

1 Toward 2004: Asia-Pacific Outlook and Prospects

Darryl S.L. Jarvis

Introduction

The 1990s were both kind and cruel to Asia; kind inasmuch as growth in the first half of the decade was robust and expansive, development was widespread and rapid by historical standards, and markets were expanding in virtually every economic sector from consumer durables to infrastructure and construction. In response, investors from around the globe poured capital into the region, convinced of its future and stability. But even the Asian miracle proved fallible, bursting in 1997–98 in a series of cataclysmic financial sector meltdowns; the economic and social effects of which are still being widely felt today.

As Asia moves forward toward 2004, its markets, economies and political systems are viewed now in a more vexed and nuanced light by creditors and investors alike, who are acutely aware of the risk premium that all emerging markets carry. Risk has become the new benchmark by which to understand emerging markets, and its purview greatly expanded beyond purely economic quarters to include political, regulatory, social, indeed cultural risk. Understanding the rubric of risk and its multifarious dimensions as they apply to the leading economies of Asia in the coming years, comprises the principal concern of this volume.

Pain and suffering: Reform and restructuring

In large measure, the future of Asia and its composite risk profile is brighter today than it was before the financial crisis, thanks in large part to the painful but on-going series of public sector restructurings and private sector corporate reorganizations and rationalizations that have been taking place since 1998–99. These are far from finalized, but point the way toward

the future, with an increasing emphasis on corporate transparency and governance, fiscal rectitude, anti-corruption crusades, and enhanced systems for public sector governance. Asia remains awash with international agencies attempting to engineer prudential and regulatory systems of governance to stabilize financial markets. Governments and populations too, have become more cognizant of the need for such measures as a means to longer-term stability and economic growth. Few would now suggest such measures unnecessary, and fewer still would want to turn the clock back to pre 1997.

In this light, and with the exception of Japan, Asia is experiencing great leaps forward, and a new-found confidence about its future. The movement toward democratization, greater electoral transparency, and popular participation in major national decisions, would have been thought largely impossible only a few short years ago. Corruption, nepotism and cronyism are all under the spotlight as antithetical to national interests, growth and political stability, and have touched nearly all the countries of the region in ways that have ushered in significant change. In the Philippines and Indonesia, these have changed governments and political systems, emblematic of a new mass consciousness of the dangers and forgone wealth that previous corrupt rule brought. Increasingly, democratic participation is now a requirement for governments to claim legitimacy, with widespread evidence of the rollback of undemocratic practices, graft and corruption. Nor should this trend be underestimated, representing a sea-change to forms of governance not imaginable in the mid 1990s.

All this bodes well for Asia's future, albeit that such reforms are far from complete. What it signals is a movement toward the formal organization of national polities along broadly concurrent liberal-democratic lines, and the formalization of markets and economies constructed along internationally recognized systems – broadly compliant with international standards in terms of capital provisions, prudential systems and regulatory norms. However, this said, great diversity remains in Asia, with some economies more advanced than others, as is evident by the diverse risk premiums attached to each country. This will continue to be the case beyond 2004, with dissimilar growth trajectories and reform processes taking place, although broadly situated amid overall regional progress.

Change and transformation: China and corporate reorganization

Of most significance to the region has been the about-face of foreign direct investment (FDI) flows, which, in the early to mid 1990s saw 50 percent of FDI into Asia locate itself in the economies of the Association of South East Asian Nations (ASEAN), with only around 16–20 percent destined for China. In 2002, this figure is virtually reversed, with approximately 55–60 percent of regional FDI locating in China and only around 16–19 percent locating in ASEAN.

The longer-term ramifications for ASEAN nations are profound, hastening them to better develop regulatory and prudential systems, and liberalize their economies more quickly in order to compete in the race for FDI, now drawn more than ever to the growth potential of the Chinese market. This is a trend that will only deepen in 2004, with China set to maintain its hold over the lion's share of regional FDI, with other Asian states forced to compete for the dwindling remainder.

