investment in these sectors of real economic activity.

Low national savings a barrier to fast growth

However, a relatively low savings rate may constrain Hong Kong's ability to increase investment and economic growth in the next five years. The savings ratio averaged 30-35% historically, but fell from 1987-91's 34.7% to 30.8% in 1992-96. As a result, Hong Kong has had a current account deficit up to 2.0% of GDP in recent years (about US$4bn pa), except for the recession in 1998-99, when the account went positive — a cyclical response. Between 1991 and 1996, the five-year moving average savings ratio dropped by about five percentage points, while the investment ratio rose by the same magnitude. Based on our projections, the investment ratio is expected to stay around 35% in the next five years, as the government has pledged to invest more than US$25bn (15% of GDP) into infrastructure investment, while the savings ratio should be roughly unchanged, at 31.0%.

In other words, further opening and improving efficiency in China, investment in technology, globalisation of the financial sector and better allocation of capital should drive economic growth in the SAR in the next five years. However, economic growth is restrained by a relatively low savings rate.

Strengths

- The most important strength of Hong Kong is China. As we discussed above, China is both the main source of aggregate demand and productivity growth for Hong Kong. (Sometimes it is also a weakness, but we do not believe this will be so in the coming five years.)
- Free port, free mobility of capital and freedom of speech.
- Inherited from the British system, Hong Kong has one of the most independent and reliable judicial systems in the region.
- With the rule of law and the "three-frees", transparency in Hong Kong at all levels is among the highest in the region.
- Hong Kong's labour force is mobile, flexible and has adapted to rapid structural changes well. Trade unionism is almost non-existent in Hong Kong.
- Hong Kong maintains, in our view, the most efficient and resilient banking system in Asia, a system that came through the Asian financial crisis smoothly. Banks are well capitalised, with an average capital adequacy ratio (CAR) of 18%.
- Both the "software" and "hardware" of Hong Kong's infrastructure are important strengths. The tax rate is low and straightforward.
- The theory of positive non-interventionist policy has been a key source of dynamism for corporate Hong Kong. With this policy, government intervention, taxation and expenditure are minimal, leaving the private sector to allocate resources.
- Most Hong Kong banks and firms are well capitalised. Gearing is kept at low levels. The government has forex reserves of US$94.3bn, the fourth-largest war-chest in the world.

Weaknesses

Relatively low saving ratio and ageing population

- As concluded earlier, the relatively low savings ratio is a key constraint to investment and economic growth. Why has the savings ratio been falling in Hong Kong? The answer — an ageing population. The launch of the Mandatory Provident Fund system (MPF) should help raise savings, but it is unlikely to have a material impact in the next five years.

Cartels

- While rightly credited as one of the freest economies in the world, Hong Kong still has a cartel-ridden economy. This reduces the efficiency of capital.

Education and language skills

- Perhaps the most important weakness is deteriorating language skills and quality of education. Although it is difficult to quantify, most employers in Hong Kong would likely agree that English and Chinese language skills have deteriorated markedly in the past decade.

Political paralysis

- Hong Kong's executive and legislative branches do not co-operate well; this inhibits reform.
- Hong Kong is one of the most polluted cities in the world.

Key risks

Cross-Strait tension

Deterioration in Sino-US relations may hurt exports and investment flows between China, Hong Kong and the rest of the world. Although we believe war with Taiwan unlikely, jitters over this and political unrest in China potentially put pressure on Hong Kong's currency, financial markets and confidence. This is the chief reason Hong Kong stands behind its 16-year currency peg to the US dollar.

Failure of structural reform in China

When the China economy sneezes, Hong Kong catches cold. In particular, if China's structural reforms fail or come to a halt, if the rise in unemployment spins out of control, or if banking reforms fail, Hong Kong could suddenly lose most of its economic momentum.

Market intervention

Concerns over whether the SAR government will abandon its "positive non-interventionist" policy have arisen since the handover. These concerns have been amplified by the government's decision to award the Cyberport project to the Pacific Century Group directly, by-passing the public tender normally required, and the seeking of an "interpretation" of the Basic Law over the right of abode of mainland-born children of Hong Kong citizens.

Singapore

Adrian Foster

Government leadership and FDI

Singapore's impressive economic growth has been heavily reliant on government leadership in attracting foreign FDI from multinational companies into the manufacturing sector, primarily electronics. Rapid growth in manufacturing has been accompanied by services sector expansion to result in robust growth of the economy. The economy grew rapidly through 1992 to 1996, with growth of real GDP averaging 9.3%. The total size of the economy in 1996 was US$91bn, 80% larger than 1992's US$50bn. By the end of the period, per capita income had reached almost US$30,000, a striking increase from US$17,600 at the start of the period.

Engines of growth

But the economy is heavily dependent on trends in the electronics industry. To combat this the government has for several years been encouraging diversification of the manufacturing base into petrochemicals and higher value-added electronics such as semiconductor equipment. It is also looking to promote growth of the financial and professional services industry. Going forward, these sectors will be important engines of growth.

Twin pillars of growth

1. Manufacturing
   A. Pushing electronics up the value chain
   B. Promoting the chemicals and petrochemicals industry

2. Services sector
   A. Finance industry (fund management)
   B. Education (regional education hub)
   C. Regional communications hub

The two pillars of growth

Singapore's drive up the manufacturing-value chain has had considerable success. Plans to install additional wafer fabrication plants have been announced and the value of semiconductor exports from existing facilities is growing strongly and already exceeds the value of hard disk drives, an industry in decline in Singapore.

Rapid growth in the chemical industry is expected to continue, providing growth impetus for the economy. Investment commitments of S$21bn (mostly directed toward the integrated petro-chemical facility on reclaimed land at Jurong Island) have already been received by this industry and the Economic Development Board is targeting S$40bn to be committed by 2010.

Growth in the finance industry is expected as the government increasingly farms out the nation's large stock of savings to private-sector fund managers with operations in Singapore.

To realise its goals of attracting producers to set up in Singapore, the government uses tax breaks and, through government-linked companies, enters into joint venture agreements to share risk. Its historically strong fiscal position and stock of built-up reserves leave it well placed to continue this policy.

