

East Asia in Transition

Lesson 3: Economics Update

World War II devastated the economic infrastructure of many East Asian states. Cities, ports, and factories were demolished. After the war, millions of people were homeless and starving. Over the next three decades, East Asian economies slowly recovered. Since the 1970s, East Asia has had the strongest economic growth of any region in the world, attracting almost half of the capital inflow into developing countries. However, the economic crises of 1997 and 2009 dented outright optimism, calling into question tenets of East Asia's miracle rise.

This update examines East Asia's economic development before turning to three important case studies in the region—South Korea, Japan, and China. Next, the 2009 economic crisis is discussed, before concluding with a look at regional economic integration efforts.

EAST ASIAN ECONOMIC DEVELOPMENT: AN OVERVIEW

(insert on page 75 before “Regional Economic Cooperation and Integration”)

During the 1970s, 1980s, and into the 1990s, economic growth in East Asia averaged over 7 percent per year.¹ Japan developed the second-largest economy in the world. Hong Kong, Taiwan, Singapore, and South Korea experienced such rapid growth that they were dubbed the “Four Tigers.” Still, other countries lagged far behind. Also, in the countries experiencing strong economic growth, significant problems often arose. These problems included environmental degradation, poor working conditions, and extreme social inequality.

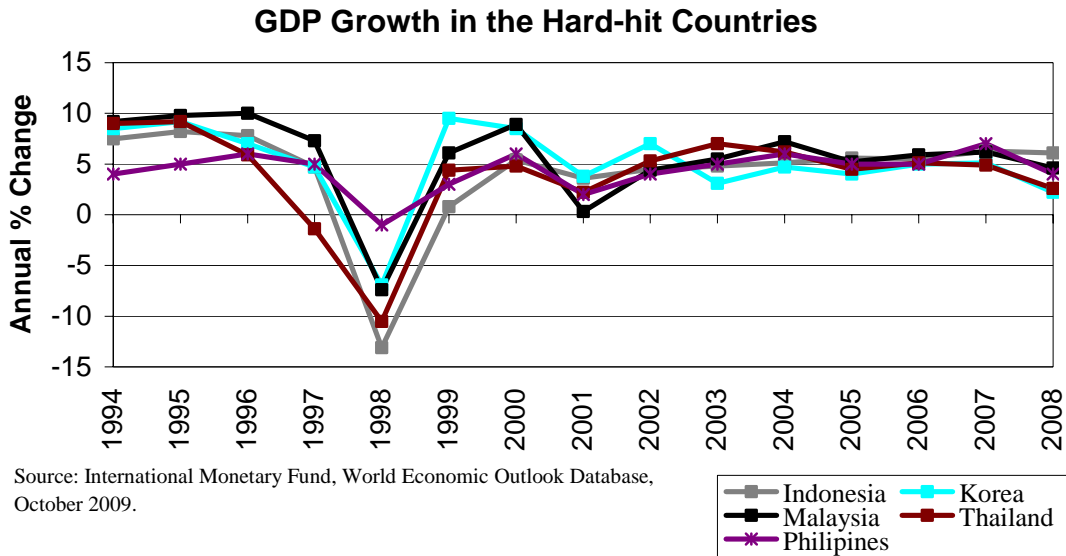
The 1997 East Asian economic crisis abruptly halted economic growth in many parts of East Asia. It started in Thailand and soon spread to Indonesia, South Korea, Malaysia, the Philippines, and elsewhere (see Chart 1 on page 2). The crisis then spilled over the region's borders into Russia, Brazil, and other developing economies. Some analysts blame the crisis on problems associated with the developmental state model (see Lessons 2 and 3 in *East Asia in Transition*), while others blame factors outside the countries, such as the international financial system.

Intent on continuing economic growth, Southeast Asian countries maintained high interest rates that encouraged foreign investment and attracted large inflows of money. The resulting large quantities of credit generated a highly leveraged economic climate, and pushed up asset prices to an unsustainable level. This problem was beset by a side effect of the developmental state model, crony capitalism. Under such a practice, the government distributed developmental money in a largely uncontrolled manner to certain people based on relational ties, rather than market efficiencies. The result was a series of bad investments that further burdened the increasingly fragile economies.