In point of fact, however, there are benefits associated with this new found competition for FDI. ASEAN states, in particular, will doubtless have to stick with their reform programs or face the prospects of a growing disinterest from international investors, while international investors can increasingly expect better terms and conditions in order to attract them, with generally improved levels of corporate transparency and cleaner financial markets in which to invest.

To be sure, however, the process has been painful for both investor and ASEAN states alike – with little sign of relief before 2004–05. ASEAN states, for example, are witnessing closures of manufacturing plant and employment downsizings, depriving their governments of important revenue streams. Foreign multinational enterprises are likewise re-appraising their commitment to many ASEAN states, and generally closing their Southeast Asian country operations in preference for Chinese corporate forms of organization that are now regionally rather country focused.

This reorientation in corporate focus will deepen throughout 2004 and beyond, with the movement toward China set to gain greater momentum. Indeed, multinational enterprises have learned a harsh lesson after the initial exuberance for investing in ASEAN and Southeast Asian states, with these markets proving fickle and too small to sustain the level of FDI interest they initially generated in the early to mid 1990s. Consider, for example, the fact that the combined gross national product of Singapore, Thailand, Indonesia, and Malaysia, only just approaches the size of the GNP produced annually in the province of Ontario, Canada. Corporate strategists should thus be mindful of the fact that foreign investment allocations need to be proportional to market size and depth. By and large, emerging economies suffer a much lower capital saturation level than do more mature economies, compounded by generally underdeveloped financial markets lesser able to allocate financial resources in a way commensurate with investor risk expectations.

Likewise, market depth and GDP per capita in most ASEAN states remains small by comparison to the more mature markets of Western Europe and North America, indicating only limited stratum of middle-class consumers with both the taste preference for high-end consumer goods and the disposable incomes to enjoy them. The lessons being learnt now, then, are as much about poor corporate strategic planning and a less than familiar understanding of these markets, as they are about the apportionment of blame for poor governance, corruption, and the absence of regulatory transparency of financial markets. Corporate risk management practices and capital exposure levels will thus have to be reassessed in light of many of these failed ventures.

Unfortunately, it is not apparent that this is the case, with the deafening rush to China reminiscent of the rush to ASEAN and Southeast Asian states only a few decades earlier. Foreign venture failure rates in China, for example, hover at around 50 percent, and are probably much higher but for corporate face-saving exercises carried out to preserve share values and reputations. Indeed, the risk premium of investing in China is rarely appreciated; with corporate executives fond of suggesting that all is now well as a result of China's entry into the WTO.

Little could be further from the truth, however, with precious little evidence of regular or substantial profit remittance from China by leading foreign multinational enterprises. It

