4. Growing Economies in APEC

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4.1 Economic Repositioning for Common Prosperity in an Age of Globalization

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The world is at the crossroads of prolonged economic stagnation and greater economic common prosperity. Economic growth has slowed down in the last three months, and there is now even greater uncertainty amongst the global economic policy leaders on the policy responses to adopt going forward.

United States Policy Debate

Take for instance the United States (US) policy debate. The important lesson that the US learnt from the Great Depression of the early 20th century is that there must not be premature withdrawal of macroeconomic stimulus. Had it not been for the outbreak of World War II, fiscal and monetary expansion would not have occurred then due to the premature withdrawal. Given this mindset, it is understandable why American economist Lawrence Summers, in his recent column in the Financial Times, called for continued high budget deficits in order to fight the economic slowdown.

On one side of the debate is that more of the same must be done. It is probably with this mindset that the Federal Reserve Chairman Ben Bernanke unleashed Quantitative Easing 2 (QE2) in November 2010, and hinted of a third round of easing if economic conditions were to further worsen.

On the other side of the debate, exemplified by the Tea Party, is that the US economy is on the wrong course. This side of the debate calls for government expenditure to be cut whenever possible, and for taxes to be reduced to contain the ability of the government to spend.

These two primary suggestions unfortunately do not properly address the challenges the US is facing. With regards to quantitative easing, according to Albert Einstein, doing more of the same and expecting a different result is irrational. The Japanese too, have been conducting many futile rounds of quantitative easing since 1995, in the hope that the Japanese economy rebounds. If something does not work, it does not necessarily mean that the effort is insufficient. The reason why it has not worked is probably because what has been done is not effective in curing the problem at hand. The role of the government has to change, but not in the way that the Tea Party has pushed for.

Growth Forecasts for the Major Economies

Table 4.1.1 shows the predictions of the growth forecast for the major economies by the International Monetary Fund (IMF). The first three columns of figures are the predictions of the IMF, released in April 2011. Two months later, in June 2011, IMF revealed an updated forecast for calendar year 2011 (see last column of Table 4.1.1). In the June update, the IMF revised downwards, most of its forecasts for the major economies. The US growth for 2011, originally forecast at 2.8%, has been downgraded to 2.5%. In the case of Japan, growth is revised to -0.7% from 1.4%, as a result of the triple disasters.

Table 4.1.1 Growth Forecasts

In %	April 2011 Estimates			June 2011
	2011	2012	2013	2011
USA	2.8	2.9	2.7	2.5
Japan	1.4	2.1	1.7	-0.7
Germany	2.5	2.1	1.9	3.2
UK	1.7	2.3	2.5	1.5
Italy	1.1	1.3	1.4	1.0
China	9.6	9.5	9.5	9.6
India	8.2	7.8	8.2	8.2

Source: IMF

From Table 4.1.1, the US is growth rate is estimated to be below 3% for the next three years. As unemployment rate is unlikely to decrease unless growth rate is above 3.5%, continued high unemployment in expected in the US. This continued high unemployment will mean continued tensions over economic policies.

The IMF predicts that growth for India and China continues to be high. These figures depict a world that is growing on two tracks. While the US speaks of a global recession at the G-20, China and India are both tightening their monetary policy in order to slow down their growth. The idea of a coordinated macroeconomic stimulus is not something that is on the cards. It is more important to note that this particular trend of higher growth in the emerging economies compared to advanced economies is merely a continuation of the situation since 1990. Since 1990, there has been accelerated economic structuring in the world and this acceleration is commonly known as globalization.

Real Economic Challenges to the US

The US views trade imbalances as the greatest threat of globalization. Protectionism is very much in the air in the US, and explains why the US agenda in G-20 meetings is always to try to get the trade imbalances down. The US policy elite has blamed the implosion of the US financial markets on the inflow of financial capital from Asia. The high feelings are best summarized by Nicholas Lardy, an American economist specializing in China, who described US as a consumption addict and China as the dope pusher. This reference to the 19^{th} century history of the Opium Wars with the aggressor and the victim reversed, reveals the unease with how the US should view globalization.

Prior to the 2010 G-20 Seoul summit, the US had managed to garner the support from the rest of the economies in criticizing China for its exchange rate policy. This meant that the G-20 meeting was likely to become a G-2 meeting. However, China was largely spared from defending its exchange rate policy as ten days before the G-20 meeting, Ben Bernanke unleashed QE2. QE2 led to great instability in the global financial markets and hence completely shattered the coalition that the US has formed, undermining US foreign policy. Ben Bernanke should have unleashed QE2 only after the G-20 meeting; a delay of ten days was unlikely to have had a significant impact on the US economy. QE2 is a case of Ben Bernanke conducting economic policy without thought of international consequences.

The US adoption of Japan's failed quantitative easing policy and the untimely announcement of QE2 are indicative of the inability of the US in handling the world and the changed economic consequences. In addition, the US policy elite has incorrectly interpreted trade imbalances as being the primary challenge of globalization. Rather, the primary challenge of globalization is an optimal adjustment to the new global division of labor. Instead of exploring another round of quantitative easing, the US should be thinking of repositioning itself for a world of different economic configuration. It should be noted that this new global configuration is not an issue unique to the US.

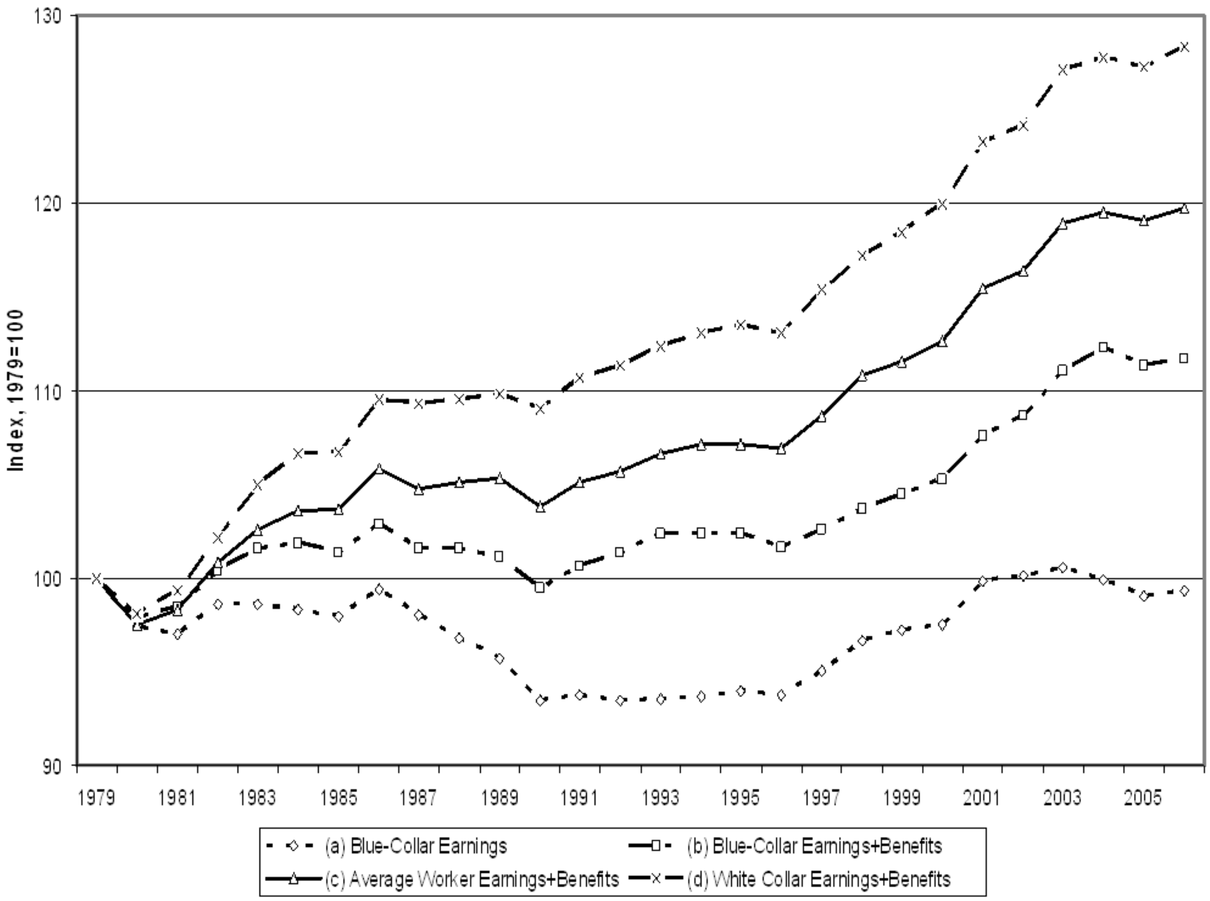
Possibly the greatest acceleration of globalization occurred on 1 January 1990. The economic isolation of the Soviet bloc started crumbling when the new non-Communist Solidarity government of Poland began the marketization and internationalization of the Polish economy on 1 January 1990. The economic transition and political disintegration of the Soviet bloc became irreversible when Yeltsin replaced Gorbachev as the unambiguous leader of Russia in August 1991 and implemented market-oriented reforms in January 1992. In 1992, India undertook massive economic restructuring in response to a balance of payments crisis. In February 1992, then paramount leader of China Deng Xiaoping recognized that the implosion of the Soviet Union meant that a third way in the capitalism-versus-socialism debate did not exist. Hence, China global practicalism began.

The period of 1990 to 1992 was a great period for globalization. It was in this period that one half of the world's working labor force that had not been active participants in international trade became participants in international trade. Of the 2.3 billion workers in the world in 1990, only 1 billion workers were participating in the international division of labor. Ten years later in 2000, at least 2 billion of the 2.6 billion workers in the world were participating in the international division of labor. Basically, the global labor force doubled with globalization.

Any Heckscher-Ohlin economic model will predict that such a scenario will tend to pull wages up in new economies and pull wages down in the advanced economies. This is the basis of American economist Paul Samuelson's diagnosis: free trade is not good for the advanced economies but good for the emerging economies.

Paul Samuelson was the person who modeled the Heckscher-Ohlin insight formally and brainwashed the profession into the idea that free trade may damage the interests of some groups of workers. Such an argument could lead to protectionist tendencies in the US. However, the prediction that the wages ought to go down in the developed world when the labor force is doubled turned out to be wrong. Indeed, wages in the US continued to rise (see Figure 4.1.1) and in fact accelerated in the mid-1990s.

Figure 4.1.1 Compensation Received by US Workers (1979 = 100)



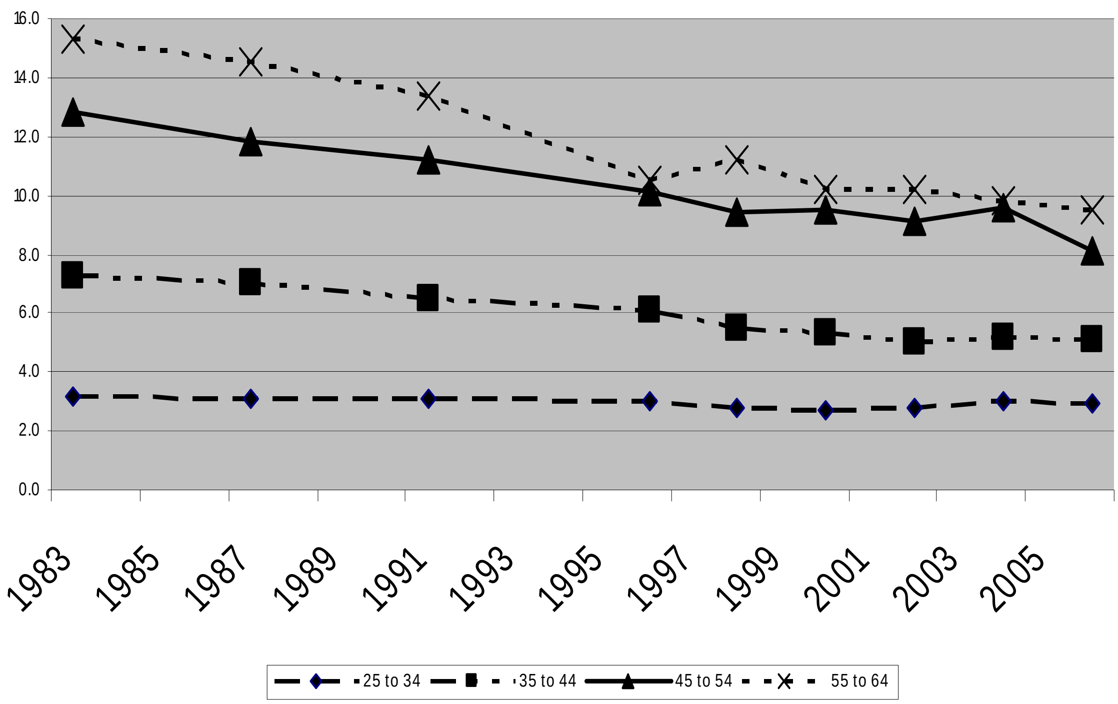
Yet it should be noted that, during the 2008 United States Presidential Election campaign, both (then candidates) Barack Obama and Hillary Clinton said that wages have been stagnant since the 1990s. This is contrary to what is being shown in Figure 4.1.1, but Barack Obama and Hillary Clinton are not incorrect in their statements. The explanation lies in the context.

Figure 4.1.1 clearly shows that the amount of compensation that US firms have been paying to blue-collar workers has been rising over time (see the 3rd line in Figure 4.1.1). What has not been going up over time is the take-home pay of the blue collar workers. That is reflected by the bottom line in Figure 4.1.1. The difference between the total compensation payout and the stagnant take-home pay is largely brought about by medical benefits. Essentially, the medical inflation in the US had consumed all the wage increases that the blue-collar workers would have gotten. That explained why Barack Obama's first job following his victory in the 2008 Presidential Election was to do something about medical care. However, although he has extended medical care, he has not put in place any cost containment. In other words, the net is enlarged but costs are not reduced.

Firms, however, were able to pay more wages to workers because the workers were more productive. Workers are more productive because another force is at work apart from globalization – technological innovations. Take for example accounting. Accounting in the US used to be an occupation that is for the middle-class and is non-tradable because one has to go to the office of the company to do the accounting. With the advent of the internet, this is no longer true. Back office work can now be outsourced to say, India or the Philippines. Hence, the middle class in the service sector is directly hit.

When workers in the US do manage to find jobs, the job pays more because of the technological innovations, which translates to higher productivity. The result is that in the US, the total compensation package has been rising because of technological improvements. The stagnation of wages was caused by healthcare. While globalization has the effect of depressing wages in the US, between globalization and technological innovation, technological innovation has been the greater force.

Figure 4.1.2 US Median Tenure at Current Job by Age of Worker (in years)



The evil twin of technological innovation is that people skills get out-of-date. Figure 4.1.2 is proof of technological innovation making skills obsolete. Figure 4.1.2 shows the median duration of a person holding the job at four different age groups. Consider someone in the age group of 45 to 54. In 1983, this worker would have probably held the same job for 12 years. In 2006, someone in the same age group could probably be in the same job for only 8 years. People are churning over more often, primarily because the industries they are in have gone out-of-date and collapsed and thus they move on to a new job. Those in the oldest age group are observed to be most affected. Some could argue that the fall in median tenure is attributed to the restless attitude of the elderly, but technological innovations remain the most likely explanation.

The confluence of two trends hitting the world – globalization and greater technological innovation – means that workers have to adjust to get to new firms. It is the reason why the US unemployment rate is stubbornly high. Lack of aggregate demand is not the main reason; rather, it is because the old jobs that workers were doing can no longer exist in the new division of labor.

Ben Bernanke's hint of QE3 can be likened to a doctor's efforts in reviving a patient who has lost a lot of blood as a result of a car accident. The initial pumping of say, two quarts of blood is the right medicine. If the patient is able to raise his/her head as a result, it does not mean that pumping in another two quarts will enable him/her to recover. In fact, pumping in the next two quarts is not going to be effective; there are other problems to be addressed.

