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Reviving Asian Economic
Growth Requires
Further Reforms

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ERD POLICY BRIEF NO. 19

Reviving Asian Economic Growth Requires Further Reforms

Ifzal Ali

June 2003

Ifzal Ali is Chief Economist, Asian Development Bank. This brief benefited greatly from extensive and insightful comments and suggestions provided by Ernesto Pernia and M. G. Quibria, as well as discussions with J. P. Verbiest, Xianbin Yao, and Jesus Felipe.

Real gross domestic product (GDP) growth rates in the Asian developing economies (ADEs) during 1998-2002 slowed markedly compared to 1990-1998. In East Asia, while the People's Republic of China's (PRC) growth dropped from 10 to 7.6 percent, Hong Kong, China's fell from 4 to 2.3 percent. The decline has been even more precipitous in Southeast Asia, with Singapore's growth falling from 7.8 to 2.9 percent, and Indonesia's from 5.3 to -0.1 percent. In South Asia, where growth has been traditionally slower, India's growth slowed from 5.7 to 5.4 percent, masking the sharper decline from 7.5 percent in 1994-1996 to 4.8 percent in 2002-2003. While the subregions of Asia are at different stages of economic development and each country faces differing constraints, the imperative to reverse the declining trend growth rates applies to all.

With a time horizon that is medium to long-term, this brief provides broad directions for policy and institutional reforms that would help revive growth in the ADEs. Given the pronounced diversity of the ADEs, specific directions are called for in each economy. However, it is not possible to address all the specificities here. The brief identifies emerging domestic constraints, examines the challenges and opportunities resulting from globalization, sketches a broad reform agenda, and concludes with a sequencing of the reforms in the different subregions.

Emerging Domestic Constraints

Extension of growth potential depends on the efficiency with which the factors of production are combined, factor accumulation rate, and rate of technological progress. Factors include labor, infrastructure assets, and noninfrastructure capital. Both the macroeconomic and microeconomic environments impact on these factors.

Macroeconomic policies influence not only the business cycle but also the underlying trend of growth. For example, price stability encourages investment and provides a sound framework for resource allocation; similarly, lower tax burdens improve the incentives to invest (OECD 2003). Generally, ADEs have adopted sound macroeconomic policies since 1998 with good results, except in the fiscal area. The problem of fiscal deficit has been acute in South Asia, worrisome in Southeast Asia like in Malaysia and the Philippines, and becoming serious in Hong Kong, China (ADB 2003a, 31-2). Relative to GDP,

the fiscal deficit in 2002 was 9.3 percent in India; 9.0 percent in Sri Lanka; 5.6 percent in Malaysia; 5.3 percent in the Philippines; and 5.6 percent in Hong Kong, China.

The volume of investment and the cost of capital are coming under strain from the ballooning budget deficits. For example, the real cost of capital at about 6 percent in India by end-2002 is estimated to be more than double that in most economies including the PRC (Wolf and Luce 2003). This is a major disincentive for private investment. These deficits have been financed from public borrowings that increase debt and interest payments, with the burden falling on public investment, particularly infrastructure. In India, the share of public investment in GDP has declined from 11.2 percent in 1986 to 6.3 percent in 2002 (ADB 2003b). In Thailand, it has fallen from 11.6 percent in 1997 to 7.6 percent in 2001. Typically, an increase in private investment does not compensate for the decline in public investment partly because public borrowings tap private savings.

While budget deficits raise the cost of capital, the inefficiency of the financial sector due to weak regulatory frameworks further adds to this cost. This is particularly true in economies where the banking sector is largely state-owned. In addition, a post-1997 financial crisis phenomenon has been the sudden rise in nonperforming loans (NPLs) (ADB 2003a, 29). NPLs reduce interest income and increase loan loss provisioning. With a decline in profit, banks are hard pressed to meet capital adequacy requirements from equity. If a bank has to borrow to meet these requirements, interest costs increase, further depressing profits. Thus, large NPLs could lead to a significant decline in the financial health of a bank. The deleterious effects have ranged from liquidity crises to deposit runs and bank failures (Mukherjee 2003). The NPL problem has caused banks both to raise interest rates and be more stringent in assessing the quality of new loans. Thus, high levels of liquidity unmatched by credit growth are a common phenomenon in many parts of Asia.

The emerging macroeconomic environment characterized by growing budget deficits, public debt, and servicing costs results in: (i) inability of governments to provide such core social services as education, health, and sanitation, as well as adequate infrastructure like power, water, transport, and telecommunications; (ii) high cost of capital and other input costs; and (iii) inadequate availability of credit. These impact negatively on both the quality and quantity of the factors of production.

At the enterprise level, product and factor market imperfections imply that both productivity of factors of production and investment

levels are suboptimal. Major microeconomic and structural constraints include the regulatory and legal frameworks, particularly those relating to exit and entry of firms, labor market inflexibility, corruption, and poor governance (Stern 2001). A comparison between the PRC and India provides useful insights. In restrictions on hiring and firing of workers, India ranked 73rd out of 75 countries in comparison to the PRC, which ranked 23rd in the Global Competitiveness Report of 2000. Bankruptcy is almost impossible for large businesses in India with 60 percent of liquidation processes before Indian High Courts continuing for more than 10 years (Wolf and Luce 2003). While starting a business takes 10 permits and 90 days in India, it requires only six permits and 30 days in PRC.

