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KEEPING THE BAD NEWS AT BAY

By William Overholt

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Reforms and a blossoming domestic market have insulated China from the global downturn.

Economies all across Asia are limping badly, hobbled by the slowdown in demand from the United States. In the first half of 2001, Japan fell into recession, and preliminary numbers suggest that Taiwan and Singapore also contracted. Yet as in 1997, when a spreading financial crisis knocked out tiger after Asian tiger, one country continues to operate on its own cycle: China notched a typically robust growth rate of 7.9 percent in the first six months of the year.

Why the difference? The short answer is reform. In today's Asia, he who reforms grows.

Asian economies share common problems. For two generations, China, South Korea and Japan funneled their financial resources into favored firms, mainly in heavy industry, and coddled those companies through cartels and protectionism. The 1997 crisis laid bare the results of this system--overcapacity, wasted money, insolvent firms, troubled banks and lack of funding for new, innovative firms. Growth could be restored only by reform and consolidation of banks, bankrupting insolvent firms, accepting the resulting layoffs and economic slowdown, and then trying to revive the economy through exports and renewed consumer confidence.

Instead, a booming United States carried the export-driven economies of the region along in its wake, allowing recalcitrant governments to avoid real reform. Japan and Taiwan actively sought to buttress the old system. They propped up their banks and helped them hide their bad loans, carried insolvent companies rather than bankrupting them, spent government funds to prop up stock markets, and in Taiwan's case also supported the currency and suppressed publication of consumer-confidence and leading-indicator numbers. The result has been economic stagnation to a degree unimaginable a few years ago.

South Korea and China, on the other hand, followed through with drastic reform. South Korea closed two thirds of its merchant banks and forced a vast consolidation of its commercial banks, in the process laying off 38 percent of bank employees. It closed 14 of the 30 big chaebol and imposed drastic (although still incomplete) reforms on the rest. But if South Korea was a hero of reform, China has been the superhero. Beijing has laid off 46 million people from its state and collective sector. It is in the process of cutting the government in half from 8 million employees to 4 million. It ordered the military to get out of business, largely accomplished within a single year. These reforms imposed so much pain that one had to ask whether any economy, any polity, could recover from them.

Last year answered that question. The Chinese economy grew 8 percent, exports 28 percent, retail sales 9.7 percent, foreign direct investment approvals 51 percent. Deflation ended. The currency was stable. Breaking most of the military's connections to business even helped Beijing collect tariffs and taxes; government revenues, once only 10 percent of GDP, rose to 14 percent. Surprisingly, consumer confidence also rose to near-record levels despite shocking layoffs: Chinese citizens believed their government's diagnosis of the problem and believed in the prescription. In Japan, the public knew their leaders were trying to mask serious problems, so confidence has been low despite relatively few layoffs.

There are three further, more particular reasons China continues to succeed in a weak global economy. One is that China has been more friendly--and more attractive, given its low costs and huge potential market--to foreign direct investment (FDI) than any other Asian economy except Taiwan. By the end of 1999 cumulative FDI in China was $306 billion, compared with only $39 billion in Japan, with China growing many times faster.

Second, China has been furiously promoting competition. In industries like airlines, telecoms, banks and power, China has been steadily encouraging more foreign and domestic competition, a policy accelerated by imminent WTO entry. The result is growth powered by rising efficiency.

Finally and perhaps most importantly, China has been shifting from export-led growth to domestic-led growth. Although not as affected as countries like South Korea and Malaysia by the collapse of tech-sector demand, its export growth has declined from 28 percent last year to 10 percent or less this year. But at the same time rapid housing reform is increasingly turning urban Chinese into the owners of their homes, thus driving sales of things like windows, doors, paint and furniture. The auto industry is taking off. Retail consumption is growing fast. Banks now know that consumers repay their loans whereas state enterprises do not, so consumer finance is exploding. This again contrasts with Japan, where foreign and domestic economists have been unsuccessfully urging a shift to domestic-led growth since the late 1970s. If Beijing continues with reforms and heads off any instability they may cause, the Chinese economy could march to the beat of its own drum for years to come.

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Overholt is head of Asia Strategy and Economics at Nomura International in Hong Kong.
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