The US has to think of a way of re-training its workforce, but re-training is a hard thing for workers over the age of 45. The US can explore a wage subsidy for workers over 45, and training can be targeted for the children of these workers so that they can move on to meet the new jobs of the more high-tech economy. That is possibly the biggest challenge to the US, and similarly for advanced economies in other parts of the world.

As a result, the Tea Party's recipe in addressing the US problem is inappropriate. The Tea Party's recipe includes cutting the budget of Pennsylvania State University and the University of California by 50% and 25% respectively. These education cuts as well as cuts in the social safety nets are untimely, especially as it is extremely crucial to upgrade human capital to address the US challenge.

China's Challenge: Sustainable Growth

China needs to continue to restructure in order to continue to grow. China sees the building of a harmonious society as its greatest challenge. To think of the greatest challenge as 'a harmonious society' is probably an admission that current economic political trends are not leading towards a harmonious direction.

One can think of China like a car in the passing lane, overtaking other economies: China overtook India in 1990, it overtook the Philippines in 1997, it overtook Indonesia in 2003 and at its present speed, it will overtake Malaysia in around 20 years. However, a speeding car can collapse as a result of three kinds of failures:

- Hardware (*eg* tyres coming off)
- Software (*eg* people fighting inside a car resulting in a car crash)
- Power supply (*eg* road block)

Hardware failure is the least of China's problems, largely because hardware failure is something that one knows how to fix very easily. The secret of fixing hardware failure is to observe what the rest of the world has done when they face similar problems and just do the same.

Clearly, China sees social stability (software failure which could include the failure of political reforms or social reforms) to be its biggest challenge. This reflects China's intellectual insularity.

In fact, the biggest threat to China's sustained growth is possibly power supply failure. The kind of global economic reconfiguration that is going on is creating a lot of tensions among China's trade partners. This could result in protectionism (equivalent of a road block in the road). When China hits it, their growth will come down overnight.

China does not realize that it is unable to build a harmonious society internally unless it helps to build a harmonious world outside of China. China has to exit from the small country mentality, which is the tendency to do nothing and be a free rider with the excuse that many things are exogenous. Specifically, the Doha Round is stuck. China has benefited most from the WTO system, and yet China has not taken leadership of the Doha Round and to push it to completion, to protect itself from increased protectionism elsewhere.

Another example of China displaying a small country mentality is the approach that it is adopting in addressing the greatest challenge it is facing, the acute water shortage in North China. Global climate change and a resultant change in rainfall pattern in China means lesser rain is falling on the northern plains. Coupled with continued urbanization, more water being pumped from the aquifers has caused the part of China north of the 36th parallel latitude to sink at a rate of 3 mm a year. China's solution to this water shortage problem is to get more water from the south. However, there are concerns that China's dams could adversely affect the flow of water to neighboring countries. Already, there is a perception that China's dams are hijacking the Mekong's water as the river runs from the Tibetan Plateau to the South China Sea, affecting farmers and fishermen in countries that share the Mekong River with China.

These are big challenges that China has to face.

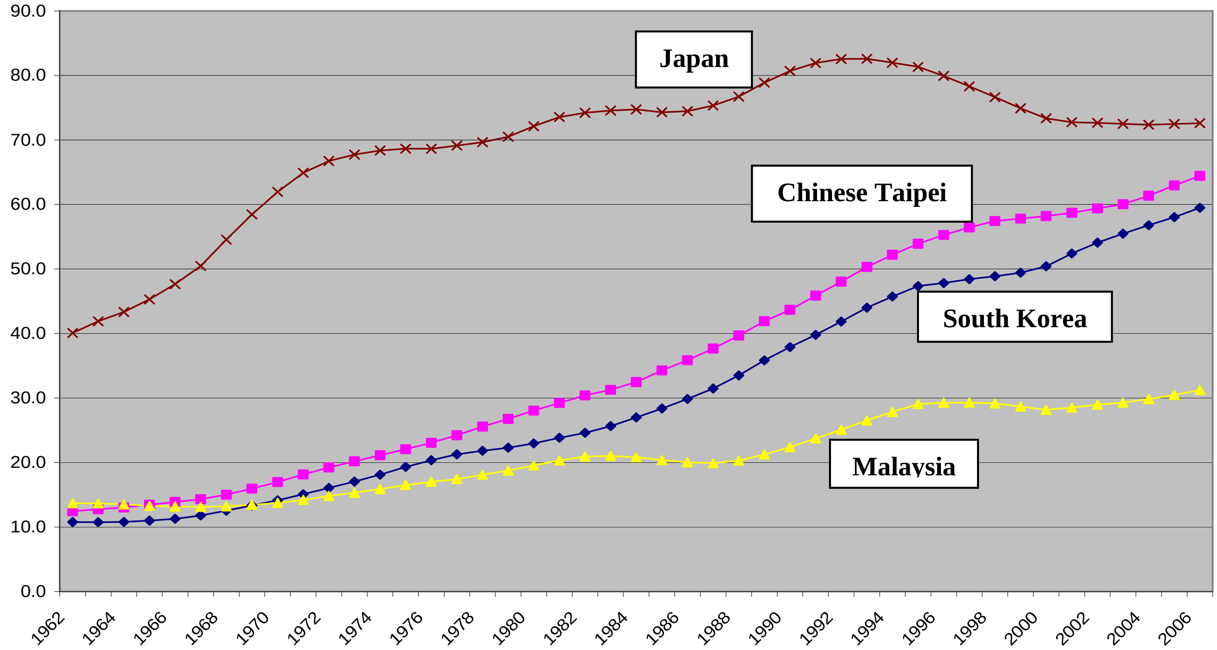
<u>Challenge to ASEAN: Middle Income Trap</u>

Malaysia and ASEAN in particular has to restructure to get out of the middle-income trap. Figure 4.1.3 illustrates the living standard of Japan, South Korea, Chinese Taipei and Malaysia as a percentage of US living standards. Singapore is deliberately omitted from Figure 4.1.3 for the simple reason that Singapore does not face the middle income trap. The star performers after Singapore in Southeast Asia are Malaysia and Thailand, and both these economies have been stagnant since the beginning of 2000. This stagnation is worrying.

From Figure 4.1.3, Malaysia is observed to be richer than Chinese Taipei and South Korea from 1960 to 1965. However, whenever Chinese Taipei and South Korea meet a challenge, they overcome it and continue to grow while Malaysia has a much smaller progress because its economic policies were not adjusted in a timely fashion. After 40 years, the economic policy in Malaysia is due for a tune-up. There are changes that will have to occur not only in Malaysia but across ASEAN, to be in line with their new global relatives.

For the common prosperity of APEC, all member countries have to think more in terms of economic restructuring rather than macroeconomic stimulus or trade imbalances. In the case of the US, it has to recognize that a large part of the unemployment is due to the fact that there is a hollowing out of the traditional industrial structure. It has to move on to new industries with more knowledge-based growth than ever. As for China, it has to move beyond the small country growth model of export-led growth, to investment targeted at internal opportunities; specifically, urbanization should replace exports. All countries face the need for a new global architecture.

Figure 4.1.3 Living Standard of Selected Economies as a Percentage of US Living Standard



4.2 The Japanese Experience

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The Japanese Economy

Before 11 March 2011, the Japanese economy was showing some recovery. As a result of the 11 March natural disaster, the Japanese economy is expected to post only 0.6% growth in fiscal year 2011 (*ie* 1 April 2011 to 31 March 2012). This figure differs from the IMF growth forecast of -0.7% (see Table 4.1.1) as the IMF forecast is for calendar year 2011.

The earthquake and tsunami of 11 March caused a very sharp decline in the economy. The annualized rate of contraction of the economy was estimated to be 3.7%. This is in part due to the magnitude of the earthquake. The physical primary damage caused by the earthquake and tsunami is estimated at 17 trillion Yen (equivalent to around US$200 billion), approximately 3.5% of Japanese gross domestic product (GDP). The estimated cost excludes the nuclear aspect, which is estimated at US$20 billion.

Private consumption has sharply declined, and industrial output has dropped by 15%. This 15% drop is the sharpest decline of industrial output that Japan has experienced in recent years. As a result of the decline in industrial output, exports also declined. The world panicked as the Japanese did; many countries banned the importation of goods produced in Japan because of the alleged radioactive aspect and this too, affected exports. Now, many countries are removing the barriers.

Although Japan posted a sudden and sharp decline in economic activities, the restoration process is taking place. The supply chain will be restored – particularly in electronic area – by the end of June-July period and for the auto industry, perhaps by October. That would certainly improve the economic conditions. By October, the supply chains are expected to be restored and the economic industrial activities would perhaps be returned to the pre-earthquake situation. After October, Japan expects a stronger economic recovery growth and to post about 2.9-3% economic growth in 2012.

Although the Japanese economy was very much affected by the 11 March disaster, the transmission of damage to the region is rather limited. The destruction of the supply chain meant that some advanced economies in the region, particularly those connected to Japan's auto industries, were affected. In addition, the electronic industry in Europe was very much affected because some of the factories which were very much damaged in the 11 March disaster supplied 70% of global supply of certain components.

Energy Supply

Japan has a very serious problem with the energy situation. The earthquake and tsunami affected a large number of power plants. At present, some of the power plants are being checked, while some have been suspended. 28% of Japan's power supply comes from the nuclear source: Japan has about 54 nuclear power plants, of which only 17 are currently working. As a result, industrial activities are very much affected.

At the end of March, the power supply capability of Tokyo Electric Power was about 310 million kilowatts, which is below the normal capacity of about 510 million kilowatts. Nevertheless, restoration activities and repair work have been going on. In addition, new facilities, mainly gas turbines, have been introduced. The power supply capability is expected to resume to its normal capacity of 510 million kilowatts, which is about 10% lower than the peak requirement recorded in 2010. In 2010, Japan had an unusually hot summer, and the maximum demand was about 610 million kilowatts.

As part of Japan's energy conservation effort, an interesting method, visualization of electricity use, is employed. With this method, the electricity capacity being utilized throughout Japan can be viewed via the internet. When the Japanese residents see a 92% utilization rate, their response is to cut off the electricity. This visualization process is working very well, and since the 11 March disaster, the peak utilization of the existing capacity is 92%.

Downside Risks

There are a number of downside risks. One is the general sentiment towards nuclear – there is a general strong concern about the safety of nuclear power plants. This disaster has resulted in all nuclear power plants (not only those affected by the earthquake and tsunami) being checked, although no damages had been reported.

Another downside risk is the concern that the recovery of the supply chain process may be slightly delayed because of the shortage of electricity.

The third downside risk is the global economic condition, particularly the European situation. Whatever affects the European financial market situation (*eg* Greece and Portugal debt worries), will definitely affect the Japanese economy.

The fourth downside risk is the Japanese political situation. As a result of the current political situation, various reconstruction measures are being delayed. The reconstruction agency was only installed after more than 100 days from the 11 March disasters. As a result, the process of reconstruction recovery is very much delayed compared to the previous large natural disaster, the Kobe earthquake.

4.3 China's Economic Growth Outlook & New Challenges

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<u>Short-Term Challenges & Responses</u>

Fighting inflation remains a major challenge for the Chinese economy as the inflation rate continued to increase and reached 5.5% in May 2011. However, Chinese Premier Wen Jiabao wrote a recent article in the Financial Times to reassure the public that he is confident that the government will be able to control the domestic inflation in the second half of the year.

Figure 4.3.1 Consumer Price Index & Producer Price Index (January 2006 = 100)

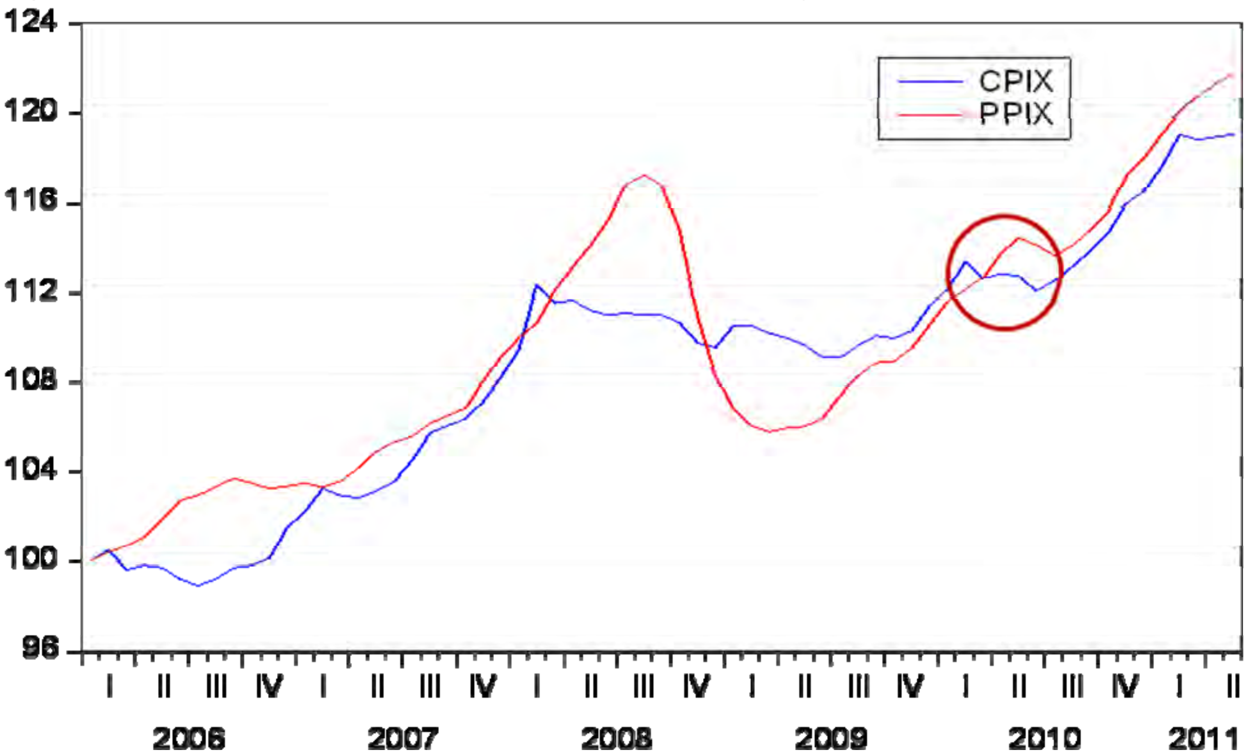
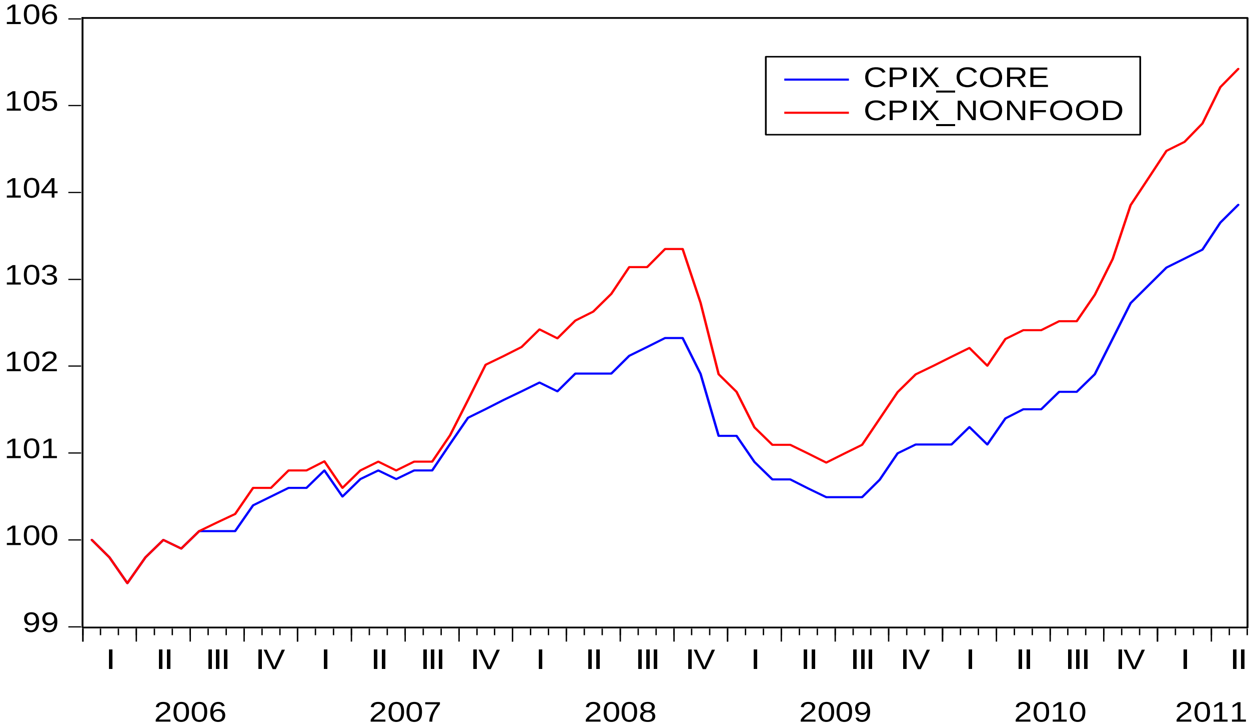


Figure 4.3.1 shows China's consumer price index (CPI) and producer price index (PPI) from 2006 to the second quarter of 2011. The CPI continues to increase after the global financial crisis, and is still increasing. The period circled in red (see Figure 4.3.1) are the CPI and PPI figures for the first half of 2010. During this period, prices were observed to reduce for a few months as a result of very tight monetary policy. Inflation resumed as soon as the tight monetary policy was relaxed in the second half of 2010. This time round, inflation appears to be widespread. The core inflation in this period is higher than the core inflation in the 2007-2008 period (see Figure 4.3.2).