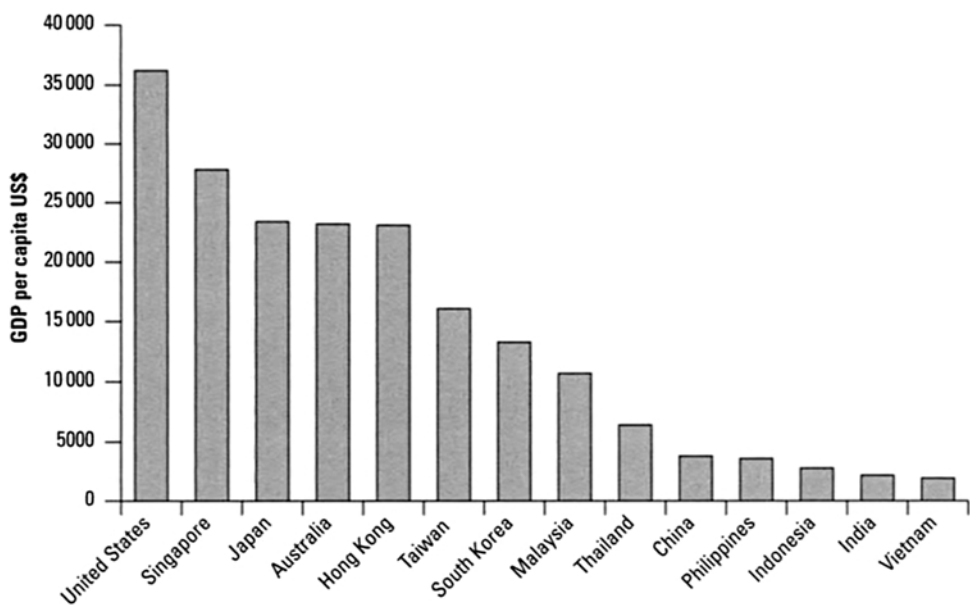


FIGURE 1.1 Rank of countries – GDP per capita US\$ billion
Source: World Bank; International Monetary Fund

might well be the case that China could turn out to be the Vietnam of the new millennium, with corporate strategists wise to remember that fewer than 10 percent of the foreign multinational enterprises originally established in Vietnam in 1994 have turned a profit after 8 years of business activity. Most have now divested themselves of assets and returned home.

The bottom line: Beware of Chinese bearing gifts

If there is a lesson here it is one which suggests the need for corporate strategists to develop robust risk management practices; a better familiarity with the chosen investment destination(s); and a need to stand aside from the herd mentality of following the example of other organizations and assuming a fit with the risk profile and business strategy of one's own organization. In the case of China, the oft-quoted parable that it is a market of 1.3 billion people hides the fact that GDP per capita approaches only approximately US\$3800, with this figure largely skewed by inclusion of income figures from the prosperous coastal cities. Indeed, if these are excluded, the GDP per capita of some 200 million Chinese is as low as US\$2.00 per day. Consequently, the ability of the vast majority of China's population to absorb the increasing levels of FDI with commensurate consumption levels necessary to ensure foreign enterprise profitability, is vastly exaggerated by the 'China hype' currently working the corporate boardrooms.

Investors contemplating a move to China should therefore be acutely aware of the downsides, which, at this point in time, and well beyond 2004, will remain considerable.

External vulnerability: Risks ahead?

Asia’s great success has rested largely on its ability to plug in to the demand structures of the Western economies, meeting the initially insatiable appetite for cheap, low-valued-added manufactured goods, labor-intensive production of consumer durables, and the provision of computer equipment and parts under the initial phase of the product cycle for personal and business computers.

This, of course, has also been Asia’s great undoing, and responsible for the ‘second regional crisis’ of 2000–01 when the worldwide tech-meltdown occurred. Particularly hard hit have been the economies of Singapore, Hong Kong, Taiwan and Thailand, with India and China relatively insulated due to the high level of protection enjoyed by India and the lower level of export reliance generally experienced by China.

The dislocation of the tech-meltdown has been tremendous, perhaps even greater in terms of longer-run implications than the crisis of 1997–98. The value of semi-conductor sales in September 2001, for example, was only half the equivalent of the levels in 2000, and only a nominal rebound was experienced in 2002. Income streams from exports in semi-conductors, otherwise extremely important to most of the Asian states, have therefore ushered in a period of profound restructuring and outright dislocation. Likewise, the end markets for these products have also suffered throughout Asia, with precipitous drops in valuations for telecom sectors in particular.

Unfortunately, little significant rebound can be expected in 2003–04, reflecting the ending of that phase in the product cycle that saw rapid demand expansion throughout the 1990s. What this signals for 2003–04 is a continuing high level of external vulnerability for

