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Brian P. Klein and Kenneth Neil Cukier

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Of all the unprecedented things that have happened during the global economic crisis, perhaps the most startling and ominous so far occurred in early 2009: shipping rates between southern China and Europe temporarily fell to zero dollars. As consumer demand in the West dried up and exports dwindled, brokers actually waived the transport fee and only charged a minimal handling cost. By April, hundreds of empty ships, representing over ten percent of the world's cargo capacity, floated idly in Asian waters. After traffic in South Korea's Pusan Harbor, one of the world's busiest, dropped by 40 percent in March, the port ran out of space to store the 32,000 unused containers that had piled up.

The collapse in shipping is more than simply a proxy for the woes facing the global economy; it also underscores the degree to which Asia is bearing the brunt of the global slowdown. On an annualized basis, Taiwan's exports shrank in the last quarter of 2008 by 42 percent, and its industrial production fell by 32 percent—the latter a bigger annual decline than the

United States experienced in the Great Depression. Japan ended 2008 with its first annual trade deficit in almost 30 years. This spring, its industrial production retreated to the level of the early 1980s. Singapore's patriarch, Lee Kuan Yew, has predicted that the city-state's economy may shrink by as much as ten percent in 2009, the steepest contraction since its independence in 1965.

To be sure, trade is starting to improve, and government stimulus programs have produced a pleasant blip. But the underlying problems have not gone away. Even China, on track to achieve GDP growth of between six and eight percent this year, has seen its growth rate, which was 13 percent in 2007, fall dramatically. Across the region, economies that just a year ago were celebrated for their consistently strong performance have stalled or gone into reverse.

This was not meant to happen. Asia resisted the financial follies of recent years. The region's financial institutions largely eschewed the toxic assets that have hobbled their peers in the United States and

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Europe, governments displayed fiscal integrity, corporations maintained healthy balance sheets, and individuals saved rather than splurged.

Even experience conspired against the region. The Asian financial crisis of 1997–98 was a debt crisis, and the flight of foreign capital decimated a handful of economies. Remembering this, as trade expanded, most Asian countries cushioned themselves by exporting more than they imported and amassing huge current account surpluses. They accelerated their opening up to foreign trade (although many are still relatively closed compared to the West). In short, Asian countries did all the right things—even enduring lectures from visiting Western officials—yet they are being hammered even harder than the West.

The cause of Asia's current economic despair, ironically, is the very development model that was the source of its prior success: its heavy dependence on exports. By deciding to hitch their wagons to manufactured exports, Asian leaders left themselves inherently vulnerable to a drop-off in Western consumption. The growth was also built on weak social and political foundations, from underinvestment in public education, health care, and social services to poor governance and a weak rule of law. These concerns were ignored by the business and political leaders who benefited the most from rapid economic growth, and the masses generally did not quibble so long as their incomes increased year after year.

Until last year, it was easy to believe in an "Asian century," with growth rates across the region exceeding eight percent and the countries basking in their newfound international political prestige. As intraregional

trade grew, there was a belief that Asia's economies had actually decoupled from the West to become a new engine of global growth. However, the economic crisis has torn the façade off the Asian economic miracle. Instead of emerging as a Goliath on the global stage, the region is suffering. The West's great consumption binge is unlikely to return anytime soon, leading to excess industrial capacity, financial difficulties for businesses, and rising unemployment throughout Asia.

The core of Asia's economic problems is structural, not cyclical. Government stimulus programs, albeit vital, have largely focused on short-term fixes, in an environment in which the quality of spending is as important as the quantity. Asia's business model has atrophied, and it is unclear what will replace it.

If Asian leaders fail to undertake the necessary economic reforms—reduce trade imbalances, promote domestic consumption, and develop social safety nets—the current crisis will produce widespread problems: a generation that recently moved out of poverty might slip back in, and a prolonged slump could even ignite social and political unrest.

THE END OF THE MIRACLE?

To understand why Asian countries made exports the linchpin of their economic growth, it is necessary to return to Japan in the wake of World War II. The country had been devastated, and its industry lay in a shambles. With few natural resources, Japan needed to import raw materials, but it lacked the foreign exchange necessary to do so. Producing exports, first of light industrial goods, such as textiles, and later of heavy industrial materials, such as steel and chemicals, was imperative. The cycle

was self-reinforcing: access to foreign exchange permitted Japan to import new technologies and become even more productive, expanding into higher-value finished products. After steel and glass came cars and radios.