Figure 4.3.2 Core Inflation (January 2006 = 100)



Inflation is important as it has a different impact on different income groups. Inflation hits different sectors of the economy differently. In this period, the impact of food inflation is relatively large. Those in the poor income bracket are found to experience a higher inflation. A simulation study reveals that, for the poorest 10% of urban households, a 3% increase in average CPI would mean

- An increase in CPI by 4.1%
- A reduction of disposable income by 6%
- A reduction in consumption by 5.4%

If the average CPI increase is doubled to 6%, a double-digit reduction in the disposable income could be observed for the poorest 10% of urban households.

Similarly, for the poorest 20% of rural households, a 3% increase in average CPI would mean

- An increase in CPI by 4.8%
- A reduction of net income by 5.3%
- A reduction in consumption by 7.3%

For the poorest families, the marginal propensity to consume is highest. As a result, the impact on the poor family is tremendous even though the inflation rate is about 5%.

However, in the last 3 months, the CPI appears to have stabilized. Figure 4.3.3 shows the month-on-month (MoM) data for March, April and May. The MoM CPI growth is observed to stabilize and the MoM PPI growth is observed to reduce to less than 6% in May. These are some early signs indicating that inflation is under control. This stabilization is achieved by very tight monetary policy.

Figure 4.3.3 Consumer Price Index & Producer Price Index (MoM annualized)

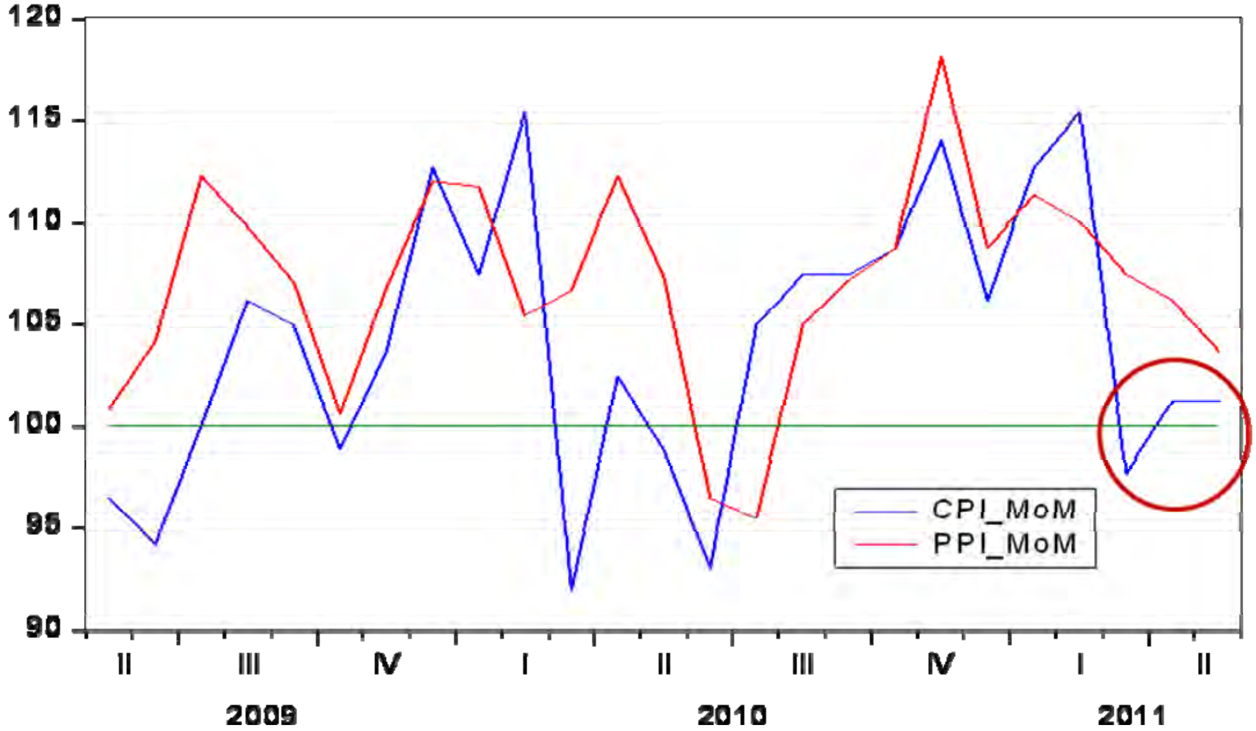


Figure 4.3.4 M2 Growth Rate (YoY)

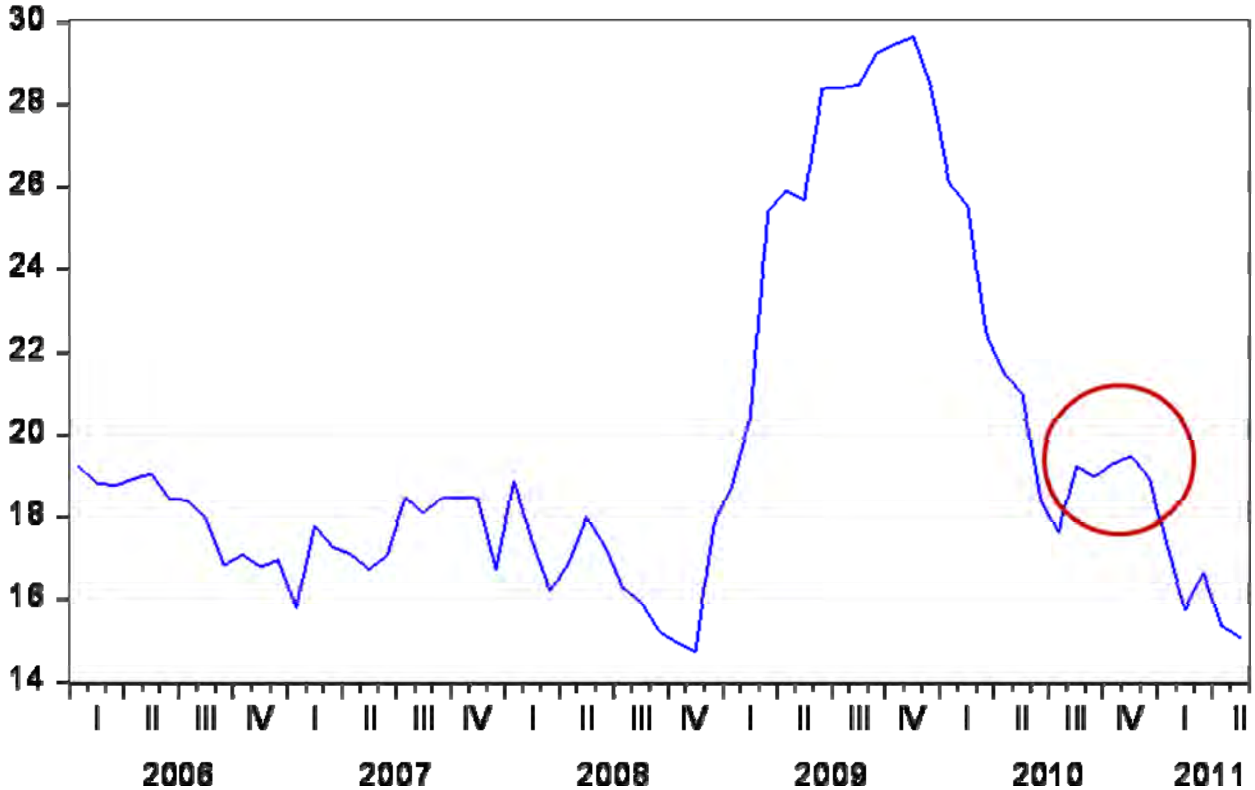


Figure 4.3.4 shows the year-on-year (YoY) growth rate of M2, broad money supply. During the 2009 and 2010 period, the M2 growth rate shot up to almost 30%; that was the period when the Chinese government propped up the investment to counter the global recession. In the second half of 2010, the monetary authority eased the money control following the release of the second quarter GDP growth figures in July. As a result, the monetary supply rebounded to about 20%.

At present, the M2 growth is about 15%, which is below the normal growth rate of 16%; the monetary control is still very tight. This tight monetary control is achieved by

- A high reserve required ratio. There have been continued increases in the reserve required ratio of the commercial banks. Since 2008, the central bank imposed different reserve required ratio for large banks versus small and medium banks. For the large banks, the reserve required ratio now is 21.5% (*ie* for every $100 bank deposit, the central bank will lock away $21.5).
- High interest rate. Interest rate was raised four times since November 2010. However, it is not considered a useful option because high interest rates will attract inflows of capital.
- Monthly limit for new loans. In May and in June, the People's Bank of China imposed about 500 billion Yuan a month ceiling.

The most effective, binding way of controlling the money supply or credit expansion is to impose a monthly limit for new loans. Even though the reserve requirement is high, the banks still keep a lot of excess reserve. However, with the credit ceiling imposed, the new loans extended are observed to decrease significantly.

Table 4.3.1 GDP Growth

	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1
GDP (YoY)	11.9	10.3	9.6	9.8	9.7
GDP (QoQ, seasonally adjusted annual rate)	8.9	8.3	10.2	10.0	8.7

Credit rationing led to a decline in GDP growth. Table 4.3.1 shows the GDP growth rate YoY and quarter-on-quarter (QoQ). The first half of 2010 registered a high YoY growth rate but this rate is lower for the second half of the year. The explanation for this lies in the momentum of growth, which is illustrated by the QoQ growth rates. The QoQ growth rate in the first half of 2010 was between 8-9%, but in the second half it rose to the 10% level, which was the result of the relaxed money supply. In addition, the QoQ growth rate in the first quarter of 2011 is only 8.7%, and is expected to be around 8.5% level in the second quarter. The QoQ growth rates in 2011 are an indication that the money supply is very tight and this will bring down the GDP growth rate by quite a lot.

As a result, imports are observed to be significantly weakened in this period, with growth in single digits (see Figure 4.3.5). Low imports are linked to a low GDP growth rate. In addition, exports (see Figure 4.3.5) and industrial value-added (see Table 4.3.2) also became unstable. From Table 4.3.2, the 2011 MoM industrial value-added growth rate for February and April is negative, but for March and May, the growth is high and positive.

Figure 4.3.5 Growth of Exports (EX) and Imports (IM)

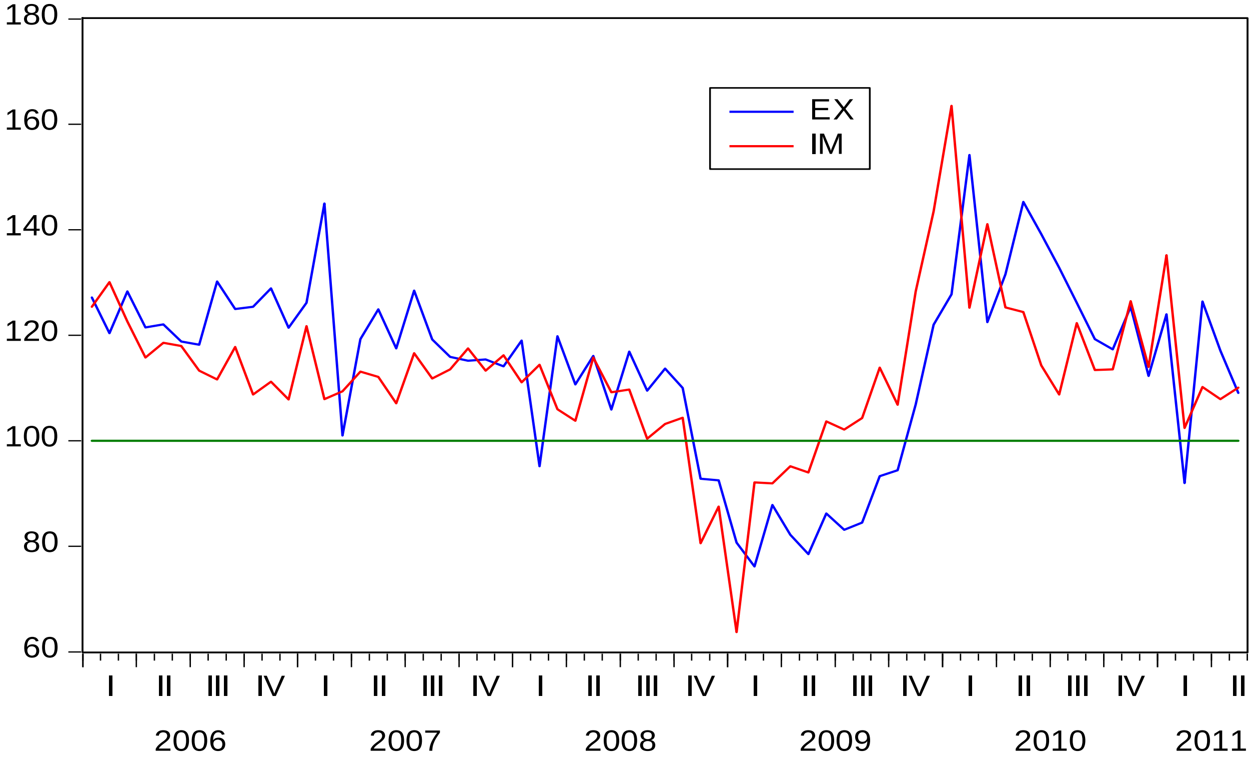


Table 4.3.2 Growth of Industry Value-Added (VA)

	February 2011	March 2011	April 2011	May 2011
VA of industry (YoY, %)	14.9	14.8	13.4	13.3
VA of industry (MoM, seasonally adjusted annual rate)	-10.7	14.4	-10.5	13.1

Figure 4.3.6 shows the fixed asset investment (FAI), with the black line representing the FAI of individual firms and mainly the private enterprises. The black line (FAI_IND) plunged close to -60%, reflecting that FAI by small and medium enterprises (SMEs) suffered a huge drop. As a result of the credit ceiling imposed by the central bank, the private sector was squeezed. The borrowing cost for SMEs was reported to have increased significantly, with rumors of borrowing cost reaching levels as high as 50% per year.