In July 1997, the asset bubble created by risky investments crashed in Thailand. Individuals and companies began to default on loan obligations, creating a panic among lenders that led to a large withdrawal of credit from the crisis countries. The Thai government did not have adequate foreign reserves to pay for the loan the country had taken. It could not support the value of its currency, the *baht*. As a result, the Thai government was forced to remove the *baht*'s fixed link

to the U.S. dollar. International banks and investors panicked and took large sums of money out of the country. They essentially called in their loans immediately. The *baht* quickly lost more than 50 percent of its value.²

Chart 1



Confidence is a very important factor in international finance, especially in an era when trillions of dollars can electronically move around the world in a day. After Thailand’s devaluation, the “herd” of international banks and investors lost confidence in much of East Asia. They assumed that neighboring countries shared the same weaknesses. Indonesia, South Korea, and other countries were unable to prevent investors from pulling their money out of their economies. The results were both economic and political. In Indonesia, intense public pressure forced the resignation of its president after 30 years in power. Countries such as China, Malaysia, and Singapore were less affected by the Asian crisis, in part because they maintained tight controls on the movement of capital. Some countries, such as Taiwan and Singapore, also possessed a large amount of foreign reserves to support the value of their currencies and insulate themselves from the economic shock.

The International Monetary Fund (IMF) initiated a \$40 billion program to stabilize the currencies of South Korea, Thailand, and Indonesia. By 1999–2000, most countries affected by the crisis were recovering. This recovery was largely due to demand for their exports in China and elsewhere. Because China was not hit hard by the crisis, it was able to sustain its demand for raw materials and other imports from East Asian countries. As a result, East Asia has reclaimed its title as the fastest-growing region in the world. Indeed, the most important long-term effect of the crisis may have actually been political and economic reform. Still, the region’s general recovery does not discount the devastating economic and social costs of the crisis. Some of these costs are still being felt. Here, we look at three important cases of economic development in East Asia: South Korea, Japan, and China.

South Korea. In 1997, after the onset of the crisis, South Korea found itself just days away from defaulting on its international loans. It had to accept a \$58 billion bailout arranged by the International Monetary Fund (IMF).³ As a result of the crisis, 23,000 businesses failed,⁴ unemployment soared to its highest level in decades,⁵ and the gross domestic product (GDP) shrank by almost 7 percent. To its credit, South Korean society—from the newly elected government to business leaders and labor unions—cooperated in implementing reforms to restore confidence and economic growth. The government forced many corporations (called *chaebols*) to restructure and lower their debt. It moved to strengthen the country’s banks. For example, the government bought up many loans that would never have been paid back because the businesses were unprofitable. Importantly, banks also changed their lending practices. They began providing loans to more profitable companies as well as individuals. The strategy paid off. Between 1999 and 2002, the country averaged roughly 7 percent economic growth, despite a global economic slowdown. This led IMF officials to point to South Korea as an example of effective economic reform.

The December 2002 presidential election was a close race between those who favored more reforms and those who favored easing restrictions on the *chaebols*. In the end, the proreform movement won, but only by a very narrow margin. Still, growth rates averaged less than 5 percent between 2004 and 2006. Economic reform remains an important part of the South Korean agenda. South Korea was affected by the 2009 Economic Crisis and growth was further slowed (see “East Asia and the 2009 Economic Crisis” section below).

Japan. High economic growth rates prevailed during Japan’s bubble period in the late 1980s. However, this period was also marked by large, often highly questionable investments, especially in the area of real estate. Because of these unwise investments, many argued that Japan’s developmental state model had actually led to unsound, and sometimes corrupt, economic decisions, another version of “crony capitalism.” Bad decisions led to bad bank loans, overbuilding, unsustainable growth, and overvalued assets.

However, cronyism, excessive regulation, and bank loans to unprofitable businesses serve as a social safety net, often blocking efforts for economic reform. This safety net preserves millions of unnecessary jobs. In Japan’s “dual economy,” the country’s efficient, export-oriented businesses subsidize less efficient, domestic-oriented businesses. The export-oriented businesses purchase goods at artificially high prices from the domestic-oriented businesses. For example, farmers and small businesses receive loans from government-backed banks. They then sell products to export-oriented businesses at prices higher than these businesses would ordinarily pay if they bought the same products elsewhere.