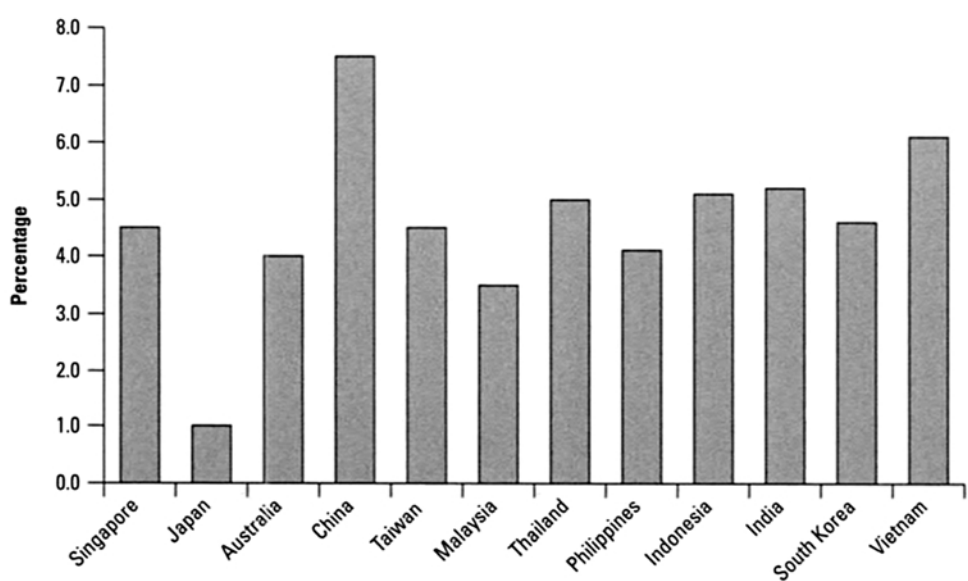


FIGURE 1.2 Growth forecasts for 2002–04
Source: World Bank Forward Estimates; Economist Intelligence Unit Forecasts

the Asian economies. In turn, much of their post-tech-sector meltdown recovery will be contingent on the fortunes of the main drivers of the global economy, principally the depth and continuity of the anticipated recovery in the United States in 2003–04, which, despite leading indicators, is still fragile.

Eyes on diversification

So too, much of the recovery in Asia will rest – especially in the longer term beyond 2004 – on the ability of governments to diversify the breadth of their economies beyond simply external demand drivers indicative of single product cycles, as with the technology sector. To a large extent, there is as yet little evidence to suggest much has been achieved, with most Asian economies, and especially those of ASEAN, currently in the midst of attempting to navigate the fallout of declining export revenues and rising unemployment levels. While this will moderate in 2003–04, astute investors should be looking for signs of economic diversification as a forward indicator of those economies that will be better placed to withstand future externals shocks.

Acknowledgement of this among regional governments is now well accepted, with a common mantra – although not always acted upon – to diversify into ‘knowledge-based economies’ and position themselves in readiness for the next product cycle likely to be driven by the anticipated bio-technology boom. Taiwan, South Korea, Thailand, Singapore, Malaysia and the Philippines have all indicated adoption of strategic plans to rapidly expand this sector of their economies, although some are better positioned than others to realize these ambitions. Singapore, in particular, is probably the regional leader, given both its