As financing from formal capital markets reduced, the share of FAI financed by self-raised and other funds are expected to grow. Figure 4.3.7 confirms that the channel of financing outside the formal capital markets experienced continued growth. In May 2011, financing via these channels was about 79%. This means that only about 20% of financing was done by the formal capital markets while 80% was done outside the capital markets.

Figure 4.3.6 Fixed Asset Investment (FAI)

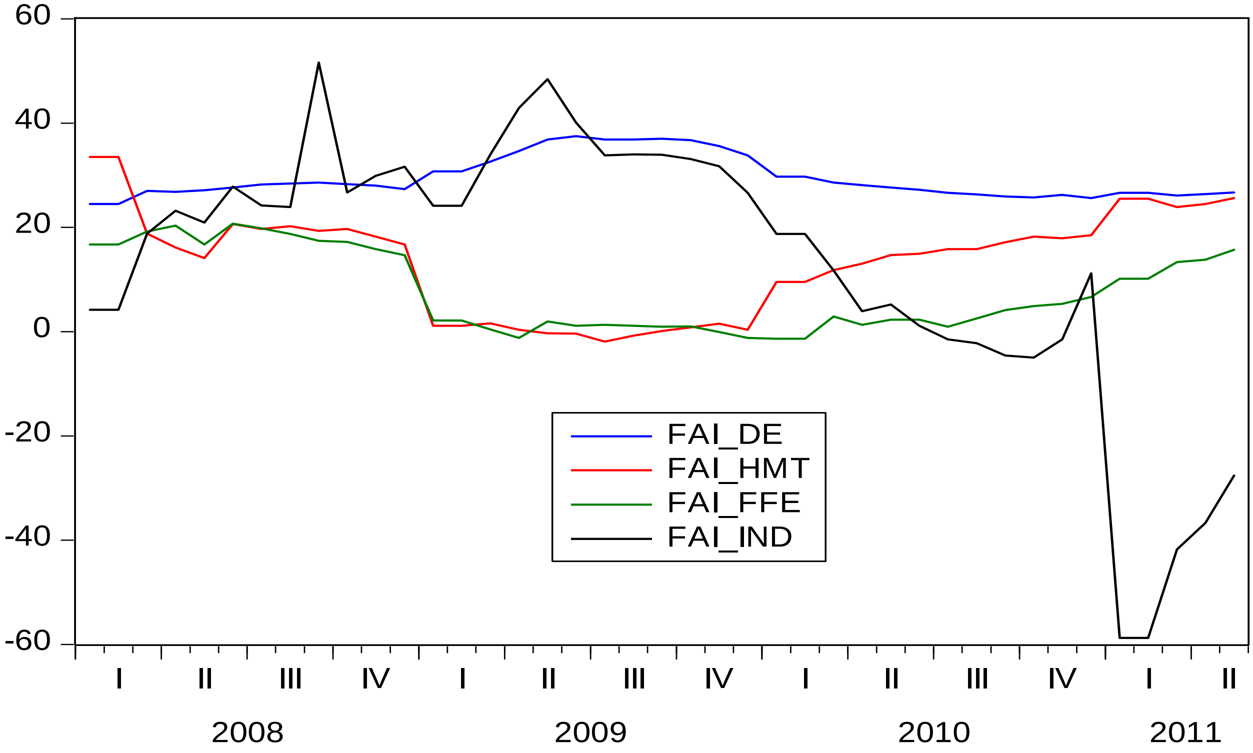
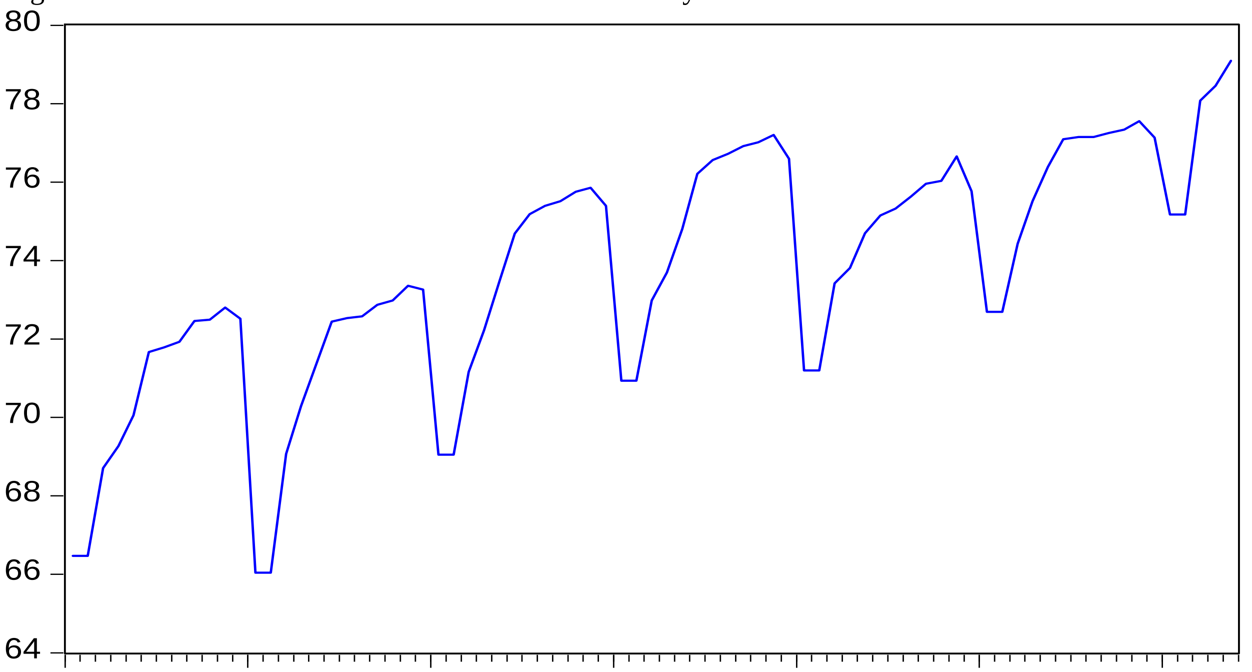


Figure 4.3.7 Share of Fixed Asset Investment Financed by Self-Raised & Other Funds



Long-Term Challenges

The way inflation is being handled may create a long-term problem for China, and cause difficulties in controlling inflation in the future. The tightening of the monetary policy is hitting the wrong sector of the economy.

As the Chinese banking sector has excess liquidity which cannot be absorbed by raising the required reserve ratio alone, a monthly credit ceiling was imposed. This administrative measure helped to keep the extra credit in check but it hit the SMEs. When bank credits are rationed, local government investment projects will still be funded, but investment projects by the private sector and SMEs will be squeezed out of the formal financial markets and this has a long term impact on China.

Renminbi (RMB) appreciation as a tool to curb inflation is found to have limited effects. A study of the impact of RMB appreciation on inflation found that the former has only marginal effect on the latter for two main reasons:

- As a continental economy, prices of imported goods have only limited influence on China's domestic prices. Hence, RMB appreciation is unlikely to significantly reduce inflation.
- Appreciation of RMB does not lead to an increase in imports. The key reason is that China has a huge processing import (*ie* the import that is needed for processing exports). When China's export decreases, so does processing import.

In fact, RMB appreciation will force China to increase its reliance on investments for GDP growth.

All things considered, China is expected to continue growing. In 2011, the growth rate is likely to be above 9% and if China continues with its tight monetary policy, the inflation will be about 5%. However, there is a possibility that the government might release the control in the second half of 2011 for political reasons. China's political cycle is such that 2011 is the first year of its 5-year plan, while China's Party Congress is to be held in 2012. A lot of local government leaders are looking for promotion, and a high growth rate is an important key performance indicator for them. There is thus a lot of 'push' for high growth rate and a looser monetary policy in the second half of 2011. If monetary policy is indeed loosened in the second half of 2011, China's growth rate will be near 10% and its inflation rate will be close to 6% for the year.

The local government official's investment hunger is apparent. Apart from 8-lane highways, replicas of say, US Capitol dome and Sydney Opera House, China is littered with many high-rise office buildings and Olympic stadiums. China can continue to grow as long as high savings persist; China's growth is limited by the high saving, high investment, and high depreciation model.

China's growth hit the most efficient side of economy, the private sector. The state sector, however, has been expanding after Zhu Rongji stepped down as Premier in 2003, and especially so after the global financial crisis. In the long run, such a growth model could be checked by employment issues (lower employment since 10% of GDP growth will only translate to 0.6% increase in employment) and resulting social unrest, as well as possible environmental disasters.

4.4 Vietnam & Economic Reforms: Achievements, Challenges & Strategic Implications

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Vietnam in a Global Picture

The Vietnamese economy was unified in 1975 but struggled for more than 10 years with many issues. 1986 marked an important year for Vietnam as the Vietnamese economic reform was implemented in that year. After more than 25 years of reform, Vietnam has achieved a certain level of prosperity and exited the low income group, with per capita GDP of $2,800 purchasing power parity (PPP). Nevertheless, Vietnam ranks at the bottom of the ASEAN nations, slightly below India, but significantly below China (see Table 4.4.1). Vietnam still has a long way to go to catch up with its neighbors.

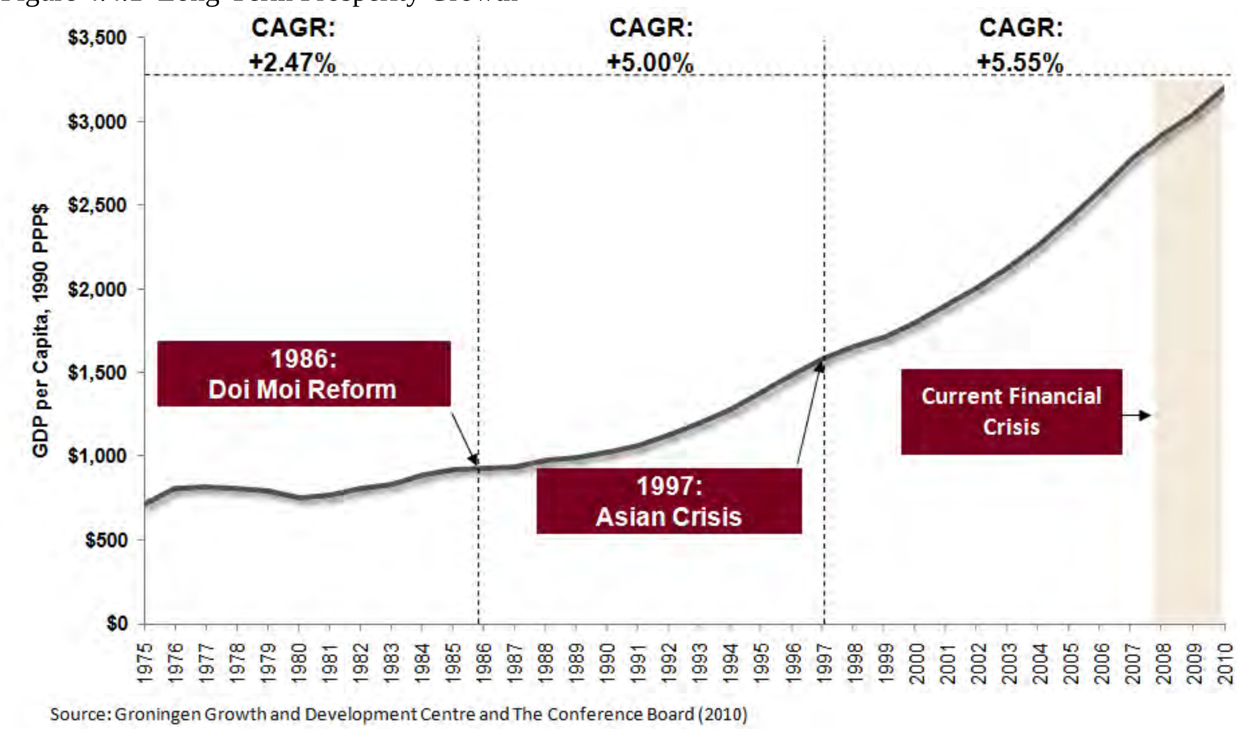
Table 4.4.1 Vietnam in a Snapshot: Selected Indicators 2009

Country	Land area (sq. km)	Population (Millions)	GDP (Billions)		GDP Per capita	
			US$	PPP$	US$	PPP$
Brunei Darussalam	5,270	0.4	14.87	19.43	37,643	49,187
Cambodia	176,520	14.8	11.03	28.09	748	1,904
Indonesia	1,811,570	243.0	521	969.2	2,144	3,989
Lao PDR	230,800	7.0	5.788	15.07	828	2,155
Malaysia	328,550	26.2	209.8	381.1	8,020	14,568
Myanmar	653,520	53.4	26.83	56.92	502	1,066
Philippines	298,170	99.9	160.6	324.8	1,608	3,251
Singapore	697	4.7	165	235.7	35,098	50,138
Thailand	510,890	66.4	269.6	538.6	4,060	8,111
Vietnam	***310,070***	***89.6***	***92.84***	***258.1***	***1,036***	***2,882***
ASEAN-10	**4,326,057**	605.3	**1,477**	**2,827**	**2,441**	**4,671**
China	***9,327,489***	*1,330.1*	***4.814***	***8.789***	***3,619***	***6,608***
India	***2,973,190***	*1,173.1*	***1.095***	***3.56***	***933***	***3,035***

Source: World Factbook, 2010

Since its reforms began in 1986, Vietnam has achieved somewhat spectacular economic growth, and the entire nation has benefited from opening up to the world and carrying out reforms. Figure 4.4.1 shows the GDP per capita and PPP adjusted in 1990 USD. Despite the Asian financial crisis in 1997 and the global financial crisis in 2008-2009, Vietnam continued to experience very high growth during those periods.

Figure 4.4.1 Long-Term Prosperity Growth



Economic reforms took place in Vietnam for the following three reasons:

- Receptivity. Vietnamese were receptive to the idea of reform as they were frustrated with the traditional way that things were carried out, and acknowledged that the old way did not work anymore.
- Crisis. Vietnam has been dependent on Soviet bloc subsidies. However, when the subsidies ended in 1986, Vietnam had to desperately look for new resources.
- Opportunity. The arrival of a new leader, Nguyen Van Linh, opened the road to reforms.

Economic Reforms: Key Success Factors & Major Achievements

Thus, Vietnamese reforms began in 1986. At the start of its reforms, Vietnam has a similar context to that of China eight years earlier; the economic reform of China began in 1978. Table 4.4.2 compares the conditions of Vietnam versus China, at the inception of the reforms. From the table, one can see that many of the initial conditions at the start of the reform (*eg* GDP per capita, share of rural population) are comparable between the two economies.