Increased liberalisation

The economy is being increasingly marketised as part of the process of internationalisation. The heavy hand of government control is being lifted in response to increasing competitive pressures from countries like Malaysia (for electronics production) and Hong Kong and Australia (for regional service business). The unleashing of competitive forces across the economy will boost growth momentum, as has occurred in other countries that have liberalised. Information now flows much more freely through the economy, protection of the local telecoms industry has been jettisoned as regional competition has increased, and several premier local companies such as Singapore Airlines (SIA SP, S$16.00 NEUTRAL) and Singapore Telecom (ST SP, S$2.51 UNDERPERFORM) are moving to expand overseas.

External demand will remain an important factor for the local economy, with total exports accounting for more than 150% of GDP. Singapore has diversified its export markets through the past decade, with the US and Japan becoming less important and neighbouring countries and Europe more important. Therefore, it is less dependent on any one market than a decade ago.

Forecast

For the coming five-year period, we forecast the economy will expand at an average annual rate of 5.9%. Electronics will remain an important sector, with independent industry observers unanimous that the global semiconductor industry is set for a sustained upswing as electronics and the Internet permeate increasing sectors of commerce. Growth in the manufacturing sector should be assisted by expansion of the services sector on the back of continuing regional growth, leading to demand for financial and professional services, and as Singapore establishes itself as a regional education (INSEAD and the University of Chicago are installing campuses) and medical service hub. Through the early years of the forecast period, residential construction is anticipated to kick in.

National savings rate should dip

We think the savings rate will fall modestly through the forecast period. The public sector is expected to remain in surplus, making a contribution to national savings, though smaller than past experience. But the private sector's savings rate is likely to fall — a trend consistent with other countries as they get richer and local capital markets get more developed (both factors leading to lower precautionary savings). Also, Singapore is one of the few countries in the region to have a growing dependency ratio in the years ahead. Singapore's high savings have the positive attribute of giving considerable scope to fund indigenous investment without calling on foreign savings. But Eastern Europe's similarly high rate under Soviet rule provides a sobering counterpoint. That region's economic growth stagnated because high savings, which financed very high investment, led to severely diminishing returns to additional investment. In the case of Singapore, local competition, the openness to foreign investment (both inbound and outbound), and the active recycling of the nation's savings into foreign assets sharply diminish this concern.

The government has no foreign debt and the country has net foreign assets. Provided the budget and the BOP current account surplus remain — both of which we anticipate — this strong external position will persist.

Human capital, higher value added production to lead

Capital has been efficiently utilised for many years, with ICOR low by regional standards, though it did increase in the late 1990s as (low-yielding) residential and commercial construction expanded. Through the next five years ICOR is likely to increase modestly from the levels of 1992-96. On the positive side, the structural budget surplus that we expect through the forecast period means the government will not be commandeering the nation's savings (as occurred in the OECD after recession) and investing them in low-yielding infrastructure and welfare, which would depress ICOR. Also, capital efficiency should improve as the country establishes itself in higher value-added production. But on the negative side, the new investments in high value-added facilities will take several years to realise their full potential and contribution to output, which should more than offset the positive effects on ICOR.

The labour force is anticipated to grow in line with the population at about the same rate as historical experience. Growth in the non-native population is expected to continue to exceed that of the native population as low domestic fertility rates and active encouragement of 'foreign talent' is used to supplement shortcomings in domestic education and skill levels.

Five-year forecasts

(5 years ending)	1997	2005F	2010F
GDP growth (% y-y)	9.7	5.9	5.0
Savings rate/GDP	48.1	48.0	46.0
Investment/GDP	37.6	38.4	36.5
ICOR average	3.9	4.9	4.4
Labour force growth	3.0	2.2	1.9
Central govt budget/GDP	6.3	2.0	2.0

Source: Nomura International (HK)

Key risks

Growing concentration on electronics

The manufacturing sector's heavy reliance on electronics makes the economy vulnerable to trend changes in this industry. A downturn in global demand for electronics would significantly reduce the growth momentum of the economy.

Domestic policy effectiveness eroded

The growing outward orientation of the economy increases the dependence on regional and global economic trends. Renewed weakness in neighbouring economies would undercut the growth of regionally focused services industries as well as the manufacturing sector. And the government would find its pump-priming options constrained. Expansionary fiscal and monetary policy would be of limited effectiveness, given that demand weakness originates from other countries.

Neighbours close infrastructure gap

Singapore's advantage in physical infrastructure is gradually being eroded as neighbouring countries improve theirs. Should the gap narrow dramatically (while we do not expect this to happen, we cannot completely discount the possibility), Singapore's higher cost base could prove unsustainable.

Weak base of local technically qualified workforce

Human capital shortcomings may stunt the economy's participation in the IT revolution. Standards of technical education in Singapore are noticeably weaker than competing countries such as Taiwan and Korea. In Singapore, about 20% of tertiary enrolment is in technical fields, compared with about 30% in Korea and 45% in Taiwan. And it is noteworthy that since late 1999 Hong Kong looks to have gained an advantage over Singapore in the telecoms industry and across the spectrum of Internet-based commerce ventures. As a partial offset, Singapore is well endowed with business and managerial graduates.

Vulnerability to critical imports

Singapore is dependent on Malaysia for clean water. While we confidently discount the danger of supply ever falling to a point that threatens the local population's health, the increasing demands of the semiconductor industry mean that even short-term disruptions to supply could hurt this industry.

Strengths

- The government has a significant financial interest in many large local companies, which is often a recipe for slow decision-making and economic stagnation. But over many years it has proven adept at adjusting policy in the face of changing economic realities, and maintaining focus on long-term goals. This is true in both a cyclical and structural sense. First, the cost-cutting measures at the beginning of 1999 highlight the ability of government to push through a counter-cyclical wages policy — it is doubtful whether any other country could achieve this. Second, in response to the structural shift of lower-value electronics producers to other lower-cost countries, the government has effectively courted foreign investment into higher value-added sectors such as semiconductors, telecommunications and petrochemicals.

- The government is pragmatic in its approach to policy, allowing a virtually free flow of foreign employees and making no requirements that foreign companies form joint ventures with local firms as a prerequisite for investing in Singapore and accessing government financial incentives. Commercial decisions are left to the private sector.
- Sound government finances. The budget remained in surplus despite the recent economic weakness.
- A well-capitalised banking system with conservative prudential control.
- Structural current account surplus translates into a growing domestic savings pool. This buttresses Singapore's ambition to be a regional financial centre.
- Singapore is an increasingly popular destination for expatriate employees.
- Singapore's high standard of English-language skills makes it a relatively easy place for foreign companies to establish operations.
- Highly rated levels of physical infrastructure.
- Geographical location straddling global shipping lanes.

