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## **East Asia needs overhaul**

By Guy de Jonquières

As high summer approaches, an unseasonably chilly wind is blowing through east Asian economies. Higher oil prices, a soft patch in the world electronics industry and sharply reduced Chinese import growth are all starting to bite. As a result, the region's growth rate is forecast to dip by at least a percentage point this year to below 6 per cent.

By Europe's dismal standards, that may seem an enviable performance. But in a region where many governments' popular legitimacy hangs on delivering rising living standards year after year, even small setbacks can cause big political headaches.

Furthermore, the problem this time is not just cyclical. The continuing shift of manufacturing to China is draining production from the rest of the region. For wealthier economies, the loss will be permanent. While a renminbi appreciation may cause investment to move from China to lower-cost locations, it will not return to Japan, South Korea or Taiwan.

In addition, China has become a net exporter of products such as steel, as a capacity glut has led producers to turn en masse to world markets. And, as China's electronics and car industries get into their stride, they will make more of the parts and sub-assemblies that are currently a mainstay of its neighbours' exports.

Those trends raise awkward questions for countries that have long based their development on manufacturing and export-led growth. The strategy has always made their economies acutely sensitive to the global business cycle. In the past, they could count on export upturns following downturns. But changing patterns of investment and comparative advantage in the region make that much less of a sure bet.

What should be done? The obvious answer is for Asian countries to balance external exposure by stimulating domestic demand. As Nick Bibby of Barclays Capital points out, those that have done so - notably Hong Kong, Indonesia, Malaysia and the Philippines - have so far been least affected by the latest downturn.

However, it is uncertain how long those policies can be sustained. Indonesia's plans to boost infrastructure investment hinge on maintaining export income, while Malaysia's recent growth has been pumped up by a surge in personal borrowing. It remains to be seen whether it will go the same way as Korea's consumer credit boom and subsequent bust of two years ago, which have left the economy reeling.

Thailand's recent experience offers an even more cautionary lesson. Thaksin Shinawatra's government came to power in 2001 promising to reduce export dependence and boost domestic demand. Though the policy seemed to work initially, it now lies in tatters, leaving hopes for a revival of the country's floundering economy pinned once again to exports.

Most Asian stimulus programmes suffer from a crucial flaw: they seek to increase demand, without attacking domestic market distortions and structural constraints on supply. But unless these are removed, stimulus packages are unlikely to be more than a short-term palliative.

In much of east Asia, market domination by powerful incumbents has kept domestic competition weak and entry barriers high, above all in the stunted and overprotected services sector. Incestuous ties between governments and producers perpetuate archaic and capricious regulatory systems that serve to preserve the established order, not to promote flexible markets, innovation and sound commercial practices.

Failure to create vigorous equity and corporate bond markets has left Asia relying heavily on often creaking banking systems. Business cronyism and weak corporate governance further deter equity investors. No wonder stimulus packages so often end up creating short-lived property booms. Finally, public and private corruption flourishes in many countries, sapping economic efficiency.

After the 1997 financial crisis, efforts were made to tackle these deficiencies. But structural reform has since run out of steam almost everywhere except China, while only Hong Kong has mastered the challenge of transforming itself into a modern services-based economy.

Elsewhere, those who have tried to revive the reform drive have sometimes been penalised for their pains: witness the Bank of Thailand, which risks being stripped of its independence after trying to tighten industry regulation.

The harsh truth is that the mercantilist model that served east Asia well for so long has become as much of a handicap for the region as Europe's discredited "social" model has for that continent. It may still give the poorest countries a step up the ladder. But for more advanced ones, it has too often become an excuse for shirking the structural reforms needed to adjust to a fast-changing regional economy.

Those reforms will be painful in the short-term. Powerful vested interests will be bound to resist them. Overcoming opposition will require political boldness and determination. But Asia's leaders need to recognise that, if they duck the challenge, they cannot count forever on being bailed out by ever-rising export demand from the rest of the world.