Japan's domestic economy was modest, and exports promised growth. Developing domestic consumption takes time and is costly; focusing on export industries lets a poor country expand rapidly and capitalize on its cheap labor. During its postwar occupation of Japan, the United States promoted this model by purchasing Japanese products as a discrete form of aid. The role of state planners, necessary to organize output following the war, was enshrined and became a dominant feature of the system.

The model was a great success. Japan's economy skyrocketed as exports grew more than fourfold in real terms between 1955 and 1965 and sevenfold over the decade thereafter. Japan produced around 50,000 cars in 1953 and exported none. By the end of the decade, it had produced 500,000 cars, almost ten percent of which were shipped overseas. Other countries in the region took note. Japan's development program became the template for Asia's "tigers": Hong Kong, Singapore, South Korea, and Taiwan in the 1960s and 1970s. Under General Park Chung Hee, South Korea's leader from 1961 to 1979, the Trade Ministry often cut the electricity at firms that failed to meet export targets. The term "flying geese" was used by economists to describe countries that were shedding low-value activities for more sophisticated ones. The gaggle later included Indonesia, Malaysia, Thailand, Vietnam, and even China. The variations on the model were, of course, as diverse as Asia itself. They encompassed military rule in Taiwan and

South Korea, strict controls in Singapore, and free-market mayhem in Hong Kong. But exports were the geese's golden eggs.

This model of export-led growth was actively encouraged by the West. In 1975, Robert McNamara, then president of the World Bank, urged Asian leaders to "turn their manufacturing enterprises away from the relatively small markets associated with import substitution toward the much larger opportunities flowing from export promotion." More than three decades on, the effects have been remarkable.

The economic transformation of Asia counts as one of the most phenomenal developments of the twentieth century. In 1960, South Korea's GDP matched Sudan's, and Taiwan's was about equal to that of the soon-to-be-independent Belgian Congo. By the 1990s, both Asian countries boasted living standards that rivaled those in the West. More than 400 million people have been lifted out of poverty in China alone since the country began liberalizing its economy in 1980.

But calls to increase domestic consumption went unheeded. The 1997–98 financial crisis weakened some countries' currencies, making Asian goods even cheaper around the world. Over the past decade, the region's exports as a percent of GDP increased from 37 percent to 47 percent. The remedies for one financial crisis, it is said, sow the seeds for the next. In Asia, the export boom that made many countries' current account surpluses surge also contributed to the low interest rates, excess liquidity, and asset-price bubble that eventually brought the global economy crashing down.

By emphasizing exports, Asian countries simply replaced a reliance on foreign capital with a dependence on foreign demand. In

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Hong Kong, Malaysia, and Singapore—because of the high volume of reexports—the value of exports equaled or exceeded their GDPs before the current economic crisis started in 2007. In Taiwan, Thailand, and Vietnam, it totaled over 60 percent. For China and South Korea, exports represented nearly 40 percent of GDP. Viewed as net exports (when imports are subtracted), the contribution to GDP is more modest. But these exports were still critical to Asia's economic success.

In recent years before the crisis, approximately half of Asia's trade had remained within the region, giving rise to the belief that Asia's economies had become largely independent of the West. However, around 60 percent of Asia's intraregional exports were of intermediate goods, which fed supply chains that usually looped through China and ended up in the West. So when U.S. consumers stumbled, Asian manufacturers fell off a cliff.

The era of export-led growth is over in its current form. U.S. consumption soared to over 70 percent of U.S. GDP between 2005 and 2008, and the U.S. household savings rate dropped below zero—major historical aberrations. The economic crisis has since wiped out two-fifths of the value of U.S. stocks and substantially eroded the worth of U.S. homes. As Americans enter a period of frugality to rebuild their household balance sheets, they will buy less of what Asia produces. What brought the region so far in the twentieth century may not take it much further in the twenty-first.

It is a harsh way to begin what was heralded as “the Asian century.” Asia's postwar industrialization appealed to an ethos of nationalism and self-sufficiency. But the export-led model Asian countries adopted has ironically left them more dependent

than ever on the whims of the West. Now, that growth model is shriveling. The economic slowdown is not responsible for this; it merely exacerbated problems that already existed due to the weak economic, social, and political foundations on which the model was built.

INCONSPICUOUS CONSUMPTION

Commercial exchange is the basis of all economies. So why should depending on foreign consumption rather than domestic demand be much different? Relying excessively on exports leaves a country vulnerable to economic downturns elsewhere. Moreover, a healthy balance is necessary so that sagging fortunes in one area can be offset by gains in another. Overemphasizing one sector also alters the incentives for businesspeople, politicians, and the public in negative ways.