Weaknesses

- Education standards are weak compared with North-east Asian standards, particularly in technical fields.
- Singapore has the highest semi-skilled labour costs in the region and its proximity to Malaysia means that low value-added manufacturing is under constant threat.
- The labour force is highly institutionalised multinational corporations and government-linked firms are major sources of employment and account for the lion's share of local production) and may not be sufficiently entrepreneurial to meet the challenges thrown up by swift growth in technology and the Internet.
- With only one or two exceptions there are no indigenous world-class companies in any industry. Therefore, if companies relocate their production facilities from Singapore to lower-cost countries, all the jobs go.
- A small domestic market of fewer than 4m people makes it unlikely manufacturers can gain necessary economies of scale serving only the domestic market.
- While Singapore's English-language skills are strong, which is a positive competitive benefit in many cases, in the competition with Hong Kong, Taiwan and China for Chinese-language computer programming and Internet content, Singapore is at a disadvantage.
- Transparency of the business environment is considered poorer than in Hong Kong, the main competitor for regional service business.
- The restrictions on internationalisation of the local currency and lack of full capital account convertibility will hinder development of the local bond market.
- The manufacturing sector remains heavily reliant on electronics.

Malaysia

Adrian Panggabean

Government-directed manufacturing growth and abundant mineral resources

Four decades ago, Malaysia enjoyed among the highest standards of living in Asia. The primary sector (agriculture, forestry and mining) accounted for 45% of GDP then, and fuelled annual GDP growth of 6.4% between 1957 and 1970 in Peninsular Malaysia. Between the late 1970s and early 1980s, substantial economic growth was sustained by public-sector expansion, with the sector accounting for around 30% of GDP. Revenues from tin, rubber, copper, bauxite, oil and other mineral resources were channelled through the budget to finance construction of social and economic infrastructure around the country. The sharp decline in the prices of primary commodities in the early 1980s, following a slowdown in world growth, brought Malaysia into a brief recession.

Trade liberalisation an added catalyst in 1990s

Continuing resource depletion, the declining role of the agriculture sector, and efforts to reduce the dependence on primary commodities underpinned the implementation of various reform measures between 1985 and 1990. These were aimed at shifting the economic power base to the private domain. Trade liberalisation measures eliminated bottlenecks in the external sector. Industrial reform also started, following implementation of the first industrial master plan (IMP) in 1986. The manufacturing base was expanded from traditional wood products, textiles, tobacco and off-estate processing to more modern chemicals, transport equipment, petroleum products, electrical and electronics products. The electronics sub-sector proved to be the principal driver in Malaysian growth during the 1990s. The sub-sector makes up almost 50% of total manufacturing output and 60% of total exports. Chemicals and related products, meanwhile, account for another 25% of total manufacturing output. During the 1980s, manufacturing growth was fuelled by inflows of FDI; in the 1990s, it was sustained by bank lending.

Engines of growth

Sound fiscal reform

Sound public and fiscal policies create the backdrop for growth. During 1985-90, the civil service system was significantly downsized, giving rise to a leaner and more efficient public sector. Strong leadership contributed to the efficiency of policy delivery. Tax reform was successfully implemented in the latter half of the 1990s, bringing tax revenues to an average of around 19% of GDP. Successful tax reform allowed the government to reverse its budget balance from deficit into surplus in the 1990s.

Natural resource endowments proved a significant catalyst to growth. Although rubber output has fallen well below that of Thailand and Indonesia, Malaysia is still the third-largest rubber producer in the world. Malaysia was a major supplier of tropical timber, though such production has fallen following the imposition of environmental controls by the government. The country remains among the largest producers of crude palm-oil, and its petroleum and natural gas reserves have insulated the economy from swings in the world energy market.

Electronics manufacturing to increase dominance...

Look for the electronics manufacturing sector to become a more important growth driver. Good physical infrastructure, tax incentives and the country's proximity to a regional financial/communications/logistics hub in Singapore should sustain Malaysia's competitive advantage in the production of electronics components over the next five years. Following implementation of the second industrial master plan (1996-2005), aimed at transforming the manufacturing sector, Malaysia's competitive advantage in this sub-sector relative to other countries in the region is expected to improve. Several measures are being implemented to address bottlenecks in the availability of technical, industrial and product-design skills.

...helped by a restructured financial sector

A restructured financial system will enhance the efficiency of resource allocation. Relative to other crisis-stricken countries, Malaysia has cleaned up its financial system and significantly recapitalised its banks. It has made considerable progress in corporate debt restructuring and made a start on banking consolidation, which is to be completed by early 2003. Mergers should create strong and reasonably large banking groups. Prudent operation of banks should promote better selection of projects and improve allocation of resources in the domestic economy.

Five-year growth projections

(5 years ending)	1997	2005F	2010F
GDP growth (% y-y)	9	7	8.5
Savings rate/GDP	38	40	43
Investment/GDP	41	38	41
ICOR average	4.8	4.5	4.0
Labour force growth (%)	3.2	3.6	3.2
Debt service/exports (%)	7.5	8.5	7.5
External debt/GDP (%)	42	40	38
External debt/exports (%)	50	48	47
Central government budget/GDP	1.2	-1	2
	1999	**2005**	**2010** (stock by the year)
Public debt/GDP (%)	36	32	31

Source: Nomura Singapore

A young population will boost savings

Economic growth is expected to remain reasonably strong over the next five years, with average real GDP growth of 7.0% driven mainly by improvements in capital productivity. The (gross domestic) savings rate is likely to rise from 38% to 40%, underpinned by an increase in household savings. Private-sector savings should grow as a result of rapid rises in per capita income. Malaysia has one of the youngest populations in Asia and one of the highest dependency ratios. In the years ahead, a falling dependency ratio and constant family size points to a growing proportion of the population being in the productive phase, with less of a spending burden. A rise in private savings is seen to offset the rise in government dis-saving as financial restructuring is completed.

However, foreign savings will fall

However, as a result of foreign investors' negative reaction to the imposition of capital controls and frequent policy shifts, Malaysia will be compelled to run current account surpluses and fund its investment primarily from domestic resources. This will force gross domestic investment levels some three percentage points below the pre-crisis average.