The main characteristics of Vietnam's economic reforms can be summarized as follows:

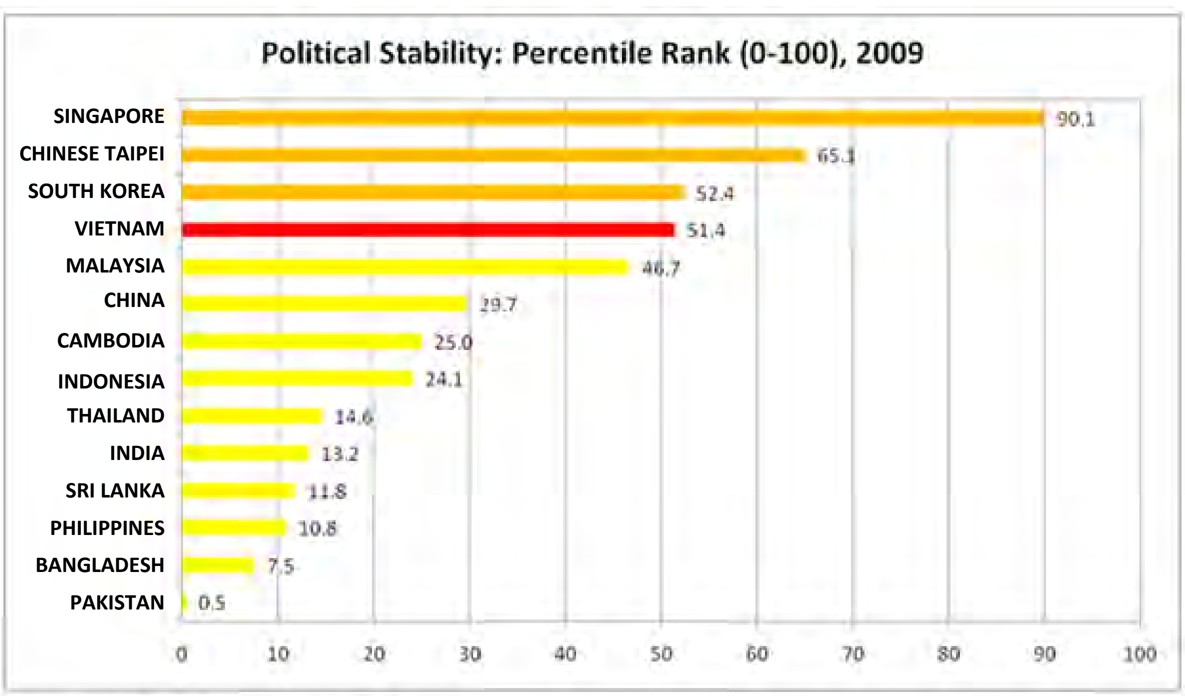
- Driving motivation: the need for survival rather than a clear vision
- Gradual approach with great concerns for political stability
- Fence-breaking and decentralization: bottom-up reforms and the increasingly important role of local governments
- Outward-looking: there are 3 million Vietnamese living overseas, and Vietnam receives a lot of foreign direct investments (FDIs)
- Heavily influenced by the reform approach and implementation that have proven successful in China

Table 4.4.2 Conditions at the Inception of Reforms: Vietnam versus China

Indicator	Vietnam (1986)	China (1978)
Human capital'		
• Adult literacy (% of total)	89.2	67.1
• Young adult literacy (% of total)	93.6	91.3
• Calorie supply (kcal/day)	2,300	2,328
• Median age	19.5	22.1
• Life expectancy at birth, years	63	67
GDP Per Capita		
• 2000 US$	203	165
• 2000 PPP$	1,031	685
GDP Structure, %		
• Agriculture	38.1	28.1
• Industry	28.9	48.2
• Services	33.1	23.7
Rural economy		
• Share of rural population, %	80.3	81.3
• Cereal yield (kg per hectare)	2,715	2,802
Openness		
• Exports of goods and services (% of GDP)	6.6	6.6
• Imports of goods and services (% of GDP)	16.6	7.1
Infrastructure		
• Main line telephones per 1,000 people	1.3	2.0

Source: WDI

Figure 4.4.2 Political Stability



Source: World Bank Governance Indicators

Vietnam has made a lot of achievements during the reforms. Its five key success factors are:

- Strategic location. Vietnam is between China and India, and its location is such that any place in Asia can be accessed in a flight time of 3-5 hours.
- Political stability. In terms of political stability, Vietnam ranks quite favorably, and is even more stable than most economies, including China or Indonesia (see Figure 4.4.2).
- Reform policy and efforts. Vietnam pays close attention to the goings-on in China, and attempts to catch up in terms of reforms. China has carried out very bold and innovative reforms, allowing Vietnam to take the task of imitating and learning without the need to innovate.
- Human capital. Vietnam performs relatively well in this category (see Table 4.4.3). From life expectancy to education to internet penetration (Vietnam is quick to embrace the technology as well), Vietnam performs favorably. Vietnam is one of the top internet adopters in Asia, comparable to China and other neighboring countries and has more students (per 100,000 inhabitants) who are receiving their education in the US (see Table 4.4.3).
- The agricultural sector. Vietnam has great advantages in this category which includes excellent climate and soil as well as proximity to sea ports. Vietnam enjoys excellent conditions for producing and exporting agriculture and aquaculture products, and is now one of the largest exporters of rice and several other things (*eg* coffee).

Table 4.4.3 Human Capital

Indicator	Vietnam	Indonesia	Philippines	Malaysia	Thailand	China	India
Life expectancy at birth (years)	74	71	72	74	69	73	65
Child mortality rate under 5 (per 1,000 population)	15	31	28	11	7	22	72
School enrollment, secondary (%)	76	63	85	76	71	74	56
School enrollment, tertiary(%)	16	17	28	32	43	20	11
Internet penetration (per 1,000 population)	210	111	60	557	200	161	72
Students studying in the US (per 100,000 population)	15	3	<10	22	13	7	9

Source: WDI, IIE

Table 4.4.4 GDP of Vietnam

Indicator	Average Growth Rate (%), 1986-2008
GDP	7.0%
GDP per capita	5.2%
Productivity	4.6%
Exports of goods and services *	16.5%

Note: * - The growth of exports is for 1990-2008

Table 4.4.5 Key Indicators of Vietnam

Indicators	1986	2008
Exports of goods and services (US$ billions)	1.20	62.70
Share of the Industrial sector in GDP (%)	28.30	43.20
FDI Stock (US$ billions)	1.50	48.30
Per capita income (constant 2000 US$)	203	647
Poverty headcount ratio at $2 a day (PPP) (% of	85.70 (1993)	48.42 (2006)
Urban population share (% of population)	19.74	27.84
Telephone lines per 100 inhabitants	0.13	34.32
Internet uses per 100 inhabitants	0.00013 (1996)	24.17

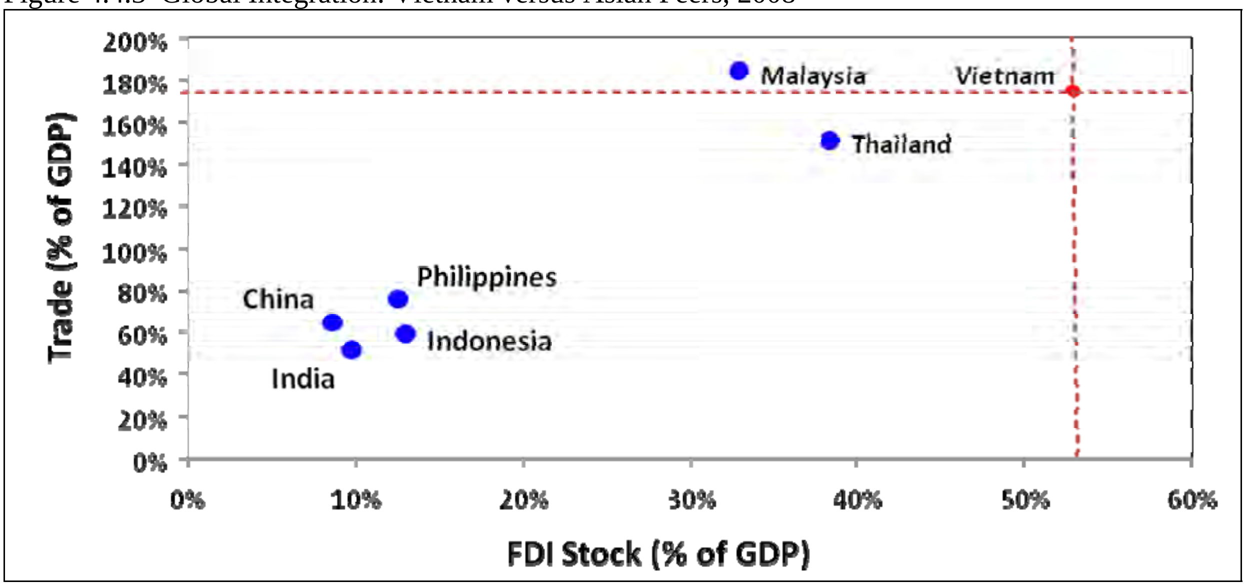
Source: WDI, UNTAD

Table 4.4.6 Accumulated FDI: 1988-2009

Number of Projects	Registered Capital *(Mill. USD)*	Materialized Capital *(Mill. USD)*
12,575	**194,429**	**66,945**

Source: GSO

Figure 4.4.3 Global Integration: Vietnam versus Asian Peers, 2008



The key figures which illustrate the major achievements of Vietnam are shown in Table 4.4.4 and Table 4.4.5. Vietnam's GDP growth rate averages around 7% over the past 25 years, and Vietnam enjoys great productivity and export growth. In terms of FDI, Vietnam has more than 10,000 projects with materialized capital of around US$66 million (see Table 4.4.6). Vietnam has become one of the most globally integrated economies in Asia (see Figure 4.4.3).

Prospects: Challenges & Strategic Implications

In terms of development prospects, the short-term outlook is still optimistic, but it tends to mask strategic concerns. The latest projections for 2011 are optimistic for Vietnam: 6.1% GDP growth with inflation of 13.3% (see Table 4.4.7).

Table 4.4.7 ASEAN6+2 Projections

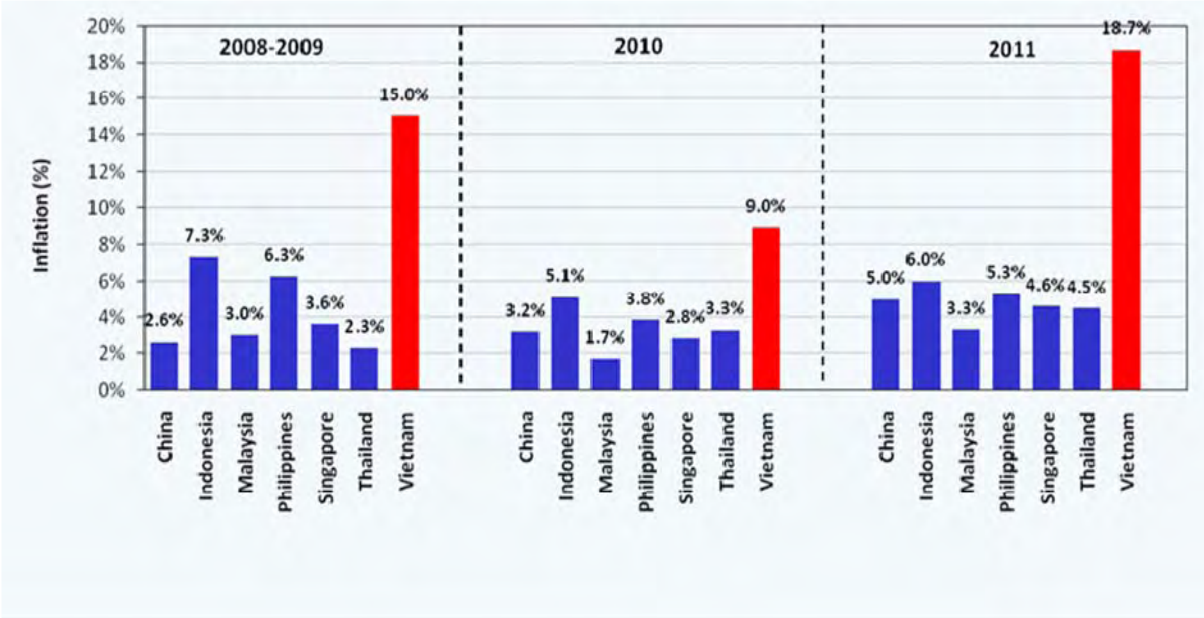
	Table 1 Growth rate of GDP (% per year)					Table 2 Inflation (% per year)				
Subregion/economy	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
Southeast Asia	**4.2**	**1.2**	**7.8**	**5.5**	**5.7**	**8.6**	**2.5**	**4.0**	**5.1**	**4.2**
Indonesia	6.0	4.6	6.1	6.4	6.7	9.8	4.8	5.1	6.3	5.8
Malaysia	4.7	-1.7	7.2	5.3	5.3	5.4	0.6	1.7	3.0	3.0
Philippines	3.7	1.1	7.3	5.0	5.3	9.3	3.2	3.8	4.9	4.3
Singapore	1.5	-0.8	14.5	5.5	4.8	6.6	0.6	2.8	3.2	2.0
Thailand	2.5	-2.3	7.8	4.5	4.8	5.4	-0.9	3.2	3.5	3.0
Viet Nam	**6.3**	**5.3**	**6.8**	**6.1**	**6.7**	**23.0**	**6.9**	**9.2**	**13.3**	**6.8**
China, People's Rep. of	9.6	9.2	10.3	9.6	9.2	5.9	-0.7	3.3	4.6	4.2
India	6.7	8.0	8.6	8.2	8.8	8.7	2.1	9.2	7.8	6.5

Source: ADO, April 2011

The prospects for Vietnam are not so bright in the short- to medium-term. Immediate challenges include:

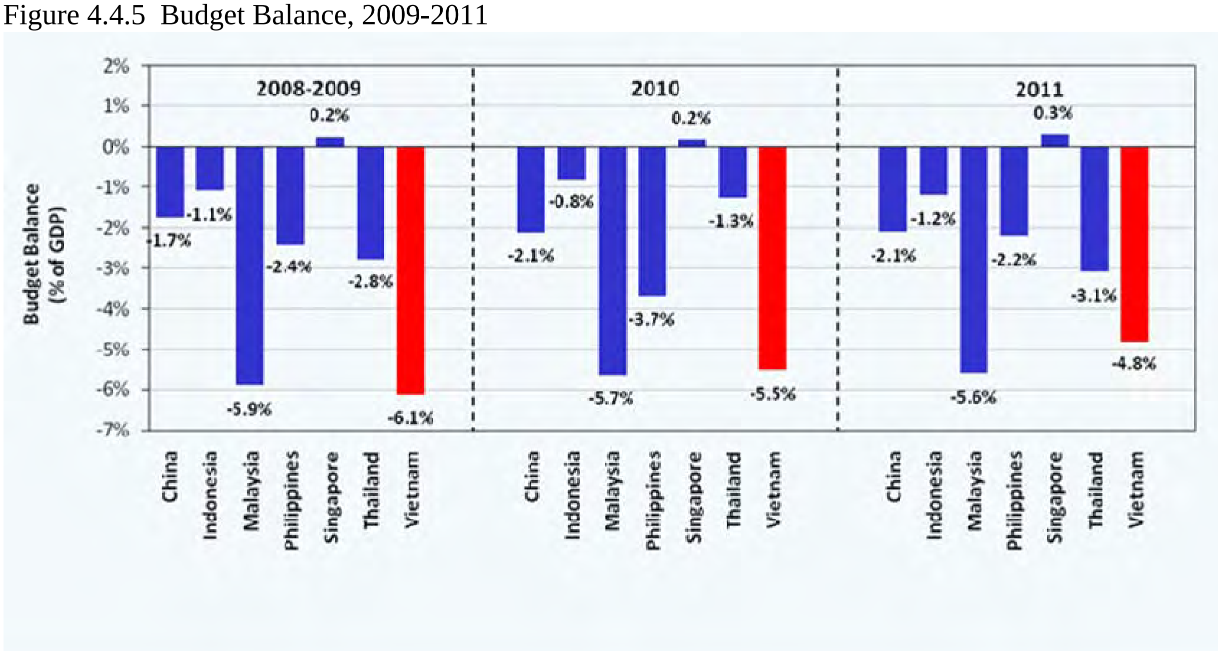
- Macroeconomic concerns: while China is fighting to curb an inflation rate of 5% to 6%, Vietnam worries about an inflation rate of over 20% (see Figure 4.4.4); high budget deficit (see Figure 4.4.5); trade deficit in Vietnam while most other economies registered a surplus (see Figure 4.4.6).
- Public policy: issues on quality and implementation effectiveness. The government effectiveness and regulatory quality is the lowest, and this is a problem (see Figure 4.4.7). In addition, the productivity of the government officials is observed to fall over time (see Figure 4.4.8). Figure 4.4.9 summarizes the results from interviewing government officials about the quality of public policy
- Ineffective control of corruption.
- Shortages of skilled labor. There is a lack of skilled labor, but this is not an immediate problem (see Figures 4.4.10 and 4.4.11).