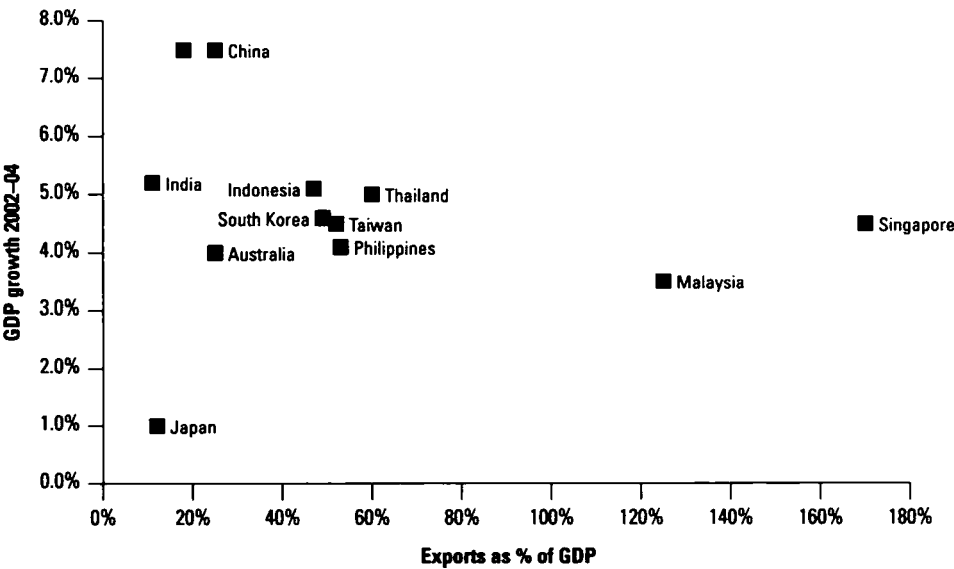


FIGURE 1.3 External vulnerability and growth prospects
Source: National Accounts; Economist Intelligence Unit Forecasts; Asian Development Bank

extensive educational infrastructure and well-developed levels of social capital. Thailand and the Philippines, by contrast, are less well positioned and likely will not realize significant FDI into bio-technology sectors.

Whatever the case, diversification will be the key to the longer-term game plans of Asian states beyond 2004, with those highly exposed and vulnerable economies already planning for such eventualities.

The Japan factor: Exporting deflation

Of equal concern to Asian states is not just the economic performance of the global and US economy, but also that of Japan. Japan remains a critical economy for Asia, being regionally predominant and the principal trading partner of most of Asia’s economies. However, Japan’s lackluster performance since the bursting of the bubble economy in the early 1990s, has not served Asia well, depressing Japanese consumption levels, import demand and asset prices, which, to some degree, have been exported to the rest of Asia in the form of lower demand levels and postponed consumption.

While reform of the banking and financial system is under way in Japan, as well as wide-ranging corporate sector reform, little meaningful resolution to this process can be expected in 2003–04. Consequently, as a demand source for Asian exports, Asia will remain dependent on the US and Western European economies if they are to achieve export-led growth. Again, this places greater emphasis on, and concentrates external vulnerability in, the US economy and its fortunes in 2003–04 and beyond.

This situation will likely continue for some time to come, not least because Japan is experiencing a rapid aging of its population, forestalling consumption expenditure by pushing up savings rates as a large segment of Japanese society prepares for retirement. So too, anticipation of deflation and continuing falling prices, while aggravating negative equity positions for investors in property markets and thus threatening savings and investments, is also stalling forward anticipated consumer expenditure with negative consequences for the region.

Unfortunately, there is little hope of any short-term solution to this conundrum in 2003–04; short of a deliberate government policy to re-inflate the economy, thereby eating away savings and forcing consumers to resume consumption expenditure for fear of seeing the longer-term value of their savings eroded. However, the current administration has steered away from any such policy, leaving the economy and the region to wait and watch for a slow, longer-term recovery.

Reform fatigue: The next great danger?

If there is perhaps a sleeping danger in Asia it resides in the onset of reform fatigue, already apparent in Thailand with creeping protectionism melded with political hubris and nationalism. The Thaksin administration, for example, has taken its foot off the reform accelerator, and shown a renewed disposition to dispense political favors through protectionist measures. In many senses, this harks back to the Asia of pre-1997, with thankfully few other economies following suit.

However, there are fears that if another round of crises were to hit the region, or the anticipated upturn in the US and global economy were less than hoped for, the reform agendas of many governments would necessarily be shelved for fear of domestic political backlash. While this looks like a worst-case and least likely scenario, it nonetheless underscores the fragility of the recovery process in Asia and its relationship to the reform process. Indeed, on the other side of the coin, exuberant growth, should it return to Asia post-2005, might also be reason for concern, with robust economic conditions tending to diminish the sense of urgency necessary to push through often unpalatable and politically sensitive reform agendas. Either way, both scenarios underscore that Asia has a limited window of opportunity with which to cement its commitment to the reform program and liberalization measures.

Regional security: Prospects and trigger points

Despite tumultuous changes in the region, stability has been more preponderant over the last few decades than at any time before. This bodes well for the immediate future, barring two on-going irritants.