Infrastructure upgrading will pay off

The current high level of human development index (and rapid improvement on the educational front, combined with technological changes under way, suggests the efficiency of investment will improve modestly. Several other factors should help drive down ICOR. Banking reform will also improve resource allocation, leading to an improvement in ICOR. Further, look for investments in physical infrastructure made over the past decade to pay off in faster manufacturing sector growth in the coming years.

External balances healthy

Unlike Thailand and Indonesia, external debt is not as serious an issue in Malaysia. Strong export performance and low debt growth should allow Malaysia to service its external debt easily. The strong build-up of foreign reserves will continue to mitigate concerns over sovereign risk.

Key risks

Dependence on an undervalued currency

If policymakers opt to stick with the fixed exchange-rate regime, it will seriously disrupt efficient allocation of resources and undercut our projections for an increase in factor productivity over the next five years. An undervalued exchange rate will fuel price pressures, subsidise non-competitive industries and threaten the outlook for capital flows.

Skilled labour scarcity and small domestic market

There is a clear risk that the manufacturing transformation may take more time than planned. Although the policy to facilitate the manufacturing transformation (from low-end to high-end products) is in place and implementation continues apace, the process is constrained by several factors. First, the institutions required to generate the necessary human resources for such industries remain underdeveloped. While there is a pool of skilled professionals educated overseas, many of these end up working in Singapore. Second, from a transnational corporation's perspective, the benefits of providing technology transfer must be balanced against the size of the domestic market and country risk. Malaysia may not necessarily be the best place to undertake technology transfer. On those counts, Indonesia and Thailand could be attractive alternatives.

Proximity to Singapore may decelerate the rate of skill accumulation as Singapore's appeal as an attractive place for foreign talent to reside increases. There is a risk that those in possession of useful skillsets move to Singapore, draining Malaysia of its skilled labour force.

Political fragmentation

Our growth projections assume a smooth political transition. However, political issues may upset the above scenario: the absence of a strong successor to Prime Minister Mahathir, and a fragmented opposition. In addition, the most recent election result suggests that a potential rise of Muslim fundamentalism and growing Malay disunity are real threats to a smooth political transition. These factors may trigger a shift in the political power base, escalate political frictions and lead to a change in the political complexion. Although we do not expect the Indonesian experience to be replicated in Malaysia, fragmentation could undermine the powerful political/business complex, freeze political reform and reduce FDI flows into the country.

The greatest risk to Malaysia would be a coincidence between the popping of a financial bubble in, say, 2003, and a difficult political transition. This is not at all beyond the realms of possibility, so the risk to our forecast of Malaysia growth is much greater than the risks to many of the other forecasts.

Strengths

- Moderately good quality of physical infrastructure by regional standards.
- Relatively good quality of labour. The Human Development Index for Malaysia is among the highest in East Asia.
- Contractual savings scheme keeps domestic savings rate high.
- Relative institutional efficiency.
- Prudent fiscal management and efficient tax system.
- Rich in natural resources.

Weaknesses

- Business environment lacks transparency.
- Relatively small domestic market makes the economy too dependent on foreign demand and thus vulnerable to cyclical downturn in its major trading partners' economies.
- Too strong a link between government and business, and continued reliance on the government picking winners as a development strategy.
- Weak judicial system, which is a hindrance to improving the quality of Malaysia's financial and service industries.
- Problems with policy transparency.

Forecast

Competence of bureaucracy eroded

Notwithstanding the significant positives that characterised the Thai economy for many years, several important flaws developed during the good times that ultimately under-cut the economy. Bureaucratic competence had sagged as talent was drawn to the private sector, and complicity between business and government had grown to unhealthy levels. And as development continued, Thailand's major weakness, low education standards, became more of a constraint. The growth dividend from investment, as measured by ICOR, has historically been poorer for Thailand than for such countries as Malaysia and Singapore.

Poor education standards, infrastructure

We forecast growth of 5% pa through the first five-year period 2001-05 (significantly below the 8% rate recorded through 1992-96). No doubt the entrepreneurial spirit still burns bright (a necessary but not sufficient requirement for rapid economic growth), but institutional weaknesses, infrastructure shortcomings and poor education standards are likely to place a tight constraint on growth over the next five years. Such inadequacies cannot be quickly remedied. The country has achieved remarkable progress in the sphere of political reform with the makings of a vibrant democracy firmly established. But competitive markets cannot function effectively without the requisite legal and institutional frameworks, and Thailand does not yet have these in place. Thailand is 'technically challenged' in terms of its indigenous R&D effort and its pool of technically-qualified manpower, and risks falling further behind in the race to attract and develop 'smart' industries.

Financial sector restructuring will sap productivity

Our central-case forecast embodies the undemanding expectation that debt restructuring continues to 'muddle' along and that rescheduling constitutes a large part of 'restructuring' agreements. We expect NPLs to continue falling gradually as the rising tide of economic recovery floats some debtors off the rocks and the corporate debt-restructuring process (under the Corporate Debt Restructuring Advisory Committee, CDRAC) moves a trickle of cases to final restructuring. But the fall-off in bank NPLs will be slow. The continuing stand-off between creditors and debtors will, in effect, stifle the forces of creative destruction so important to economic advancement. Additionally, a considerable amount of public spending will continue to be diverted to servicing the financial sector bailout debt away from productive investment. That, together with the shortcomings of the country's physical and human capital, will likely undermine the returns to investment over the medium term. We expect ICOR to rise modestly to 5.5 over the next five years, from 5.2 in the five years before the crisis.

And drain national savings

The national savings rate, meanwhile, is anticipated to fall modestly over the next five years. First, the government's budget is expected to remain in deficit for several years, cutting national savings. Second, the passing of the belt-tightening required during the crisis will propel consumption growth ahead of overall GDP growth for several years, which will translate into a fall in savings. Following the severe balance-of-payments crisis, the level of domestic investment will be constrained by available national savings in the economy. The level of gross investment is not expected to reach 1996's high point even by 2005.