The experience of Cambodia brings all this into stark relief. Before the current crisis, Cambodia's economy was soaring on the back of low-value garment exports, which represented 80 percent of the country's total exports, most of which were shipped to the United States. But when the global economy soured, orders evaporated. Between September 2008 and early 2009, around 50,000 garment workers, or 17 percent of the total, were reported to have lost their jobs. Whereas the economy grew by ten percent in 2007, this year the World Bank forecasts that it will contract by one percent—which is expected to lead to increased poverty in 2009.

An excessive focus on exports also leads to economic distortions. Corporate investment, government spending, and foreign direct investment flood into the export sector, at the expense of the broader domestic economy. Social goods, such as

public education, health care, unemployment insurance, and social security, often get neglected.

This helps explain why Asians save as much as they do: they need to “self-insure” and shoulder these economic burdens themselves. Across the region, the typical household saves between 10 and 30 percent of its annual income. National savings (which include government and corporate savings) amount to as much as half of GDP in China, Malaysia, and Singapore. Although thrift is normally a virtue, in this case it is a vice, because it pulls money away from consumption, where it could be used to improve people’s standards of living and their countries’ overall economies.

Domestic demand in Asia has been held back by several other factors, including a persistent misallocation of resources. Misguided investment has led to a blind pursuit of real estate development despite often weak real (nonspeculative) demand. New office construction continues in Beijing and Shanghai despite rising vacancy rates. At the same time, access to capital remains severely restricted for small and medium-sized enterprises. Banks generally favor larger projects and those backed by government initiatives, which are considered at lower risk for default and can provide better collateral. This is a particular problem considering that small companies generally use capital more productively, are more innovative, and disperse wealth more widely.

Also, lending is disproportionately oriented toward powerful economic and political interests, be they state-controlled companies in China or family-owned groups and mega-conglomerates in Hong Kong, India, Japan, Malaysia, and South Korea. In China, small and midsize firms represent 70 percent of GDP but tap only

20 percent of the country’s financial resources, a trend that cannot be explained simply by the capital intensity of big firms.

The preference for big projects and big companies places power in the hands of elites. On the eve of the Asian financial crisis in the late 1990s, the top 15 families in Hong Kong controlled the equivalent of 84 percent of the country’s GDP; in Malaysia, the figure was 76 percent; in Singapore and the Philippines, it was almost 50 percent. Although much has changed since then, family dynasties from Hong Kong to New Delhi still exert outsized influence over their countries’ economies. Samsung, controlled by the Lee family, currently accounts for almost one-fifth of South Korea’s total exports.

This concentration of wealth and power has contributed to weak corporate governance across the region. In Japan, many managers take pride in ignoring both foreign and domestic shareholders. In South Korea, executives found guilty of embezzlement, bribery, or tax evasion are regularly allowed to return to their corner offices on grounds of their personal importance to the economy. The implosion this year of Satyam Computer Services, an Indian information technology firm that had cooked the books for years, marked the beginning of the Indian business community’s serious scrutiny of corporate management. Although malfeasance is certainly not unique to Asia—the United States has boasted some colossal corporate meltdowns—accountability there is still largely absent.

Because capital is so concentrated, the growth of Asia’s middle class has been stunted. Although hard to believe when visiting the region’s major cities—newly blanketed with luxury malls, expensive

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bars, and fancy cars—private consumption and wages as a proportion of the region's overall GDP have actually fallen over the past two decades, even as they have risen in absolute terms. In many countries, workers cannot afford the merchandise that they produce; domestic consumption simply cannot pick up the slack from a drop in exports.

In China, as exports and corporate earnings soared between 1997 and 2007, wages actually declined, from 53 percent to 43 percent of GDP. Although people across Asia are much better off than in the past, their well-being has not kept pace with the growth around them. The effects can be seen in consumer behavior. Over the past decade, as Asia's economies grew, domestic consumption stayed roughly the same or actually declined relative to GDP. In China, it dropped from 45 percent to 35 percent of the economy. Although spending has increased, the huge and wealthy consumer class that economic growth was meant to create has not yet fully materialized.

The average annual income in most of Asia's emerging economies is less than \$3,000 at market exchange rates, or less than \$10,000 in purchasing power parity. Moreover, the size of the wealthy, urban class is meager, relatively speaking. A recent report by the consulting firm McKinsey & Company estimated that 1.6 million households in China earn more than \$36,500 a year. Although this is splendid for luxury brands, it is insufficient to support broad-based domestic growth. There may be two billion new consumers in China and India alone, but most of them are very poor.