Figure 4.4.4 Inflation, 2008-2011



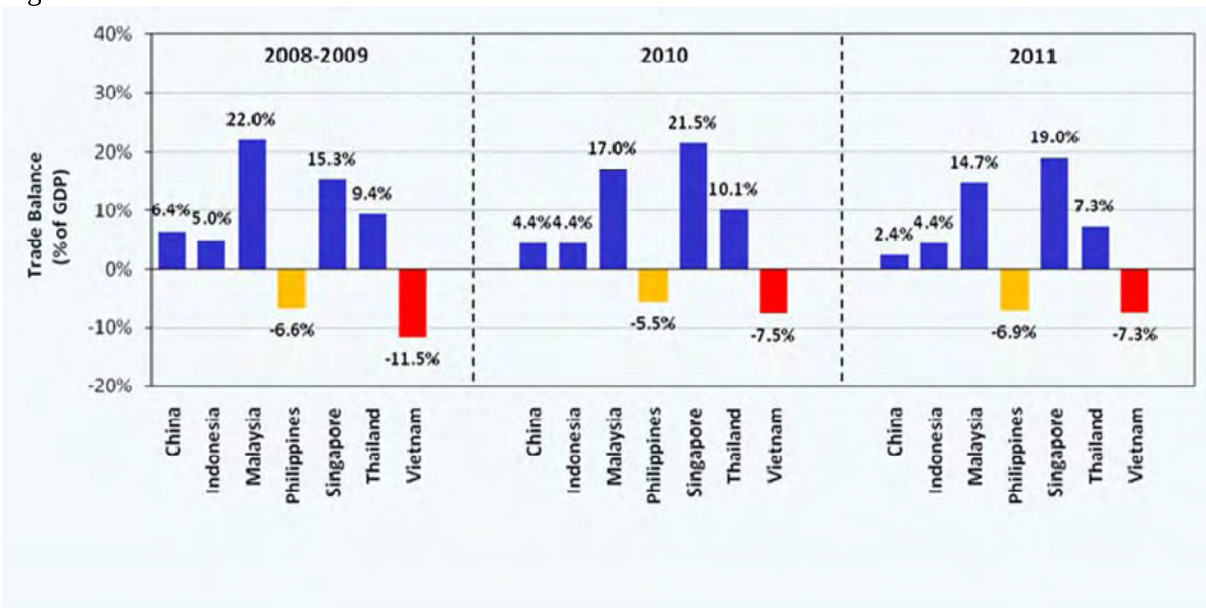
Source: EIU

Figure 4.4.5 Budget Balance, 2009-2011



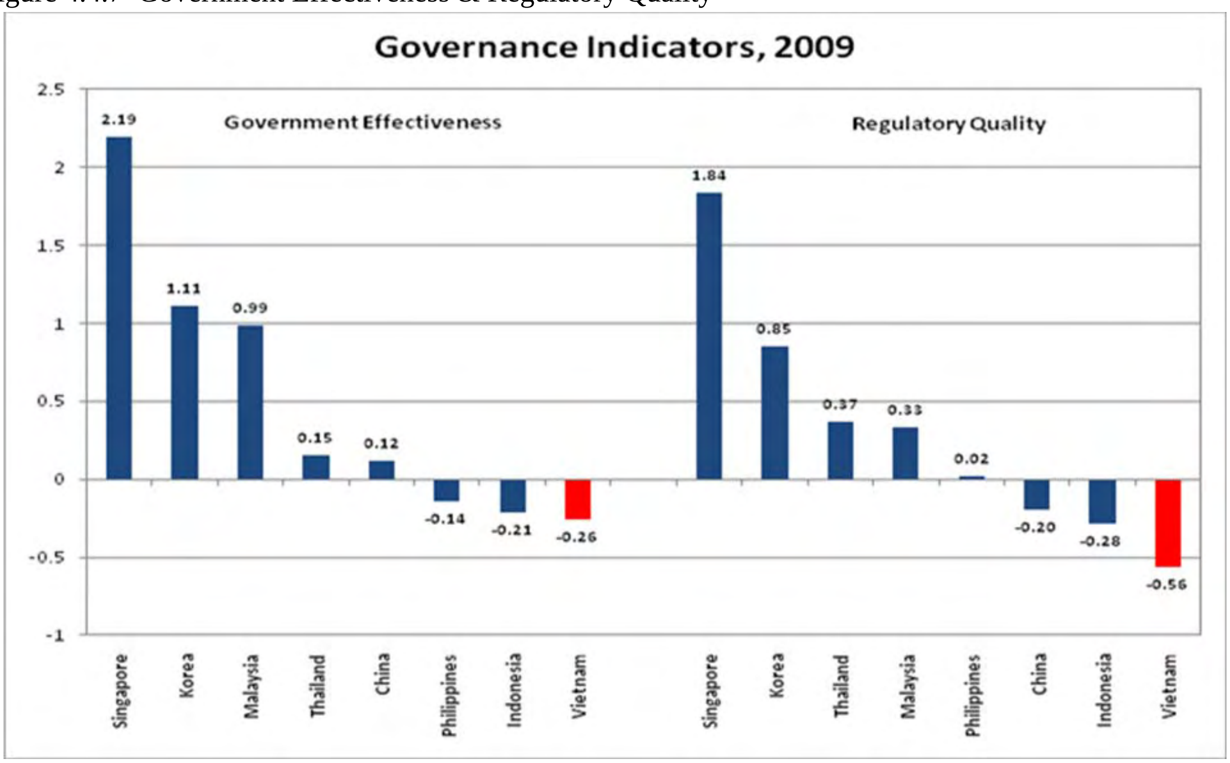
Source: EU

Figure 4.4.6 Trade Balance 2008-2011



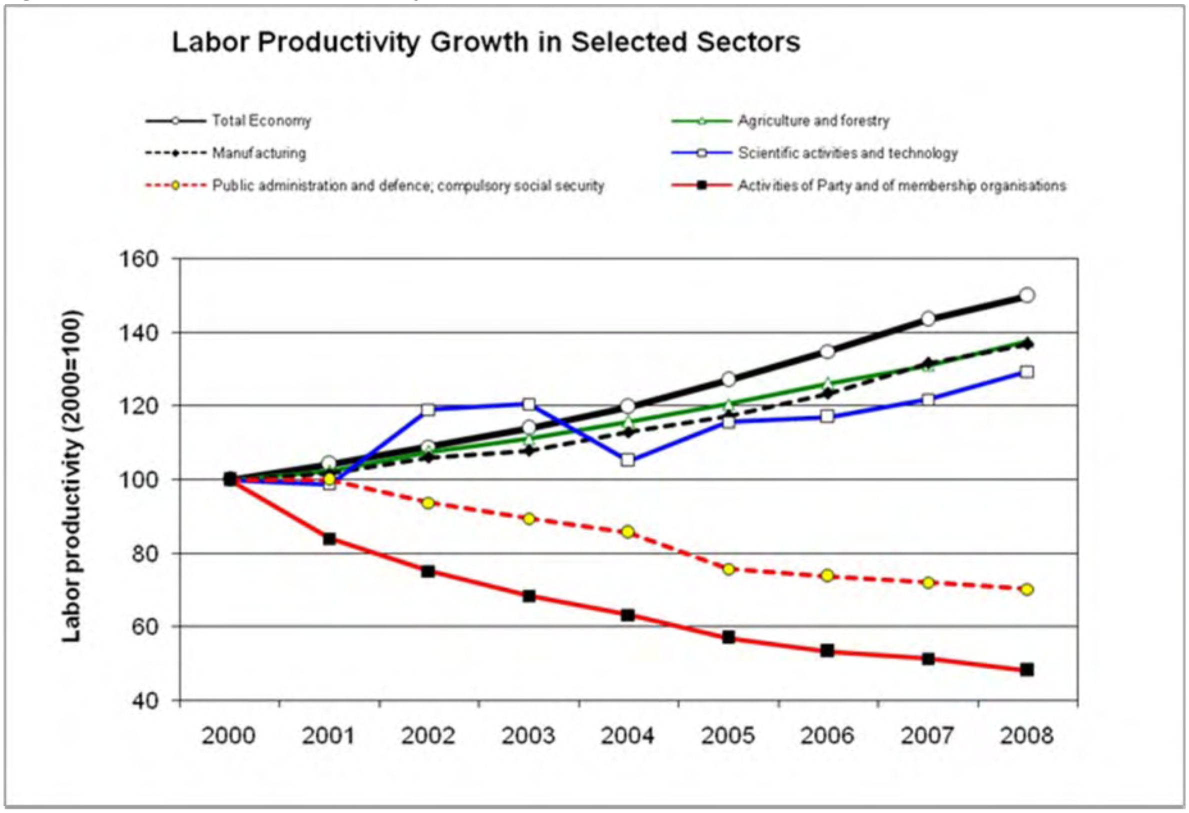
Source: EIU

Figure 4.4.7 Government Effectiveness & Regulatory Quality



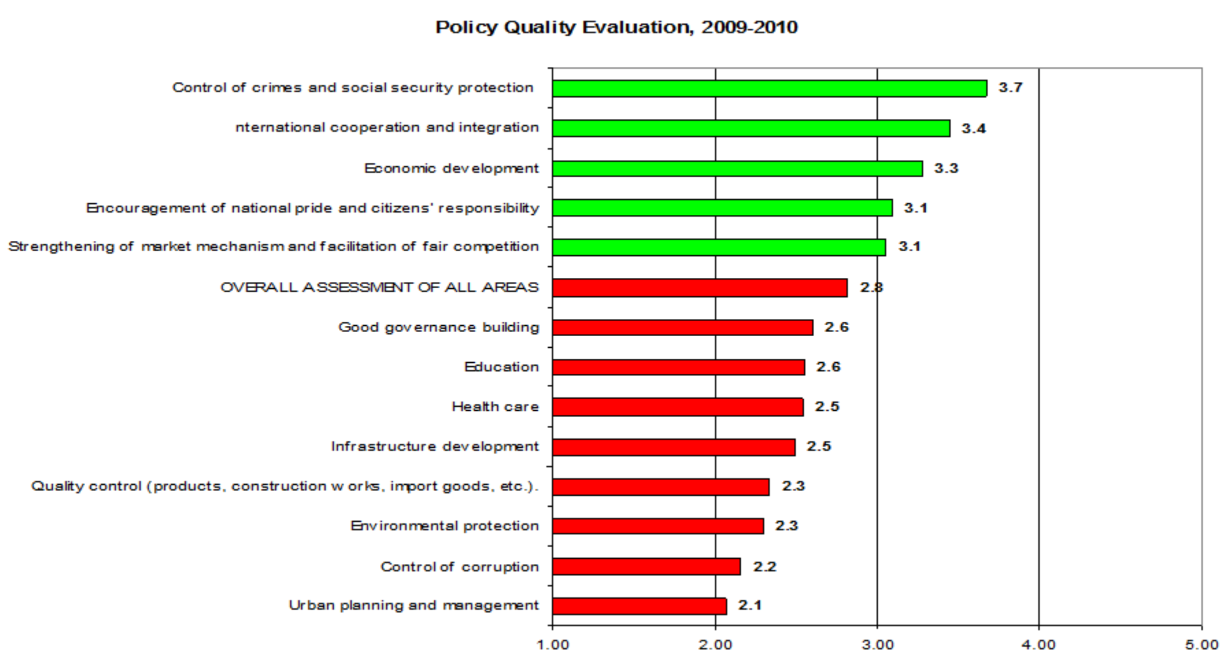
Source: World Bank Governance Indicators

Figure 4.4.8 Government Efficiency



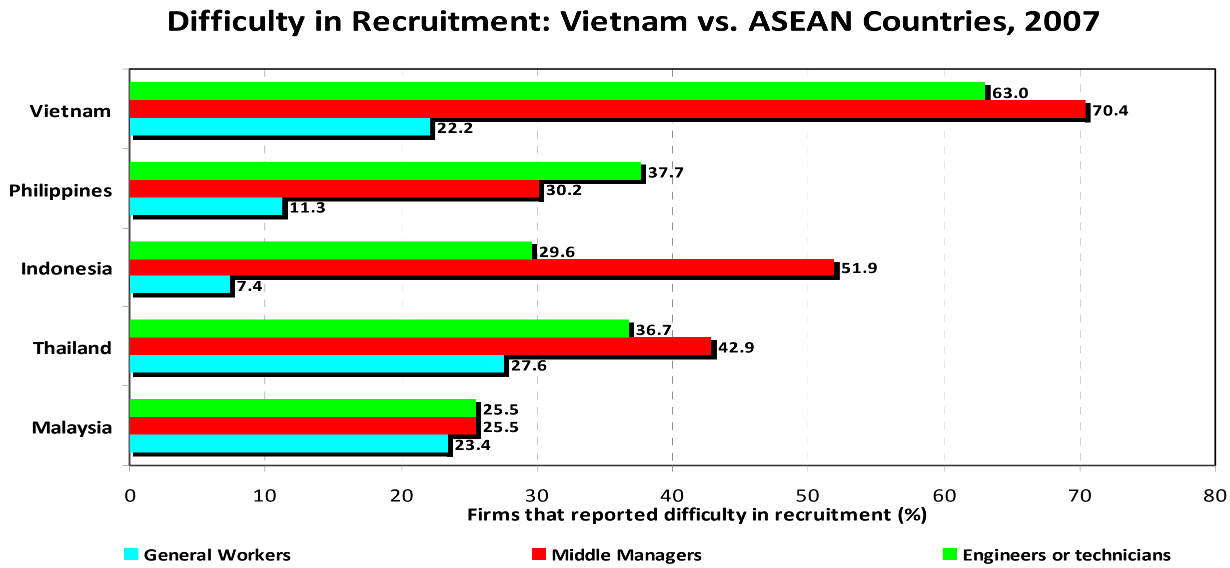
Source: GSO

Figure 4.4.9 Quality of Public Policy, 2009-2010



Note: 1=very poor; 2=poor; 3=average; 4=good; 5=excellent. The respondents are government officials (n=265).
Source: LKYSPP

Figure 4.4.10 Difficulty in Recruitment: Vietnam versus ASEAN Economies, 2007



Source: JETRO's survey "Japanese-Affiliated Manufacturers in Asia"
The figures are reproduced from Mori et al (2008).

Figure 4.4.11 Difficulty in Recruitment: Vietnam 2003-2007

Source: JETRO's survey "Japanese-Affiliated Manufacturers in Asia"
The figures are reproduced from Mori et al (2008).

Many international advisors usually come to Vietnam to help in addressing the short-term issues but overlook the major ones. The more fundamental issues that Vietnam faces include:

- Commitment to the free market principles
- Formulating an effective development strategy
- Building good governance
- Cultivating and mobilizing human capital

Vietnam has bright prospects in the long-term. However, in the short- to medium-term, Vietnam faces very fundamental challenges. Profound reforms are critical for the economy to overcome its development challenges and unleash the nation's great potentials. Without fundamental improvement in development strategy and institutional building, Vietnam will likely face serious setbacks in economic development in the medium-term. Vietnam should embrace a catch-up framework to formulate and implement its development strategy and policy.

4.5 A Reassessment on Indonesian Economic Development

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Recently, the Indonesian economy has been doing very well. This session looks at the long-term perspective of around 10 to 15 years, and discusses the basic structure of the economy and the current challenges that Indonesia faces.