Five-year forecasts

(5 years ending)	1997	2005F	2010F
GDP growth (% y-y)	6.1	5.0	5.2
Savings rate/GDP	33.8	32.2	32.5
Investment/GDP	40.1	30.5	35.0
ICOR average	5.2	5.5	5.2
Labour force growth	0.5	1.9	1.4
Central govt budget/GDP	1.8	-2.0	1.0
Debt service/exports	13.5	16.0	10.0
External debt/GDP	52.5	53.0	42.0
External debt/exports	114.0	87.9	77.0
As at	**1999**	**2005**	**2010**
Public debt	59.0	56.0	40.0

Source: Nomura International (HK)

External balances to improve modestly

Thailand's level of foreign debt as a share of GDP is expected to be essentially unchanged through the next five years from the levels seen in 1992-96. The run-up in the value of external debt following the floating of the baht has since been reduced as the local banking sector has repaid some of its external liabilities; and over the next five years this trend will continue. The reduction in total foreign debt recorded last year in conjunction with robust export growth translates to a sizeable drop in the size of debt relative to exports. In coming years, export growth should continue to outpace the stock of foreign debt, so this ratio should continue falling. The debt-service ratio is expected to decline modestly.

Risks

Bad-debt overhang

Several risks could undercut growth in the short to medium term. If debt restructuring disappoints, the banks will remain mired in bad loans and the debtor companies will be unable to access new funds for expansion. This issue will increase in importance as capacity utilisation rates increase. Ongoing squabbling over existing wealth, which is what protracted debtor-creditor negotiations amount to, is detrimental to growth prospects because it is at the expense of the creation of new wealth.

Fiscal balances challenged

There is also a risk that fiscal consolidation could be delayed if the economic recovery disappoints and the government continues to pump-prime the economy. The growing overhang of government debt and deficit threatens discretionary control over fiscal policy as a result of higher public debt-servicing costs. In such a circumstance, the government may resort to printing money, with adverse consequences for inflation and ultimately the value of the currency. Sovereign creditworthiness would also be damaged with adverse consequences for foreign investor confidence.

Thailand has a lot to gain from uninhibited access to developed market economies. Therefore, the possible implementation of links between labour standards and market access, as is being supported by the US and Europe, represents a risk to Thailand. If such links were introduced, the resultant disruption to existing production and trade patterns would slow economic growth for a few years while adjustments filtered through the economy.

China's accession to WTO will undermine FDI flows

The issue of China's entry to the WTO also represents a risk. We do not rate the threat of increased competition from China in third markets as particularly significant because China already has easy access, especially to the US market. But the country will become a more competitive destination for inbound FDI, and this could come at the expense of countries such as Thailand.

The future of the monarchy

Deterioration in the political environment also represents a risk to the economic outlook. The king is widely revered and has played an important stabilising role through times of turmoil, including the recent crisis. He has just celebrated his 72nd birthday, and his age means his future tenure is unclear. To an extent this risk is ameliorated by progress on political reform, which will make for a more stable political system, but we cannot completely dismiss concerns that any weakening of the monarchy will result in less ability to cope decisively in moments of national stress.

Shortcomings in human capital

The medium to long-term risk facing Thailand is that educational standards continue to lag and the country will be essentially bypassed by the technological revolution. And even though progress is being made in improving education standards, the ultimate objective is a moving target.

Strengths

- The government has traditionally listened attentively to business in formulating its policies, a positive for the economy (though it was ultimately one of the factors that led to Thailand's downfall because it resulted in a diminution of good governance).

- The country is a major exporter of a range of agricultural products and raw materials such as rice and rubber, and is a leading gem-cutting centre. The resource surplus allows for the importation of hi-tech goods that the country does not itself produce itself. Also, the agri-foods business derives its momentum from the country's rich rural base.

- The dynamism of the manufacturing sector constitutes another engine of growth; investment in general and the resulting increase in manufacturing output has been a major underpinning of economic growth. It has been boosted by sizeable investments from a range of international manufacturers which chose Thailand as the main regional production centre for products such as cars and trucks.

- Inter-racial harmony, always an asset, has not suffered as a result of the recent downturn the way it has in other countries, such as Indonesia. Notwithstanding one or two unfortunate exceptions, foreign business activities have been left unscathed, Chinese business interests remain ensconced and increasing foreign ownership of Thai companies seems to be accepted by the populace, if not the parliamentary opposition.

- The country is well placed geographically to serve as a regional production centre for Asean-focused businesses, and moves to more fully integrate the region through the Asian Free Trade Agreement will make this advantage all the more significant in the years ahead.

- There is a ready supply of low-cost, unskilled labour and the degree of unionisation is very low. The lack of institutional rigidity makes the labour market very responsive to market conditions. For example real, inflation-adjusted, wage rates fell in Bangkok as unemployment rose through 1998 and 1999. The reflux of workers back to rural areas as a direct result of the economic crisis translates into a ready pool of workers that can return to urban areas as employment opportunities grow.

- A domestic market of 70m people.

Weaknesses

- While cheap labour is readily available, its skilled counterpart is not. This makes it difficult for Thailand to stay ahead of increasing competition from countries such as China as they move up the value chain.

- Government institutions and political decision making are poor as a result of widespread corruption and incompetence.

- Creditors remain at a disadvantage to debtors owing to weaknesses in Thai law. Therefore, debt funds are unlikely to expand significantly unless collateral and guarantees become more legally binding and banks have effective ways to recoup loans.

- The country's poor standard of familiarity with English makes knowledge transfer slower than would otherwise be the case and complicates business and social dealings.

- The country continues to suffer from low-quality physical infrastructure, with surveys of regional managers and business people rating Thailand below Malaysia.

- The country is not a particularly attractive destination for expatriate staff, being rated below Malaysia (but ahead of South Korea).

- The growing electronics industry is focused on low-value assembly and lacks the original design- and research-driven capability that countries such as South Korea and Taiwan possess.

Indonesia

Adrian Panggabean

The remaking of a "basket case"

Indonesia is the story of the underdog. Back in 1945, few believed Indonesia would stay in one piece. The economic and political situation was chaotic. Virtually no development took place until 1969, when the country embarked on its first five-year plan. Even then, Indonesia was still considered a laggard. There was reason to be pessimistic. Imagine Indonesia in 1969: it had a population of around 125m (more than 90% of which was illiterate, scattered among 17,000 islands and ethnically divided), an income per capital of less than US$50 (lower than in Nigeria), an inflation rate of 600%, and acute political instability. Following 25 years of economic expansion (at an average rate of close to 7% pa), the illiteracy rate was down to 10%.