Another element of the Asian economic miracle—centralized planning—is leading to difficulties today. State control that created stability in earlier stages of develop-

ment is now suppressing entrepreneurship and more robust domestic growth. Despite three decades of reform, the Chinese government still owns 76 percent of the country's wealth, controls the banking sector, and oversees state-owned enterprises that account for one-third of the economy. Likewise, in India, where the government has dismantled the jumble of rules known as "the license raj," red tape continues to strangle business. And in Japan, there is even a term, *kansei fukyo*, for a recession caused by the blunders of policymakers.

Ultimately, pursuing export-led growth entailed hidden costs. It distracted policymakers and business leaders from the hard work of building and strengthening the institutions necessary for sustainable domestic economies. Much of the new wealth was used inefficiently or simply squirreled away. Meanwhile, those countries that acted to keep their currencies weak in effect subsidized exporters at the expense of other domestic producers and consumers. Glaring weaknesses in some countries were also ignored—from corruption and an inadequate rule of law to environmental degradation. Indeed, as the export model proved successful, structural reform became even more difficult, since vested interests grew more influential. The region as a whole is now ill prepared for a drawn-out period of slower growth. Asia is left with some very hard decisions to make in a decidedly more difficult economic environment.

NO SAVING GRACE

In the West, the economic crisis has ushered in a period of great deleveraging. Financial institutions that ratcheted up their earnings by taking on huge quantities of debt have had to scale back their

exposure, which has contributed to the huge fall in asset prices. It is a painful but necessary adjustment. Likewise, a similar process needs to take place among Asian economies—a great rebalancing—whereby the reliance on exports is reduced in favor of stimulating domestic consumption.

Initial government reactions have been mixed. To their credit, Asian countries have been quick to respond to the downturn. Those that experienced the sharp end of the financial crisis in 1997–98 know the importance of decisive action. Across the region, approximately \$1 trillion has been earmarked for stimulus measures. China announced a nearly \$600 billion two-year spending package (albeit generating concerns over how much of it is new money). Japan's stimulus plans total \$250 billion, around five percent of GDP. Malaysia and Singapore have allocated between eight and nine percent of their GDPs.

However, although the plans make a point of investing in social programs, the bulk of the spending is on infrastructure (useful because it employs unskilled workers). Less than four percent of China's spending is on education and health care. The country even raised the rebate on the export tax for labor-intensive products, which will provide temporary relief for exporters but will only reinforce the emphasis on trade.

Instead, there are more substantial policies that Asian countries can pursue, in the areas of promoting human capital, improving incomes, and reducing savings. One obvious positive long-term effort would be to promote education. Yet rather than simply building more schools, it is critical to expand the tiny national student loan and grant programs that currently exist. This would not only reduce the financial

burden on the poor but also let the younger generation spread out the cost of education over the course of their careers. In this way, parents could pare back their savings, which would likely increase domestic consumption. This is a potent example of how the paucity of financial services in Asia, not simply poor physical infrastructure, holds back the domestic economies there.

Asian countries will also have to improve the structure of their labor markets and increase minimum wages. Although a recession does not seem like the right moment to increase the cost of business, there never is an ideal time, and in good times the pressure is off. Depressed wage growth is one reason why household income as a proportion of GDP has actually declined across Asia in recent years. Likewise, the high savings rate in the region is due in part to income insecurity. Most job arrangements in Asia are informal. The share of formal salary and wage employment is only around 40 percent of total compensation in Indonesia, the Philippines, and Thailand and as low as 15 percent in China. (By contrast, it is around 90 percent among G-7 nations.) This provides flexibility to companies but means uncertainty for workers.

Changing the structure of the labor market and paying workers more would boost the overall economy and fuel domestic consumption. This was the experience of the United States in the early 1900s, when Henry Ford declared that he wanted to pay his workers enough for them to be able to buy one of the cars rolling off his assembly lines. Starting in 1914, Ford raised the minimum daily wage from around \$2 to \$5 and established the two-day weekend—actions for which he was heavily criticized by other industrialists. Ford's

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goals were to reduce employee turnover, increase productivity, and create a massive new market for his cars. Ford's idea of "welfare capitalism" was copied by others, helping to create a broad-based consumer class in the United States. The same sort of consumer revolution needs to take place in Asia, and increasing wages is a necessary first step.