Recent Macroeconomic Development

Table 4.5.1 shows the growth of the economies in the region. From the table, the Indonesian economy is seen to register good growth from the 1980s to the current period when compared to other economies in the region. The Indonesian growth is particularly impressive in the 1980s, at almost 7%, but less so afterwards. Indonesia is still growing quite well, although its growth performance is below that of the 1980s. During the Asian financial crisis, Indonesia was the most severely hit country in the region, with a contraction of 13%. However, in the recent global financial crisis, its growth was surprisingly quite impressive with a resilience of 4.5%.

Table 4.5.1 Growth of Selected Economies

Period	Cambodia	China	India	Indonesia	Lao PDR	Malaysia	Philippines	Thailand	Vietnam
1986-95	...	9.9	5.7	6.8	5.0	8.2	3.4	9.5	6.5
1996	5.0	9.6	7.5	8.0	6.9	10.0	5.8	5.9	9.3
1997	6.8	8.8	5.0	4.5	6.9	7.3	5.2	(1.4)	8.2
1998	3.7	7.8	5.8	(13.1)	4.0	(7.4)	(0.6)	(10.5)	3.5
1999	10.8	7.1	6.7	0.8	7.3	6.1	3.4	4.4	4.2
2000	7.0	8.0	5.4	4.9	5.8	8.9	4.4	4.8	5.5
2001	5.7	7.5	3.9	3.5	5.8	0.3	1.8	2.1	5.0
2002	6.6	9.1	4.6	4.5	6.9	5.4	4.4	5.3	7.1
2003	8.5	10.1	6.9	4.8	6.2	5.8	4.9	7.1	7.3
2004	10.3	10.1	8.1	5.0	7.0	6.8	6.4	6.3	7.8
2005	13.3	11.3	9.2	5.7	6.8	5.3	5.0	4.6	8.4
2006	10.8	12.7	9.7	5.5	8.6	5.8	5.3	5.1	8.2
2007	10.2	14.2	9.9	6.3	7.8	6.5	7.1	4.9	8.5
2008	6.7	9.6	6.4	6.0	7.8	4.7	3.7	2.5	6.3
2009	(2.0)	9.1	5.7	4.5	7.6	(1.7)	1.1	(2.2)	5.3
2010	4.8*	10.5*	9.7*	6.1	7.7*	6.7*	7.0*	7.5*	6.5*

Table 4.5.2 Indonesia: GDP by Expenditure

Period	GDP	Private Consumption Expenditure		Government Consumption Expenditure		Gross Fixed Capital Formation		Export		Import	
	Overall Growth	Share	Growth	Share	Growth	Share	Growth	Share	Growth	Share	Growth
1993	--	51.9	--	8.2	--	23.2	--	37.6	--	29.1	--
1994	7.54	52.1	7.83	7.8	2.31	24.6	13.76	38.4	9.94	32.6	20.30
1995	8.22	54.2	12.58	7.3	1.34	25.9	13.99	38.2	7.72	36.4	20.94
1996	7.82	55.1	9.72	6.9	2.69	27.5	14.51	38.1	7.56	36.1	6.86
1997	4.70	56.8	7.82	6.6	0.06	28.5	8.57	39.3	7.80	39.5	14.72
1998	(13.13)	61.3	(6.17)	6.4	(15.37)	22.0	(33.01)	50.2	11.18	43.1	(5.29)
1999	0.79	63.7	4.63	6.4	0.69	17.8	(18.20)	34.0	(31.80)	25.4	(40.68)
2000	4.92	61.7	1.58	6.5	6.49	19.9	16.74	41.0	26.48	30.5	25.93
2001	3.64	61.6	3.49	6.8	7.56	20.4	6.49	39.8	0.64	30.6	4.18
2002	4.50	61.2	3.84	7.3	12.99	20.4	4.69	37.6	(1.22)	28.1	(4.25)
2003	4.78	60.7	3.89	7.7	10.03	19.6	0.60	38.0	5.89	27.2	1.56
2004	5.03	60.6	4.97	7.6	3.99	21.4	14.68	41.1	13.53	32.8	26.65
2005	5.69	59.6	3.95	7.7	6.64	22.5	10.89	45.3	16.60	36.5	17.77
2006	5.50	58.3	3.17	8.0	9.61	21.9	2.60	47.0	9.41	37.6	8.58
2007	6.35	57.6	5.01	7.8	3.89	22.5	9.32	48.0	8.54	38.6	9.06
2008	6.01	57.2	5.34	8.1	10.43	23.7	11.86	49.6	9.53	40.0	10.00
2009	4.58	57.4	4.85	9.0	15.72	23.4	3.32	42.8	(9.70)	32.5	(14.97)
2010	6.10	56.6	4.63	8.5	0.25	24.0	8.49	46.4	14.94	36.0	17.27

Table 4.5.2 shows the GDP by expenditure for Indonesia: private consumption remains the major driver. One of the reasons for Indonesia's resilience in the global financial crisis was the strength of the Indonesian domestic economy compared to others in the region, like Thailand and Singapore. The consumption is still strong, but investments are growing as well although FDI is still concentrated in Java.

In terms of inflation and monetary policy, there is a clear relationship between inflation and money in circulation, although the monetary policy of Bank Indonesia (BI) is often behind the curve (see Figure 4.5.1). Inflation is a threat with the rise of food and energy prices, and Indonesia is expected to raise interest rates by end of 2011.

The spread between domestic interest rate and the loan rate is relatively large and that encourages capital inflow. One problem that Indonesia needs to address is the asymmetric information problem where banks are reluctant to grant access to businesses out of mistrust. Development of a more effective credit bureau is one of the solutions that can address this issue.

Figure 4.5.1 Inflation & Monetary Policy

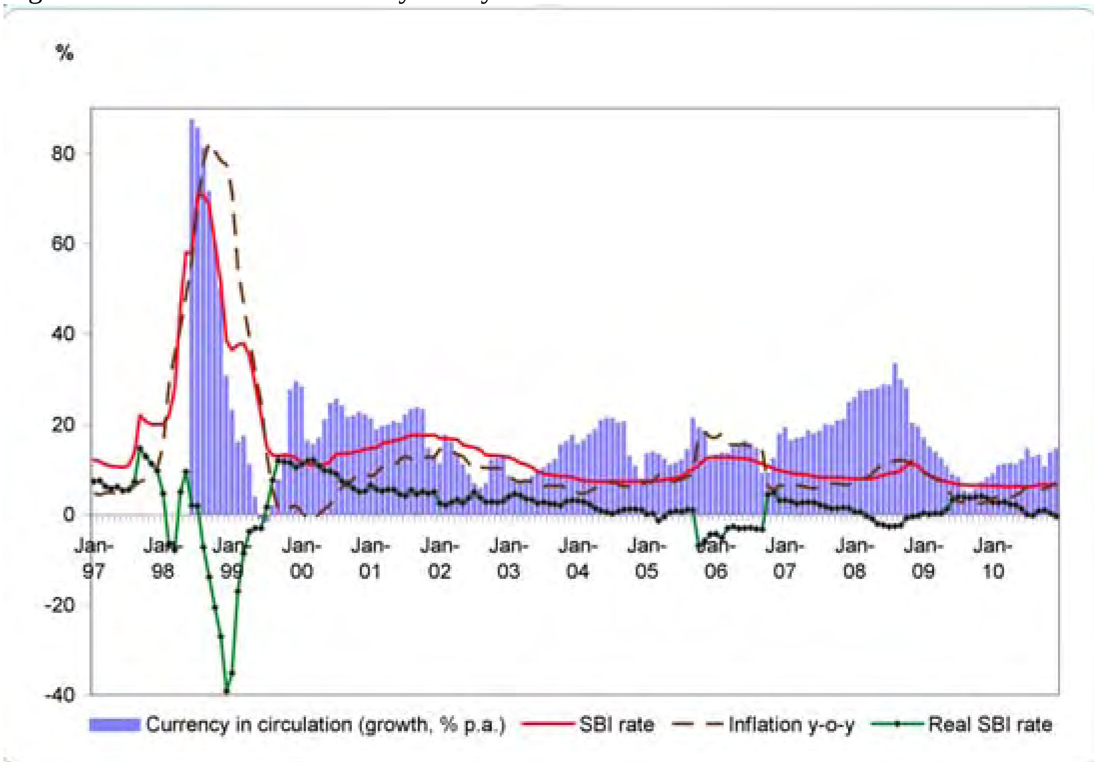


Figure 4.5.2 Rupiah Exchange Rate

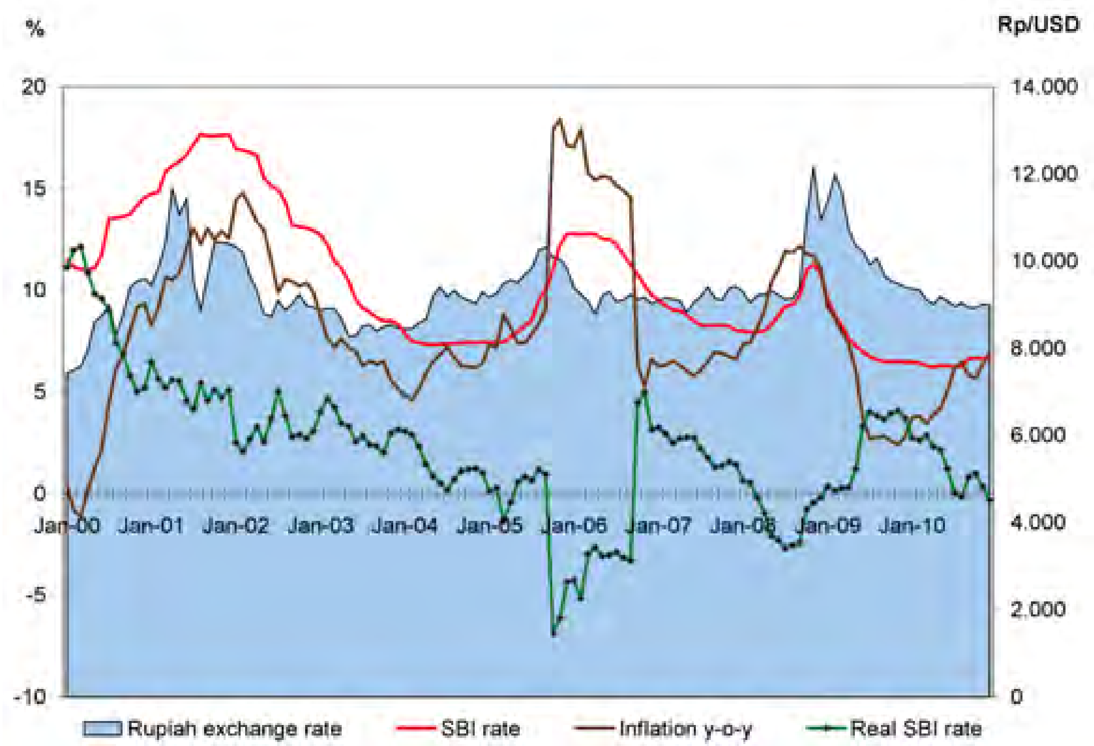


Figure 4.5.2 shows that the Rupiah exchange rate has been quite stable relative to the USD. There was a recent concern that the Rupiah might be too strong which might affect the trade balance. However, the Rupiah typically falls between 8000 and 9000 per US$1. The concern will be when the Rupiah hits the lower bound but thus far, it has been quite manageable around 8,400 Rupiah per US$1.

Table 4.5.3 Subsidy in the National Budget

	2009	2010	2011
	(Actual)	(Revised)	(Proposed)
Total Subsidies (USD bn)	13.3	22.0	19.9
% of GDP	2.5	3.2	2.6
% of Expenditures	14.7	18.0	15.4
Energy (USD bn)	9.1	15.7	14.4
Fuel (USD bn)	4.3	9.7	10.0
Electricity (USD bn)	4.8	6.0	4.4
Non-energy	4.2	6.3	5.5
Memo:			
Exchange Rate (IDR/USD)	10408	9200	9300
Budget Deficit (% of GDP)	1.6	2.2	1.7

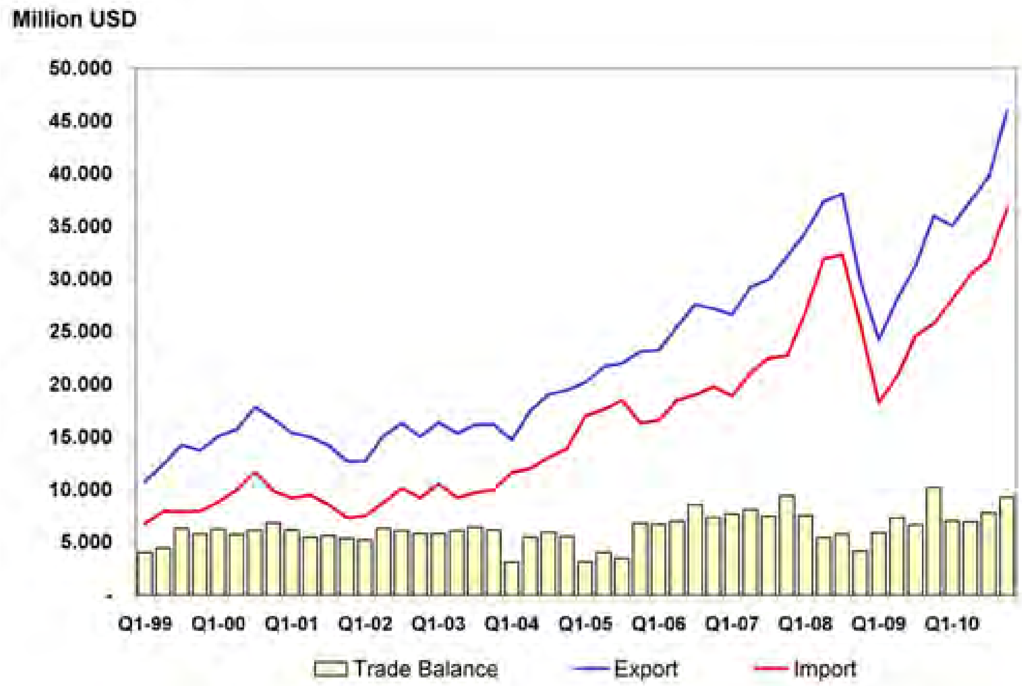
On the fiscal side, the concern is on the fiscal policy related to fuel subsidy. A huge amount of the budget goes to subsidies, especially the fuel subsidy (see Table 4.5.3). This policy is not good for at least three reasons:

- Mistargeted. The fuel subsidy, targeted at the low income households, is not effective since almost 50% of the subsidy is enjoyed by the 10% highest income group, and only less than 2% is enjoyed by the bottom 10%.
- Not productive. The biggest constraint of Indonesia economies is infrastructure, but funds allocated to infrastructure are always less allocation for subsidies. So the subsidies, especially for fuel, are not productive at all.
- Not environmentally friendly. On the production aspect, fuel subsidies suppress the incentive for business to move to renewable energy production. On the consumption aspect, fuel subsidies suppress the incentive to move from say, private cars to public transportation.

Trade balance is relatively constant and strong (see Figure 4.5.3). There is reduced dependency on oil and gas on the export side, but increased dependency on imports of raw materials and capital goods. Similar to the case for China, imports are needed because 90% of the imports are imports of raw materials and capital goods, and only 10% are imports of final goods. There is a strong relationship between imports and exports; in order to increase exports, there is a need to increase imports because the production has high imported content.

With regards to the financial account, one concern is the huge, short-term capital inflow due to the big interest differential. However, in recent months, the FDI has been growing again and the proportion of short-term capital inflow (even though it is still quite big) is decreasing compared to the proportion of FDI. This is a good sign as it shows that investors have confidence in Indonesia and is investing in the economy.