Engines of growth

From natural resources to manufacturing

Growth has been driven by a number of factors — reflecting changes in the development focus of the country. During the 1970s, growth was driven by windfall profits from natural resources channelled through the public sector. In the early 1980s, an industrialisation policy supported by strong FDI inflows was key to growth. In the mid to late-1980s, strong exports supported by continued industrial sector reform and robust Japanese demand were the engines of growth. Finally, the financial market boom of the late-1980s and mid-1990s, driven by financial liberalisation measures, attracted huge inflows of foreign funds and boosted growth.

Along with the gradual move toward a market-driven economy, the role of the public sector in investment generation diminished. During the 1970s, 70% of domestic investment was generated by the public sector. Twenty years later, the role of the public sector in investment was only 30%.

But weak institutions and centralised government

Economic development over the past 25 years, however, has been characterised by a rigid and weak institutional structure, largely attributed to the centralised nature of governance, which was aimed at maintaining political stability at the cost of economic efficiency. Total factor productivity (TFP) contributed only 20% to Indonesian economic growth during 1975-95. This is low in comparison to Malaysia, Singapore and Thailand.

Financial restructuring and decentralisation the key going forward

Going forward, look for corporate and financial restructuring to be the catalysts of growth. The most recent financial and economic crisis has forced the rationalisation of the country's banking sector and overhauled the government-industrial nexus. Insolvent banks have been closed, weak ones have been merged and the entire financial sector has been consolidated into more commercial entities. Simultaneously, substantial parts of the corporate sector have been nationalised and managements changed, and political patronage of a few chosen companies has ended. At the margin, the Indonesian industrial sector has been forced to improve corporate governance and to be more competitive, and the foundations have been laid for more efficient use of resources.

At the supra-structure level, democratic institutions should enhance political stability in the longer term. They will also provide a stronger basis for sound and transparent economic policies. Combined with greater economic and political openness, the country's capacity to absorb advanced technical know-how will be enhanced.

Shift into more productive sectors

From a sectoral perspective, economic growth drivers have shifted from agriculture to manufacturing and financial services. Serious efforts to transform the agricultural sector and strengthen the industrial structure lead to us believe that the role of these sectors will be enhanced.

Given Indonesia's natural resource endowments and stage of development, the manufacturing sector will still be important. Policy moves to further strengthen the links between small and medium enterprises (SMEs) and large enterprises (LEs) will reduce the dependence of manufacturing industries on imported inputs and thus create a stronger domestic industrial structure. As a result, the manufacturing sector's role as the engine of growth will be enhanced. We expect that the contribution of manufacturing to GDP will increase to 30% in 2005 from the present 25%.

Financial reform now under way is expected to create stronger and more accountable banks. Combined with a more diversified source of funds, stronger capital markets and more prudent supervision, financial sectors may in fact become an even more powerful engine of growth. The financial sectors contribution to GDP is also expected to increase, from 6% currently to close to 10% in 2005.

Decentralisation...

The emergence of new growth driver: decentralisation. Administrative and fiscal decentralisation programmes, both prepared since the 1980s, will bring with them new growth drivers. Under the new decentralisation laws, provinces and districts are being given significant discretionary power to decide on development priorities that are relevant to regional needs. Besides, more fiscal funds will flow into local government budgets and thus enable these authorities to undertake projects. A closer link between needs and resources is the essential ingredient. Hence, production efficiency at the sub-national level will be enhanced.

Increased factor mobility

Inter-provincially, the immediate effect of this decentralisation policy will be in the form of stimulation of capital and labour mobility, which in turn would further stimulate economic activities in outer Java and especially in the eastern part of the country.

Sectorally, the country's marine resources are expected to be one of the most promising areas of growth in the coming years. Around two-thirds of the 5m square kilometres covered by Indonesia's borders is water. Marine resources contribute a meagre share of the agricultural sector output. This is attributed to the largely undeveloped fishing and aqua-culture sub-sectors. The fishing sub-sector has made up some 1.6% of GDP in the past 10 years. The government's move to develop this sub-sector will have flow-on effects on shipping and shipbuilding industries.

Five year-growth projections

(5 years ending)	1997	2005F	2010F
GDP growth (% y-y)	7	6	8
Savings rate/GDP	30	29	32
Investment/GDP	33	28	32
ICOR average	3.5	3.6	3.2
Labour force growth (%)	2.8	3.0	3.1
Debt service/exports (%)	33	40	50
External debt/GDP (%)	61	72	60
External debt/exports (%)	226	215	300
Cent Gov deficit/GDP (%)	0.1	-3.5	-2.0
	1999	2005	2010 (stock by the year)
Public debt/GDP (%)	100	80	60

Source: Nomura Singapore

Restructuring will depress investment

Economic growth in Indonesia over the past 25 years has been backed by capital accumulation. The investment to GDP ratio has increased from 22% in the 1970s to 26% in the 1980s to 31% in the 1990s. Crises brought a sharp cutback in investment. Going through 2005, owing to the continued diversion of resources for restructuring the banking system, we expect investment ratio to come down to — around 28% — the level constrained by the availability of national savings. This translates into an average growth rate of around 6%.

Falling dependency and institution of contractual savings will raise savings long term

A continued fiscal deficit will contribute to a sharp reduction in the savings rate. But there are several factors that may partially offset the decline in the savings rate. First, demographic dynamics should help. A slowdown in population growth implies a sustainable expansion in per capita income, while a declining dependency ratio will allow national savings to increase. Additionally, we expect that contractual savings programmes along the lines of the EPF in Malaysia will be introduced in Indonesia in the near future; these should increase the savings pool considerably.

The net effect of several push-pull factors should be a stable ICOR. Weak investment between 1998 and 2001 will likely push down ICOR during 2000-03. Implementation of far-reaching institutional restructuring will likely improve ICOR. However, such positives are likely to be mitigated by the choice of projects undertaken over the next five years. Significant spending by the public and private sectors on financial restructuring and governance is expected to drag down capital efficiency, offsetting the previous two factors. Over the next five years, therefore, we do not envisage any improvement in ICOR.

Total external debt stay high

Indonesia's stock of foreign debt is expected to increase quite significantly. The low savings rate, coupled with high spending needs, forced the government to resort to non-inflationary financing from foreign sources. IMF-sponsored loans are expected to continue up to 2005. These factors will add to the total debt stock, though as a share of GDP this should be unchanged at around 80%. The debt service ratio is expected to remain stable since a sizeable amount of foreign debt has been rescheduled. The debt servicing burden will likely only start to pick up approaching 2010.