Anticompetitive product-market regulations; limitations on factor mobility; and inadequate infrastructure that inhibits the free movement of goods, factors, and information result in poorly functioning markets. This leads to inefficient utilization of factors of production and misallocation of resources. Removing these domestic constraints would lead to efficiency improvements that extend the frontier of opportunities for an economy. In South Asia, reforms pertaining to improving the policy and institutional environment in which enterprises operate are in their infancy. In parts of Southeast Asia like Indonesia and the Philippines, they have a long way to go.

Globalization and Expanding Opportunities

Globalization is the process of integrating various economies with the world economy through the removal of barriers to trade and mobility of skilled labor and capital, as well as diffusing knowledge and information (ADB 2003a, 208). Free trade, mobility of skilled labor, capital mobility resulting in the inflow of foreign direct investment, portfolio investment, external borrowings, as well as inflows of knowledge and technology extend the frontier of opportunities. East Asia, Southeast Asia, and South Asia have benefited from globalization, in descending order.

The less advanced ADEs, learning from the experience of the more advanced neighbors, particularly those in East Asia and partly in Southeast Asia, have accepted the need for freer trade. In South Asia, quantitative restrictions on imports and tariff rates have been substantially reduced in the 1990s. In terms of the International Monetary Fund's trade restrictiveness index in 2001, Hong Kong, China and Singapore are the most open while India and Bangladesh

are still the most closed, immediately preceded by Thailand and the PRC (International Monetary Fund 2002). This relative ranking is also true for nontariff barriers and tariff ratings taken individually. India's average tariff is three times the average tariff for Asia. There is considerable room for further trade liberalization in both South and Southeast Asia.

The efficiency gains from free trade are well known (Yusuf and Evenett 2002). In integrating domestic with global markets, the market discipline imparted on the domestic economy is a major advantage. Deviations between domestic and foreign prices after adjusting for transportation costs provide a transparent and automatic index of identifying policy and institutional distortions that need to be reformed.

Sustained foreign capital inflows depend on the soundness of macroeconomic management, competitiveness of domestic markets, governance structure, and quality of physical and social infrastructure. The rating agencies' qualitative and quantitative sovereign rating of a country provides investors with an independent assessment that assists them in making informed decisions on the volume, maturity horizon, and expected returns commensurate with the risks of their investments in developing Asia. The rating agencies and international capital markets are quick to "punish" countries that lack sound macroeconomic management, smoothly functioning product and factor markets, and a good governance structure.

Another key feature of globalization is the introduction of new technology. Technology and competition are the drivers of change in the era of globalization (ADB 2003a, 208). Technology and competition are both driven by and are drivers of globalization. The revolution in information and communication technology has made possible the seamless transfer of ideas and knowledge. Further, with inventions and innovations occurring frequently rather than discretely at irregular intervals, global firms are ever more dependent on technological innovation to increase their capabilities and competitiveness. While addressing domestic constraints will cut costs of production and transportation, firms in the ADEs will need to develop their capability to first adopt and then create new and more technology-intensive products. Flexibility to respond to changing demands will increasingly depend on the ability to imitate, invent, innovate and adopt new technologies.

The ADEs will face major challenges in capturing the opportunities offered by globalization. The East and Southeast experiences in the electronics sector point to the importance of the distinction between leadership and catch-up competitiveness and the

role of innovation (ADB 2003a, 257-61). Except in a few highly selected areas in Republic of Korea (Korea), all ADEs are in the catch-up stage. Within the catch-up stage, ADEs could move from original equipment manufacture, where local firms learn assembly process for standard simple goods; to own design and manufacture, where local firms learn process engineering and detailed product design skills; to own-brand manufacture, where local firms conduct manufacturing, product design, and research and development for new products. Thus, in the areas of innovation and competition, there is a wide spectrum of opportunities that face each ADE.

Agenda for Reform

Extending potential growth rates or the frontier of opportunities will require addressing six policy challenges:

- (i) Fiscal stability leading to high rates of savings and investment would need to be ensured.
- (ii) Weaknesses in the financial sector including corporate governance, regulatory oversight, and NPLs must be dealt with.
- (iii) Open trade regimes and exchange rate management—complemented by appropriate domestic policies—to support sustainable current account deficits must be put in place.
- (iv) Removal of exit-entry barriers, reform of labor laws, deregulation to improve efficiency and reduce corruption, and significant improvements in the quality and quantity of infrastructure must be attained.
- (v) Progressively, the engine of growth will derive steam from innovation and adoption of new technology rather than from factor accumulation.
- (vi) Human resource development will need to be continuously pursued to ensure an educated and creative workforce for the adaptation and adoption of new technology and the conduct of research and development.