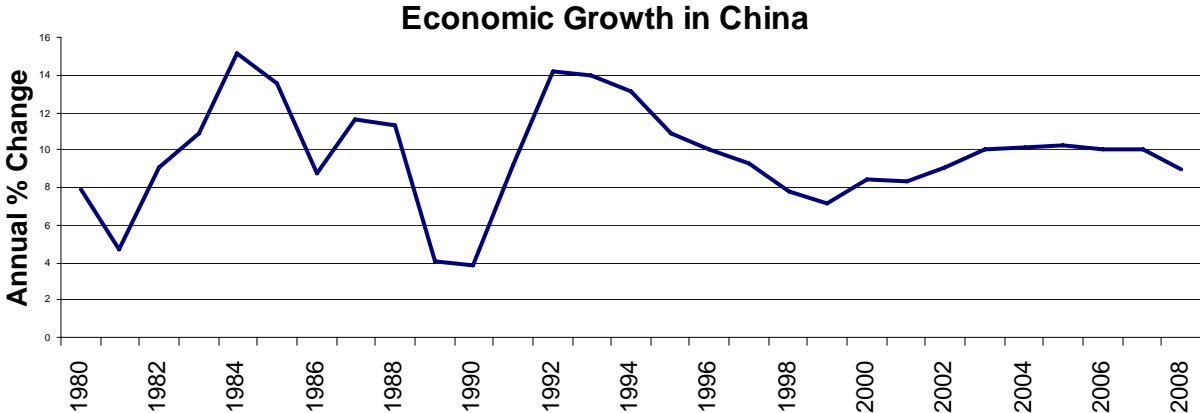
Nevertheless, Japan has overcome the worst of its economic stagnation. It has been able to achieve this recovery mainly through exports. Between 1997 and 2002, the country averaged less than 1 percent annual economic growth. Between 2003 and 2006, it averaged almost 2.5 percent growth.⁶ Still, because of traditional values and concerns about their country’s long-term economic recovery, the Japanese people have not increased their consumption of domestic products. This lack of consumption means Japan remains dependent on exports, especially to China.

China. China has served as an engine of growth in the region and in the world for the last several years. However, it also has the potential to experience its own financial crisis. Indeed, when discussing the Asian economic crisis and its aftermath, communist China has several important similarities and differences with its East Asian neighbors. One key difference is that some sectors of the economy remain heavily state-dominated, which protects these state-owned enterprises (SOEs) from market pressures and foreign competition when needed.

However, as with several of its Asian counterparts, the country has severe banking problems, overbuilt assets, and significant problems with corruption. China’s weak banking system stems from its loans to unprofitable SOEs and other policy goals. Most of these loans may never be paid back. Modernizing or privatizing SOEs is politically difficult because many of these companies would go bankrupt. Reform would also add to the tens of millions of increasingly restless unemployed people in the country. Instead, the government is counting on high growth rates coupled with gradual reforms to solve its economic problems.

China’s economy has averaged roughly 10 percent growth per year since 1980, despite a slowdown following the 1989 Tiananmen Square massacre (see Chart 2). Although this amount of economic growth would be spectacular for many countries, China needs to sustain such a level to lift its many impoverished citizens out of poverty. If growth falls below this level, domestic, social, and political pressures could threaten stability. Roughly 340 million Chinese, more than a quarter of the country’s population, live on less than \$2 a day.⁷ The rapid economic growth has resulted in increased economic inequity, as well as in severe environmental problems.⁸

Chart 2



Source: International Monetary Fund, World Economic Outlook Database, October 2009.

Nevertheless, there is also a lot of dynamism in the huge and diverse Chinese economy. In many ways, China rivals Japan as the pivotal economic player in the region. Trade is a critical part of the picture. In 2004, China’s total trade volume surpassed Japan’s. China is now the second-largest trader in the world, after the United States and Germany.⁹ Foreign-funded enterprises produce more than half of Chinese exports. These exports are primarily based on cheap

manufacturing and labor.¹⁰ China continues to attract a significant share of the world's foreign direct investment (FDI). In 2008, FDI in China topped \$108 billion.¹¹

China is also increasing its level of imports at a record rate due in part to its December 2001 entry into the World Trade Organization (WTO). Under the terms of the WTO entrance treaty, China pledged to significantly reduce its import tariffs and take other steps to allow for foreign participation in its economy. By 2005, the average tariff had dropped to under 10 percent.¹² China is now the largest export market for South Korea and Taiwan.¹³ Japan's recent economic recovery is partly due to its exports to China.

In the end, China is a paradoxical picture. It has inefficient SOEs, excessive state control, poverty, corruption, repression, and environmental decline. However, it also has high growth, booming trade, record foreign investment, and an expanding middle class. By 2005, China had the world's third-largest economy in terms of GDP.¹⁴ Politically, the government has tried to adapt to dramatic economic and social change while maintaining the authority of the Communist Party.

EAST ASIA AND THE 2009 ECONOMIC CRISIS

Unlike the 1997 crisis that originated in Thailand, the 2009 economic crisis began in the United States and quickly spread through developed and developing countries. Though the exact cause is undetermined, experts point to the inflated U.S. subprime mortgage market and the trading of risky financial derivatives* that damaged the solvency of financial institutions globally. Some experts also point to imbalanced trade relationships created by artificially reduced currency values.

In East Asia, the crisis was chiefly manifested in sharp increases in commodity prices and corresponding inflation. For example, the Korean *won* lost up to 30 percent of its value. Like most regions, East Asia was subjected to drops in production, heavy layoffs, and decreasing amounts of FDI.