Risks

Political uncertainty

Our projections are based on a base-case scenario whereby the political situation is brought under control by the new democratic government. But there is a risk that political uncertainty may take more time to resolve. Indonesian politics is murky. It is driven by fear of disintegration and often characterised by abrupt changes in political attitude. Judging from what has been achieved, there is reason to believe that the government can bring about a more stable political environment. But any transition to democracy is inherently risky. Look for political struggles between the present government and foot-draggers to dominate the political scene over the next five years. Thus, there is a significant downside risk to every stage of Indonesia's political development, which may well deflect our projections.

Fiscal balances strained

Risk may also come from a potential erosion in fiscal discipline, on two fronts: (1) the difficulty in striking a balance between growth and equality; and (2) populist pressure that may deflect the government from applying tough fiscal measures. Crises have led to a deterioration in socio-economic conditions. The percentage of people living below the absolute poverty line has returned to 1985 levels, from 11% in 1997 to 24% last year. The government has been faced with a difficult policy trade-off: securing long-term growth versus reducing economic inequality. Political pressure to bring about equality may force the government to over-emphasise the need to improve social welfare schemes and, hence, spend too little on growth-oriented projects. Overspending on social infrastructure, which is low-yielding in nature, could undermine long-term growth.

Ongoing political struggles may also give rise to a populist policy stance at the risk of undermining budget discipline. Any erosion in budget discipline would run counter to the objective of putting in place a sustainable fiscal policy.

Potential political intrusion in the ongoing privatisation programme is another risk that may produce an unnecessary fiscal drain, eroding fiscal discipline. All of these factors could have negative knock-on effects on the sustainability of the restructuring programme.

Public debt at 100% of GDP

Total public debt stock, currently 100% of GDP, is very high by international standards. A slippage in growth, a jump in interest rates, another large corporate/financial sector bailout or a weakening of the rupiah could send the economy into a debt trap, scuttling economic growth.

Banking crisis still unresolved

Indonesia's banks are not merely lubricants of the national economy or the components of just another employment-generating sector. They are important channels of political influence. Nearly all bank owners are politically well-connected and have used their banks to finance their economic, and political, investments. Resolving the issues facing the banking sector in Indonesia has been complicated by the fact that closing the banks would hurt the conglomerates behind them. It is this combination of political and technical problems that could prevent banking problems from being resolved. To the extent that these efforts fail, our base-case scenario is jeopardised.

Strengths

- Very large domestic demand with sufficient buying power. Indonesia since 1990 has successfully gone through the demographic transition period. Population has grown at a stable rate of around 1.6% pa, and a population explosion is no longer a threat. This gives rise to a sustainable expansion in per capita income levels and in the buying power of the average consumer.

- The diverse nature of the country presents an array of business opportunities. Differences in consumption patterns and tastes can translate into product diversification.

- No international territorial disputes. Political independence allows Indonesia to play an important role in regional and global politics. The country's size and geo-strategic location may contribute to its attractiveness.

- Press freedom, and with it improved flows of information, should accelerate R&D spending and education in Indonesia. In the longer term, this should contribute to the emergence of a stronger middle-class — a factor vital to sustainable growth.

- Relative availability of basic economic and physical infrastructure. The quality of infrastructure in Java, Bali and Sumatra (where some 70% of Indonesian population resides) is broadly comparable to that in Malaysia and Thailand. The quality of road infrastructures in "outer islands" (the other 30%) is obviously lower but nevertheless is roughly comparable to that in former Soviet republics in Central Asia. Basic transport and telecommunications infrastructure is spread throughout the country.

Weaknesses

- Surplus labour but low technical qualifications. The proportion of graduates to the total population stands at just 0.7%. Indonesia's human quality (measured by HDI), along with China's, is the lowest in East Asia.

- Weak industrial structure; quantity over quality. Inter-industry linkages are weak. On average, two-thirds of manufacturing input is imported. This makes producers vulnerable to foreign-exchange fluctuations. Industries also tend to be more concerned with the quantity of output than quality. Similar products made in other countries readily compete with their Indonesian rivals.

- Language barriers prevent an acceleration of knowledge transfer.

- An archipelago of more than 10,000 islands limits economies of scale and adds to transport costs.

Philippines

Adrian Foster

Engines of growth

Weakest track-record of growth

The Philippines has had the most varied experience of economic growth over the past few decades of any of the main Asian countries. The country's many advantages, such as familiarity with the English language, history of close ties with Western countries, the legal and political apparatus given by these close ties, and a broadly educated workforce are often cited as reasons why the economy should perform well. But political machinations have dominated economic considerations and, with one or two exceptions, the record on economic growth is poor. Political stability under Ramos looked finally to have freed the country from the political turbulence of the Marcos era (which continued into Aquino's term by virtue of proximity). Economic momentum was clearly building through the first half of the 1990s, as evidenced by the acceleration of GDP growth through this period and the establishment of manufacturing facilities by several US and Japanese companies. The onset of regional crisis took the wind out of the economy's sails, and now the challenge is to reset the spinnaker and regain momentum.

Through the five-year period 1992-96, inclusive, the economy grew at 3.5% pa — the weakest growth of the main Asian economies. Nonetheless, by the end of the period the economy had expanded to US$83bn, an impressive increase from US$53bn in 1992. With the passing of the Asian financial crisis, the Philippines' recovery is lagging several neighbours'. Through the five-year period 2001-05, we expect growth to average 4.7% — better than the experience of 1992-96 but below our expectations for other countries. The institutional reform and fiscal consolidation initiated by former President Ramos has slowed, and we do not expect it to be resurrected comprehensively in the coming years. Accordingly, we expect FDI to favour Asian economies with more vibrant restructuring efforts and broader-based technology sectors.

Agriculture's leverage on growth

Agriculture has been a primary driver of the economy and will continue to be so. It accounts for about 20% of total output, but its leverage on total GDP growth has been far greater than the headline numbers suggest. A whole range of manufacturing industries is agriculture-dependent and a host of services — financial to trade — revolve around the agricultural cycle. Further, the agriculture sector comprises 40% of total employment and is a crucial driver of domestic demand and of exports. However, agricultural efficiency in the Philippines lags many countries in the region, and increased mechanisation and higher-value crops can go a long way in enhancing factor productivity in this sector. As this releases more and more surplus factors of production, the Philippines has great scope to increase the share of the higher-productivity non-agricultural sectors. We expect the ongoing sectoral shift from agriculture to manufacturing to play an important role in upgrading factor productivity in the years ahead.