The three key aspects of globalization emphasized are capital mobility, removal of barriers to trade and competition, and technological change. On capital mobility, there are two issues to consider. First, since the Asian financial crisis, selected Asian

economies have doubled their levels of international reserves to a total of about \$1 trillion at the end of 2002 (ADB 2003a) owing primarily to rising current account surpluses. These reserves have been largely invested in the United States and have been an integral component of the risk management strategies of Asian central banks. However, they could also be viewed as foregone investment in ADEs. A factor contributing to this phenomenon is the health of the banking sector, which has not recovered from the NPL problem, making banks risk-averse. A comprehensive revamp of the banking system in Asia and development of domestic capital markets are required to give Asian firms access to domestic financing, increased investment, and growth. The second issue is that economies that do not have sufficient domestic savings need to attract foreign capital. A necessary condition is fiscal consolidation with fiscal deficits and government debt being reduced to more manageable levels. Without these reforms, it would be difficult to attain sovereign ratings sufficient to attract the required volume of capital inflows at reasonable cost and maturity suitable for investment in a developing economy.

An important implication of fiscal consolidation is the future role of the state in many developing economies. Significant downsizing, streamlining, and appropriate prioritization are called for. The focus should be on the provision of essential public goods and services, including maintenance of law and order. Likewise, determined efforts are required for faster transition to a new and sustainable public-private partnership.

With the government focusing on the provision of essential public goods and services, the engine of growth in the 21st century will be the private sector, and improving labor productivity at the firm level in a sustained manner will be a key determinant of future growth. As economies reduce trade barriers to integrate themselves in the global economy, enhanced flexibility will be critical in responding to changing domestic and external demands. Effective and efficient financial and infrastructure services will facilitate the ability of domestic firms to compete and attract FDI. These have to be complemented by the ability of firms to reallocate labor and capital in line with changing market conditions. A regulatory framework that allows labor and capital to move from inefficient to efficient uses is essential (Srinivasan and Tendulkar 2003). Improved governance in the form of transparency and automaticity in the design and implementation of regulatory frameworks and tax administration are needed to curb corruption and significantly reduce transaction costs. All these initiatives are needed to improve the investment climate facing firms (Stern 2003).

In this regard, the results of two recent studies on India and Korea are noteworthy. If certain states in India could attain the best practice already achieved by the most progressive states in terms of investment climate, the potential rate of growth of the Indian economy would increase by about 2 percentage points (World Bank 2002). In Korea, productivity increases resulting from technological improvements could add up to 1.5 percentage points to the potential rate of growth over the next decade. There is room for a further 0.5 percentage point addition to the potential growth rate resulting from better institutions, improved governance, and openness (Hahn, Choi, Kim, and Lim 2002).

Nurturing innovations will require a significant break from the past. Innovations require an educated and creative work force, research and development, information technology, and dynamic urban clusters (Yusuf and Evenett 2002). Public-private partnerships to stimulate innovations through creating the enabling conditions rather than targeting specific industries will be essential for success of individual firms and the economy as a whole (Felipe 2003).

The agenda for reform is wide-ranging and involves winners and losers among the various stakeholders comprising industrialists, bureaucrats, politicians, large farmers, and organized labor. There will always be vested interests that benefit from the status quo. Unless reforms lead to substantial increases in growth rates and employment opportunities in a timely manner, sustaining a coalition of supporters in favor of the reform process could prove to be difficult. The domestic political economy of the reform agenda indicated is likely to be very complex.

Conclusion

While the Asian developing economies continue to outperform other regions, there has been a marked deceleration in their growth rates in the aftermath of the Asian financial crisis. In the 1990s there was a growing realization that the costs of bureaucratic failures outweighed those of market failures. The advantages of outward-oriented market economies were recognized and certain policy and institutional reforms were initiated. This brief advocates an acceleration of these reforms toward rationalization and stringent prioritization of the role of the state combined with the private sector becoming the main driver of the growth process.

With so many policies and institutions influencing the growth process and while there are synergies among them, establishing the priorities for reform is crucial. Given differing initial conditions and constraints, the sequencing and timing of the reforms inevitably differ across the subregions and, indeed, across individual countries. Fiscal consolidation and financial sector reform need to be undertaken by all ADEs. There is also a need to recognize the critical role of education to increase work force skills to generate knowledge for innovation. South Asia and most of Southeast Asia will need to urgently improve the environment in which enterprises operate. Policy, institutional, and governance issues will need to be addressed squarely in the face of vehement opposition from vested-interest groups. In addition to improving governance, the challenge to East Asia is to step up the rate of technological progress that will provide the impetus for further growth.

Globalization, technology, and competition provide the overall context within which the reform agenda would need to be designed and implemented to step up the potential growth rates. In order to exploit the opportunities offered by freer trade and the mobility of skilled labor and capital, the ADEs would need to develop physical, social, and legal infrastructures as well as the institutional and policy framework that adhere to certain standards of global acceptability. These are essential for the ADEs to revive growth in the decades ahead.

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