Regardless, the recent crisis is not expected to have a transformative effect on East Asia and its rebound has been surprisingly swift. A timely fiscal and monetary stimulus in most East Asian countries set in motion a regional recovery. The rebound is particularly acute in China, where an aggressive stimulus package was delivered in anticipation of a decline in export-led growth. Like other East Asian countries, most of the stimulus was applied to infrastructure-orientated government-influenced projects. As a result, real GDP growth surged to 8.9 percent in the third quarter of 2009 from a low of 6.1 percent in the first. For East Asia as a whole, GDP growth is set to slow to 6.7 percent compared to 8 percent in 2008.¹⁵

* According to the Merriam-Webster online dictionary, a derivative is "a contract or security that derives its value from that of an underlying asset (as another security) or from the value of a rate (as of interest or currency exchange) or index of asset value (as a stock index). (<http://www.merriam-webster.com/dictionary/derivative> accessed January 25, 2010)

As a result of the financial crisis, the East Asian development model is facing revision. After the 1997 East Asia Economic Crisis, recovery for many East Asian countries was based on an export-led growth model (see previous section). However, in light of the 2009 crisis, many countries are contemplating a shift away from this type of development because it creates dependence upon the buying proclivities of wealthier nations. Developing countries will possibly look towards policy measures that will awaken the domestic consumer markets, thereby extracting growth not only from the continued sale of exports, but from the purchasing power of their populations.

REGIONAL ECONOMIC INTEGRATION

(insert on page 76 before “Economics in East Asia”)

The 2009 economic crisis strengthened an already acute move towards regional economic cooperation and integration. In East Asia, as in other parts of the world, economic integration is viewed as a way to accelerate economic growth and development. The rationale behind this view is that economic integration permits the formation of large market areas without restrictions on trade. Freer trade fosters economic growth and development through larger economies of scale and increased efficiency. Here we focus on two East Asian efforts at economic integration and cooperation: the Association of Southeast Asian Nations (ASEAN) and the Asia-Pacific Economic Cooperation forum (APEC).

ASEAN. ASEAN was formed by Indonesia, Malaysia, the Philippines, Singapore, and Thailand in 1967. Since its founding, it has added Brunei, Vietnam, Laos, Myanmar, and Cambodia. Today, the ASEAN region has 550 million people and a combined gross domestic product of more than \$1,030 billion.¹⁶ The United States’ annual total trade in goods with ASEAN states tops \$153 billion.¹⁷

According to its charter, ASEAN’s aim is to “accelerate the economic growth, social progress, and cultural development” of its members and to “promote regional peace and stability.”¹⁸ Economically, steps have been taken to loosen barriers to trade between member states. In 1992, ASEAN members agreed to form the ASEAN Free Trade Area (AFTA). In the early and mid-1990s, foreign investment in the region grew rapidly. However, the pace of integration slowed because member states were reluctant to take steps that would undermine protected industries and national sovereignty. Also, because of the economic problems faced by several ASEAN countries, they were hit extremely hard by the 1997 economic crisis.

At the turn of the century, the ASEAN states were recovering from the economic crisis. By 2003, significant tariff reductions had been made among the members. In 2005, investment inflows were at record rates.¹⁹ In November 2007, the ASEAN members signed the ASEAN charter, a constitution governing relations among its members and establishing itself as an international legal entity, thus moving one step closer to “an EU-style community.”²⁰

However, the union is not without controversies. Some countries, such as Singapore and Malaysia, have received significantly more investment than other countries within the organization. In addition, intra-ASEAN trade remains only a small part of ASEAN’s total trade.

Other challenges that face the ASEAN states include the extreme poverty found in many of its countries, and the continuation of the harsh military regime in Myanmar.

APEC. APEC is a much larger initiative. It was established in 1989 by twelve Pacific Ocean–bordering states (Australia, Brunei, Canada, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, South Korea, Thailand, and the United States). It has since grown to twenty-one members. The new members are Chile, the People’s Republic of China, Hong Kong, Mexico, Papua New Guinea, Peru, Russia, Taiwan, and Vietnam. APEC is one of the few international bodies that have both China and Taiwan as members. It links 2.6 billion people, which is over 40 percent of the world’s population.²¹

APEC’s goal is to enhance growth and prosperity in the Asia-Pacific region. Its members want to eliminate all trade barriers among them by 2020. Member states are also working to increase investment and support economic reform. APEC has contributed to a number of bilateral trade initiatives among its member states since its inception. However, the Asia-Pacific region is dynamic, huge, and complex. Numerous political and economic obstacles remain in the way of reaching the 2020 goal for economic integration.

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¹⁷ International Monetary Fund, *Direction of Trade Statistics*, p. 510, op cit.

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