First, the obvious great power rivalry between the United States and China, especially in terms of each wishing to exert a sphere of influence commensurate with its power capabilities, provides a backdrop to on-going regional tensions, demonstrated in 2001 with the downing of the US spy plane on Hainan Island.

There is every indication that these sporadic irritants will continue, with the Sino-US relationship likely to be underscored by a mutually suspicious, albeit congenial, relationship intermittently tested by diplomatic spats.

Importantly, however, there is no indication of the desire for hostile engagement, with the prospects for hot war rated as extremely low. Obviously, however, the trigger point

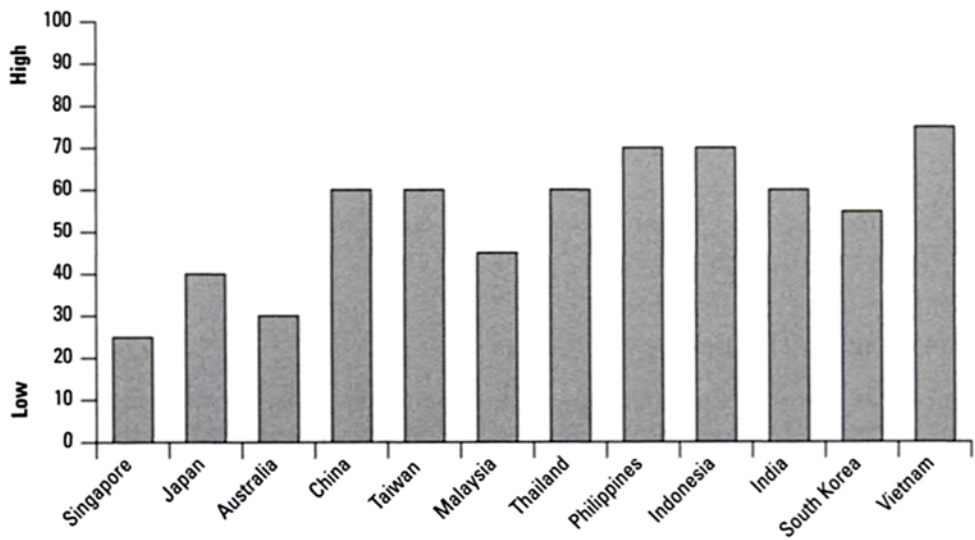


FIGURE 1.4 Risk rankings for Asian countries

leading to such outcomes lies in the alignment of US strategic interests with the protection of Taiwan’s independence, something the United States under George W. Bush has been keen to reiterate, to the annoyance of Chinese authorities. Little is expected to change in 2003–04, with the issue of Taiwan remaining an on-going thorn in US–Sino relations.

Likewise, the War on Terror poses no overt security concerns for foreign investors in the region as a whole. While there are, to be sure, locally active militia and terrorist organizations, there is no discernible trend in the region toward Islamic militancy as a whole. The Philippines remains one exception to this, with a well-documented series of military skirmishes on the southern island of Mindanao requiring US troop deployment to help the Philippine administration secure its territorial integrity. However, there are few prospects of this spilling over into other countries and, for the most part, the security concerns are well contained.

Equally, the fear of resurgent Islamic fundamentalism in Indonesia is also contained, and represents a backlash against the breakdown of civil society and all forms of organized political expression that existed under Suharto. Much of the agitation currently in evidence in Indonesia, is thus better appreciated as the beginnings of organized political opposition, albeit using the instruments of Islam as a vehicle to mobilize mass political action. As such, it does not represent the beginnings of any nationally based fundamentalist movements with ambitions to terrorism and hostile engagement with the West or the United States.

In all, then, what can be observed about the region is inter-state stability in diplomatic and strategic affairs, and the continuance of this trend to at least 2004. What security concerns currently exist, are localized and are not tending to spill from one state to the next, as was often the case in the past. Foreign investors can thus approach Asia with few concerns about regional security stability in the coming decade.



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