Figure 4.5.3 Trade Balance



Structural Change

The structural change from 1993 to present is not as rapid as that in the period 1966-92. There is a concern about a shift towards the services industry but at the same time, there is also concern about the labor. The dominant role of non-tradable sectors today is of concern because there is an issue of the industrialization, but the agriculture and manufacturing sectors are still employing much labor. Before the Asian financial crisis, the manufacturing industry could contribute 11-12%, but now the growth rate is only 3-5%. While the manufacturing sector is still considered as the labor absorber, it now faces a problem of employing much labor and this is sometimes described as a problem of the industrialization. Despite the continuation of industrial transformation, export-oriented manufacturing has been growing in the capital-intensive sector relative to resource- and labor-intensive sectors.

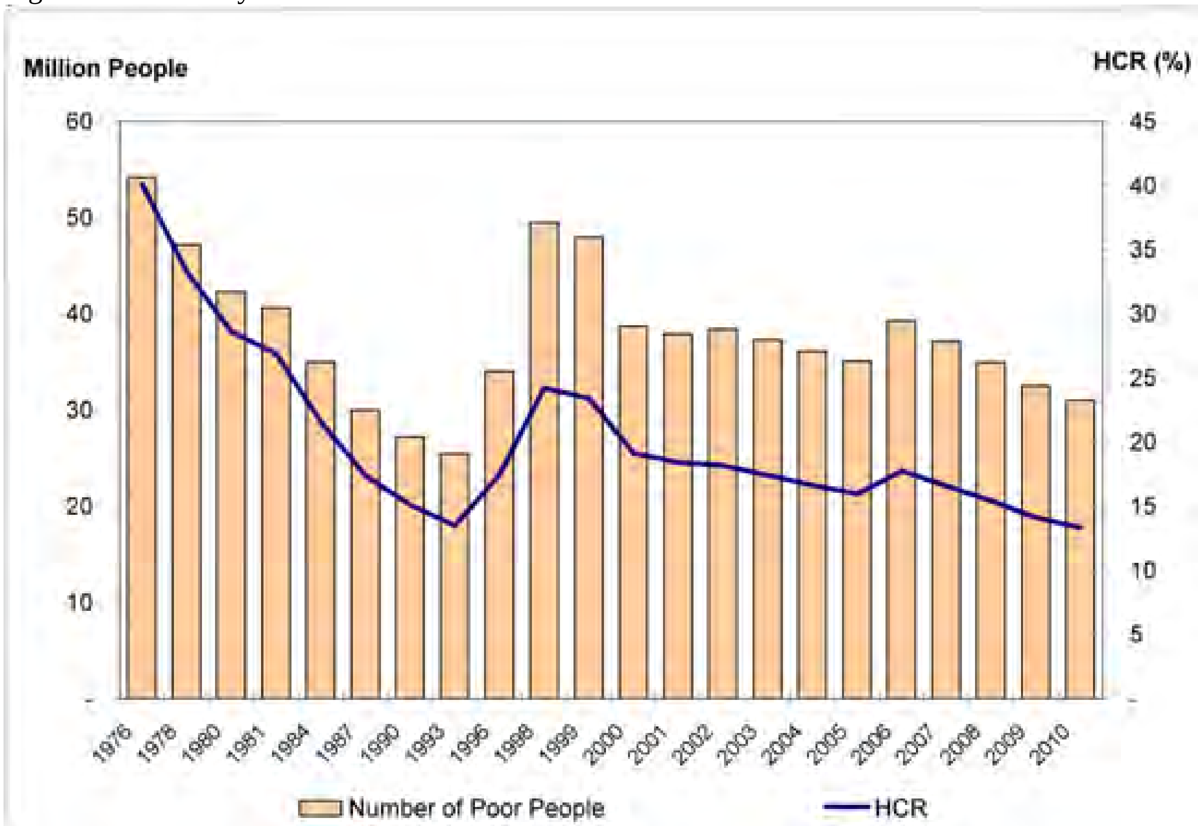
Social Development

Poverty and inequality has been reduced. Nonetheless, Indonesia's poverty and inequality measures (close to India, Cambodia and Vietnam) are still poor compared to other economies (see Table 4.5.4). The Gini coefficient has to be analyzed with caution as the measures may differ from economy to economy. More than 30 million people are still poor (see Figure 4.5.4). Indonesia, just like other economies, is in need of a good social security system. The absence of such a system means that only those who can afford to be unemployed are unemployed in Indonesia. Of the unemployed, official statistics reveal that many of them have a high school diploma. There is the possibility that those armed with a high school diploma may reject certain jobs because they believe themselves overqualified – this is a problem for Indonesia.

Table 4.5.4 Poverty & Inequality

Country	% Population below $2 (PPP)/day	Income Ratio of Highest 20% to Lowest 20%	Gini Coefficient
China	35.7 (2005)	8.3 (2005)	0.415 (2005)
India	75.6 (2005)	5.6 (2005)	0.368 (2005)
Indonesia	54.6 (2005)	6.2 (2007)	0.376 (2007)
Lao PDR	76.9 (2002)	4.9 (2002)	0.326 (2002)
Cambodia	57.8 (2007)	8.1 (2007)	0.442 (2007)
Malaysia	7.8 (2004)	7.0 (2004)	0.379 (2004)
Philippines	45.0 (2006)	9.0 (2006)	0.440 (2006)
Thailand	11.5 (2004)	8.1 (2004)	0.425 (2004)
Vietnam	48.4 (2006)	6.4 (2006)	0.378 (2006)

Figure 4.5.4 Poverty in Indonesia



Sustainability is an important issue, especially as Indonesia is also one of the biggest emitters in the world (see Table 4.5.5). Deforestation, too, is worrying as the deforestation rate is very high, especially compared to China and India where there is now reforestation as opposed to just deforestation (see Table 4.5.6).

Table 4.5.5 Forest Coverage & CO_2 Emission

Country	Forest coverage (% of land, 1990)	Forest coverage (% of land, 2005)	CO_2 emission (thousand metric tons, 1990)	CO_2 emission (thousand metric tons, 2007)	CO_2 emission per cap (metric tons, 1990)	CO_2 emission per cap (metric tons, 2007)
China	16.8	21.2	2460744	6538367	2.2	4.9
India	21.5	22.8	690577	1612362	0.8	1.4
Indonesia	64.3	48.8	149566	397143	0.8	1.8
Cambodia	73.3	59.2	451	4441	0.0	0.3
Malaysia	68.1	63.6	56593	194476	3.1	7.3
Philippines	35.5	24.0	44532	70916	0.7	0.8
Thailand	31.2	28.4	95833	277511	1.7	4.1
Vietnam	28.8	39.7	21408	111378	0.3	1.3

Source: ADB 2010

Table 4.5.6 Deforestation & Other Environmental Indicators

Country	GDP/unit of energy use (1)	Deforestation rate (2)	NOX (3)	Methane (4)	Agri land (5)	Arable land (6)	Cropland (7)
China	3.4	-2.1	566.7	995.8	59.3	15.1	1.3
India	4.9	-0.0	300.7	712.3	60.5	53.4	3.6
Indonesia	4.1	2.0	69.9	224.3	26.8	12.1	8.6
Cambodia	4.8	0.5	3.8	14.9	30.9	21.5	0.9
Malaysia	4.7	2.0	9.9	25.5	24.0	5.5	17.6
Philippines	7.1	2.1	18.9	44.8	38.6	17.1	16.4
Thailand	4.7	0.4	28.0	78.8	38.7	29.8	7.3
Vietnam	3.7	-1.9	37.5	75.1	32.5	20.5	9.9

Source: ADB 2010

Notes: (1) 2005 PPP USD/kg oil equivalent, (2) Average percent change 2000-2007, (3,4) Million metric tons CO2 equivalent, 2005, (5,6,7) Percent of land area, 2007

Supply Constraints

Supply constraints are the most binding constraints of Indonesia's recent economic development. Indonesia has started to join in the regional production network, but even though the region is integrating, Indonesia is still lagging behind economies like Thailand and Philippines. Even between regions within the economy, the market in Indonesia is disconnected. Integration is weak mainly as a result of poor infrastructure and logistics.

Table 4.5.7 Infrastructure Quality

	Indonesia		Philippines		Malaysia		Vietnam		China	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Quality of Infrastructure (overall)	46	96	94	98	19	27	97	111	58	66
Quality of Roads	105	94	94	104	17	24	102	102	51	50
Quality of Railroad Infrastructure	58	60	85	92	17	19	66	58	28	27
Quality of Port Infrastructure	104	95	100	112	16	19	112	99	54	61
Quality of Airport Infrastructure	75	68	89	100	20	27	92	84	74	80
Quality of Electricity Infrastructure	82	96	82	87	71	39	104	103	68	61
Telephone Lines	100	79	105	103	31	72	37	36	47	49

GCR 2010

Table 4.5.7 shows a comparison of infrastructure quality. Indonesia lags behind many of the other economies. To improve on this aspect, new developments in infrastructure are required. As the government's capacity for infrastructure development is only 30%, there is a need for private sector participation. In order to encourage the private sector to invest, it is necessary to have in place a good investment climate and good public-private partnership schemes.

While Indonesia's economic progress has been relatively stable in the past few decades, it seems that the achievement thus far is still sub-optimal. In order to reach its potential, Indonesia needs to tackle its most binding constraints: infrastructure and logistics.

4.6 Comments & Discussion

Comments & Discussion: Professor Woo Wing Thye's Presentation

Questions related to the US were asked. First, what does Professor Woo Wing Thye see as the impetus for the US to restructure the economy. Second, whether the Obama administration will have the political will to push for much broader economic restructuring and third, what is likely to happen when the US fails to extend the debt by the 2 August 2011 deadline.

With regard to the impetus, Professor Woo Wing Thye responded that Winston Churchill once famously said that one can always count on the Americans to do the right thing, after they have tried everything else. The US is a restless country, always willing to experiment and change: the fact that US has Obama as its president is proof of this. If Obama is re-elected for a second term (where there is no possibility of a third term) more daring policies and approaches will be expected. If however, a new president is elected, paralysis is expected for another 4 years, largely because the newly elected president would mostly want a second term, and that is when policy paralysis is the norm.

In Professor Woo Wing Thye's opinion, if the debt ceiling was not raised by 2 August 2011, the immediate outcome would be dependent on how much cash the government has in hand. There would be a shutdown of the government, and that would certainly create the dynamics to come to a deal on the budget that would accompany the raising of the debt ceiling. The stock market will post a decline, although the magnitude of the decline will depend on how long the market participants think the government will be shutdown. After the debt ceiling is raised, the stock market could either fall or rise depending on the package that was put in place to allow the debt ceiling to rise. As both parties are looking at the elections, it is unlikely that an agreement would not be reached, as whoever is blamed for the shutting down of the government would most likely be punished quite severely in the next elections.

A member of the audience asked for further clarification of Paul Samuelson's diagnosis: free trade is not good for the advanced economies but good for the emerging economies. According to Professor Woo Wing Thye, Paul Samuelson's conclusion rests on the assumption that the advanced economies have already reached the limit of technological potential and emerging economies have completely caught up with the technology of the advanced economies. If, however, the advanced economies were to continue to be as innovative as they are, then free trade will still be a win-win situation.

On his views on Indonesia being the emerging giant in ASEAN, Professor Woo Wing Thye agreed that the next few years are exceeding positive outlook for Indonesia partly due to the following reasons:

- Other ASEAN economies running out of cheap labor
- Good policies

Indonesia is finally part of the global production chain in a bigger way than before. Specifically as Malaysia has run out of cheap labor, the footloose industries are now moving to Indonesia. Indonesia has maintained a more open economic system than before, and is now reaping the fruits of ending its relative economic isolation. There have been significant changes within Indonesia, specifically the fiscal decentralization that has empowered the different provinces to be independent centers of policy initiatives. This is very similar to China's experience. In the case of China, the states were motivated to compete with each other to grow as a result of decentralizing fiscal resources. The same mechanism is unleashed in Indonesia and is working to a certain extent. Indonesia will continue to do well during the phase of its surplus labor. It is the next phase that will be very challenging to Indonesia.

<u>Comments & Discussion: Professor Chen Kang's Presentation</u>

A member of the audience wished to confirm if the tight credit situation in China, coupled with the high savings held by China's state-owned enterprises (SOEs) will inadvertently or deliberately increase the share of SOEs in the economy at the cost of SMEs.

Professor Chen Kang agreed with these observations. China's SOEs have deep pockets. Since 1993, SOEs do not need to transfer their profit to the government budget and therefore, SOEs have a lot of available funds. These funds appear to be channeled to real estate development. Therefore, the tight monetary policy will actually lead to the expansion of the state sector and such a phenomenon is already happening, especially in the last 3 years.

On the possibility of structural change in China following RMB appreciation, Professor Chen Kang's response was that RMB appreciation will probably align the energy price such that the price of oil in USD will be cheaper to China. Import oil will become cheaper and China will face pressure to increase the domestic oil price. That will change the behavior of energy consumption. However, RMB appreciation will also cause the government (which holds a lot of the purchasing power) to increase the imports. In addition, China's capital control may complicate matters. Further studies must be done to investigate the impacts of the various factors.

Professor Chen Kang was also asked his opinion on whether rumors of China's investments being a waste of money is valid, and if China does need more investment. To this, Professor Chen Kang's response is that China needs more investment in the right area. At present, the investment is in the wrong area. During the 2009 expansion, a lot of money was wasted. There is a very inefficient capital market in China: the financial system is the least reformed sector compared to other markets (*eg* goods and services market and labor market). Such a scenario is a result of the current growth model of China, which is mostly the local government driven model. The local government will be able to grow as long as they can obtain credit, and the central government's task is to suppress that growth. That has been happening in the last 5-7 years.

When then Premier Zhu Rongji cut the link between the local government and the credit market, China went into a deflation period from 1997-2002. This is so as, when the link was cut, the local government had no way to develop the local economy and so the growth rate was reduced. However, after Zhu Rongji stepped down, that link was reestablished and local governments now have several investment arms and platforms to raise funds. This was what fostered the current growth pattern of China, and will likely lead to a lot of wrong investments in the wrong area. The right area of investment is private sector investment; SMEs are the engines of growth and are essential for a competitive and efficient market. The current growth model of China will affect the long-term employment prospects. The unemployment problem will become a big issue.

Comments & Discussion: Dr Arianto Patunru's Presentation

A question on the labor market was posed. In particular, the labor union was known to have played a very important role in discouraging FDI a few years ago. Given the importance of FDI to the Indonesian economy, Dr Arianto Patunru was asked if the government will explore ways to create a friendlier environment for foreign investors.

Dr Arianto Patunru agreed that the labor law is currently unfriendly. As an example, the severance payment in Indonesia is one of the heaviest in the world such that compensations of 25 to 30 months' salary may have to be paid by the employer for firing a worker, regardless of reason. Businesses get around this harsh rule by hiring contract workers, which is not beneficial for workers as they have no insurance or pensions. Dr Arianto Patunru agreed that the labor law should be changed. In fact, in 2006, the labor law was to be revised. Unfortunately, it was leaked to the press even before the businesses and labor union was consulted with (since the plan was tripartite). As the media reported that the government only consulted with the businesses, there was a riot in Jakarta and thus the plan was cancelled in 2007.

In response to the difficulties involved in removing the fuel subsidy, Dr Arianto Patunru attributes one of the reasons to Indonesia's general election in 2014. Although it is currently a few years away from the general election, the atmosphere is such that unpopular policies are unlikely to be passed from 2011 till 2014. Instead of attempting to educate the people on why the fuel subsidy should be removed and instead better spent on infrastructure or education or health development, the government's argument is that the fuel subsidy is a burden to the budget. It is difficult to convince the people with such a reason.

General Comments & Discussion

On the future of the Asia-Pacific economic growth, Dr Vu Minh Khuong responded that Asia-Pacific has great potential to be a very prosperous area. However, 3 Ps are necessary: peace, passion, partnership. Similar to Professor Woo Wing Thye's advice to China in his presentation, to build a harmonious society, one must first build a harmonious community within Asia.