Overseas remittances remain an important source of savings

The steady inflow of remittances from Filipino overseas workers has long been a stabilising influence for the economy, providing a much-needed inflow of foreign capital, which supports the balance of payments and economic activity. In line with the economic recovery in East Asia and the brighter outlook for oil-producing countries, remittances from overseas workers can be expected to expand steadily over the next five years. These will bolster the country's balance-of-payments position, reinforce aggregate demand and contribute to the pool of financial savings.

The rising influence of electronics exports

External demand will remain a significant determinant of the economy's performance, with total exports (of goods and services) accounting for about 60% of GDP. The importance of external demand has steadily increased, with Ramos' reform drive attracting several US and Japanese producers to install electronics assembly facilities, thereby allowing the Philippines to narrow the foreign-investment gap that had opened between the country and most neighbours through the 1980s. The growing exposure to electronics exports in the Philippines should position the country to ride the robust growth underway in the IT industry.

Forecast

Modest level of sustainable growth

Economic growth is expected to remain modest by regional standards through the coming five-year period, averaging 4.7%. The services sector will continue to be the most stable underpinning of growth. Industrial output growth of about 6% pa is seen to lead the overall economy, supported by improved physical infrastructure provision and ongoing FDI.

National savings will lag those of neighbours

Five-year growth projections

(5 years ending)	1997	2005F	2010F
GDP growth (% y-y)	4.4	4.7	5.0
Savings rate/GDP	19.1	20.9	22.0
Investment/GDP	23.7	22.0	24.0
ICOR average	5.7	4.9	4.8
Labour force growth	2.9	2.1	1.9
Central govt budget/GDP	0.1	-1.2	0.5
Debt service/exports	17.4	12.0	9.0
External debt/GDP	62.8	64.0	50.0
External debt/exports	147.9	102.0	90.0
As at	**1999**	**2005**	**2010**
Public debt	57.8	58.0	42.0

Source: Nomura International (HK)

The savings rate is likely to increase moderately, a continuation of the trend seen before the crisis. The budget deficit has been a constant drain on the nation's savings, but this call should diminish as fiscal consolidation occurs (albeit slowly) through the period. Private-sector savings should grow as the dependency ratio falls and the population bulge enters its productive years. But even by 2005 the nation's savings rate will remain significantly below those of its regional neighbours. Given our expectation that FDI inflow will be low, the level of national savings will effectively cap the level of investment. Growth in the labour force through the next five years should be slower than that experienced in the five-year period ending 1997 and other things being equal, result in slower economic growth. But the large rural labour force breaks this nexus, since there are many under-utilised workers in the farm sectors who can migrate to urban areas and raise the overall productivity of labour.

Sectoral shift will those of underpin productivity

The efficiency of investment was fairly good through the late 1980s, though this then deteriorated through the early 1990s. The ratio is likely to improve modestly in the next few years (though around a reasonably unimpressive growth rate for investment and the economy as a whole), for several reasons. First, the ongoing shift from agriculture to the more productive manufacturing sector should boost factor productivity. Second, improved banking transparency and supervision holds the promise of better resource allocation, with lending expected to become increasingly based on merit. Third, despite hiccups along the way, we anticipate several liberalisation measures — in the retail sector and in external trade — will ultimately succeed, which will attract foreign investment into several previously closed areas of commerce, thereby boosting the level of investment efficiency.

Sovereign risk to ease marginally

Conventional risk parameters look set to improve following the currency and economic crisis. The ratio of foreign debt to GDP will increase modestly from the five-year period before the crisis, mainly owing to currency translation effects. The fiscal deficit is expected to shrink during the forecast period, and growth in public debt should be below the rate of economic growth. The robust growth in the US-dollar value of exports that we anticipate through the next few years is expected to wind back the debt burden as a share of exports. Consequently, the debt service ratio should improve modestly.

Key risks

Vulnerability to adverse weather

Adverse weather is a perennial risk for the Philippines, given the central role agriculture plays in the economy. Back-to-back years of agricultural underperformance would seriously damage economic growth prospects, undermine fiscal consolidation projections and stifle whatever economic reform is being attempted.

The rise of populist policies

While the political environment is much better than pre-Ramos, there has been slippage in the past year, with President Estrada seen to be leaning toward populism at the expense of sound management. Further slippage would seriously dent the country's credibility, increasing the risk of ineffective policy at a time when fiscal consolidation is becoming necessary and the country needs to push forward with liberalisation measures. Transparency of the business environment is poorly regarded by international businessmen, and political transparency looks to have deteriorated under the current president. Whereas Ramos conducted regular weekly cabinet meetings and held a press conference afterward, now cabinet meetings are irregular at best. And increasing use of presidential advisers to circumvent the cabinet muddies the flow of policy advice.

Slippage in fiscal consolidation

If fiscal consolidation and privatisation projects progress too slowly, this could place upward pressure on interest rates and continue to divert a large share of public resources into unproductive expenditure. Sovereign creditworthiness could also suffer and significantly increase the cost of overseas borrowing that the Philippines needs each year.

Chinese threat to exports

The Philippines remains vulnerable to several threats on the trade front in the medium term. A downturn in demand for electronics would dent growth momentum. The heavy reliance on US demand for exports makes the country vulnerable to weakness in the US economy. The issue of China's accession to the WTO also represents a risk. We do not rate the threat of increased competition from China in third markets as particularly significant because China already has easy access, especially to the US market. But China will become a more competitive destination for inbound FDI, and this could be at the expense of countries such as the Philippines.

Strengths

- Familiarity with the English language and Western customs, including legal and political factors, makes knowledge transfer easier and gives the country an advantage in attracting foreign investment.
- The banking system remained functional through the regional crisis, and non-performing loans are lower than in many neighbouring countries.
- A significant contingent of overseas Filipinos provides an important source of foreign currency resources.
- The country has an established procedure for the democratic change of political power.

Weaknesses

- Low savings rates by regional standards makes the country dependent on foreign capital if it is to quickly improve its economic performance.
- Vulnerability to weather-related disruptions of economic activity.
- Poor quality of physical infrastructure — rated below China on some measures.
- One of the least favoured destinations for FDI, and regional recovery together with China's WTO accession could erode that further.
- Ongoing disputes over outer islands such as Mindanao.

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