Most important, Asian countries must establish viable social safety nets. The lack of basic economic safeguards is the biggest reason why Asians save so much, and reducing those savings would unlock consumption. However, in addition to taking a long time to set up, genuine social welfare systems would require adequate initial funding and testing by citizens before they changed their savings behavior.

One way to do this is to create a "social wealth fund." Just as a nation's "sovereign wealth fund" invests its foreign reserves abroad for public gain, this fund would receive a portion of the government's stakes in state-owned companies and earmark the dividends for social initiatives such as education and health care. Asian countries carry assets of tens to hundreds of billions of dollars in their state-owned enterprises, from telecommunications operators and oil companies to tobacco firms. Apportioning a large part of these shareholdings for a special fund would demonstrate the government's commitment to social reform.

In some places, creating a durable social safety net will be especially hard. In China, for example, the idea of a broad, state-based pension system—whereby workers subsidize retirees—would bump up against unfriendly demographics: the birthrate in China has been declining just as life expectancy has been dramatically increasing. Due to the one-child policy, over

the past three decades the number of dependents (both children and the elderly) per worker fell by half—a factor that has contributed to China's economic growth. But over the next three decades, the number will increase by 50 percent. It is doubtful that tomorrow's shrinking work force will want or be able to pay for its growing elderly population.

In the end, overhauling Asia's social model over the next half century will be a task of the same magnitude as reforming its economies during the past half century was. It will be an equally difficult and long process—but it must begin now.

EXPORTING INSTABILITY

In this year's annual threat assessment for the U.S. Senate Select Committee on Intelligence, presented in February 2009, Dennis Blair, the U.S. director of national intelligence, identified the global economic crisis as "the primary near-term security concern of the United States." His biggest worry was "regime-threatening instability," but trade also made the list. "Unlike the Asian financial crisis of 1997–98, the globally synchronized nature of this slowdown means that countries will not be able to export their way out of this recession," he explained. The problems "make it difficult to achieve long-time U.S. objectives, such as the opening of national capital markets and increasing domestic demand in Asia."

If the downturn is prolonged and countries in the region fail to reform, the consequences for Asia will be profound. Trade protectionism could easily undermine globalization, as it did during the Great Depression, when hefty tariffs led to the contraction of global trade by two-thirds. Since October 2008, some 66 restrictive trade measures have been

proposed worldwide and 47 have been enacted. They run the gamut from the aborted “Buy American” legislation to India’s ban on Chinese toys. Such legislation will slow the economic recovery for everyone, and Asia will bear the brunt of the pain.

Moreover, poverty is on the rise in Asia. More than 600 million people across the region live in extreme poverty. This year, some 60 million people who would have been lifted out of poverty had the economy not slowed will remain impoverished. According to the Asian Development Bank, this number could increase by an additional 100 million in 2010 unless the global economy rebounds. Remittances from workers abroad, which account for a substantial portion of incomes across Asia, have fallen dramatically. An economic crisis that began in the rich world risks becoming a humanitarian crisis everywhere else.

A failure to reform could also make the biggest fear of the United States’ national intelligence director come true. Thailand remains in a delicate situation: protests by the red-shirted supporters of former Prime Minister Thaksin Shinawatra, who generally hail from rural areas and had benefited from his populist policies, are threatening the government of Prime Minister Abhisit Vejjajiva, whose support comes mainly from wealthy city dwellers. Vietnam has cracked down on union leaders and labor activists; India has seen factory managers held hostage and, in one case, killed by a mob. And cell phones and the Internet have made it far easier for people to organize protests.

China is a special case. For the moment, Chinese protests are limited to specific factories, issues, and areas. Chinese officials are less concerned about the 20 million

migrant workers who have lost their jobs (since these laborers are used to unsteady employment) than they are about the six million university students who graduate each year and face trouble finding jobs. The latter understand the bigger economic picture, and students have traditionally been at the vanguard of China’s social change.

Asia’s export model of growth was never meant to be the sole answer to how the region’s economies would develop. But once it was under way, it was hard to make the shift toward a better balance. The model largely worked, and the last quarter century saw global trade grow at twice the rate of global GDP. Yet the model has served its time.

It is in no one’s interest to see Asia in disarray. A prosperous Asia can increase global economic growth, provide regional stability, and help with trouble spots, such as North Korea. How the region responds to the current crisis—and how the West helps it cope—will determine the depth and duration of Asia’s economic woes. The region will still boast powerful economies in this century, but a more sustainable economic model, one entailing higher domestic consumption, must be found. If the root cause is not addressed, Asia’s problems will become the world’s. 🌐