Asia: a Locomotive of the World Economy

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Distinguished Guests
Ladies and Gentlemen

Introduction

First of all, I would like to thank my good friend Dr Kurt Lauk for inviting me to revisit this lovely city of Berlin. I first came to Berlin in the summer of 1967 when I was a poor student volunteer working in the TierGarten in West Berlin. In Berlin, watching the Wall and how my fellow Germans students worked as a team, I learnt the meaning of freedom and “arbeit”, the famed German spirit of hard work. I still remember vividly watching on TV the fall of the Berlin Wall in 1989, marking a change in global political and economic realpolitik from which we are still feeling the consequences.

What is a securities regulator doing here talking about global economics, politics and history? I must declare here that the views expressed here are totally my personal views. Kurt has asked me to talk about Asia as a locomotive for world growth. I understand there is grave concern in Germany and in Europe about slowing growth. There is concern about deflation, terrorism and now global epidemics like SARS. Asia seems to be the only spot of global growth, but will Asia be a competitor to Europe and cause of

1 The views expressed in this paper are entirely personal and do not reflect those of the SFC, Hong Kong. The author is grateful to Professor Geng Xiao for his help and comments in preparing this paper and also to Ms GL Tan and Ms Wang Yuan for their valuable comments and suggestions. I bear full responsibility for any errors and omissions.
deflation? This is the large canvas that I have to paint for you. Because of time constraints, I must be brief on the major points I wish to make.

If you wish to understand China, there is a famous book, which every Chinese, including Chairman Mao, reads called “The Romance of the Three Kingdoms”. The book begins with the famous quotation, “Nations join and cleave asunder”. Europe and China are in the joining phase. Europe is in the phase of enlargement, with new members from Central and Eastern Europe, whilst the return of Hong Kong in 1997 and Macau in 1999 has been seen as the re-unification of China after 150 years of decline and foreign incursion.

The Romance of the Three Kingdoms brings back echoes of a 21st century version of the Tri-polar world dominated by America, Europe and Asia. Many people see China and Asia as the new rising giants. But allow me to use some cold facts to bring everyone to reality.

First of all, Asia accounts for 55% of world population, one quarter of exports and just over one fifth of world GDP, compared with US, which accounts for less than 5% of world population, 14% of exports and one third of world GDP. Europe is more comparable to the US – 6% of world population, accounting for 36% of world exports and 20% of world GDP. But in capital market terms, the US alone accounts for 55% of MSCI market capitalization, EU 17% and the whole of Asia 13%. So, Asia is a population giant, growing in trade weight, but small fry in financial market terms [Chart 1].

<table>
<thead>
<tr>
<th>(% of World, 2001)</th>
<th>GDP</th>
<th>Exports</th>
<th>Population</th>
<th>MSCI Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASIA</td>
<td>22.8</td>
<td>26.1</td>
<td>55.4</td>
<td>13.15</td>
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<tr>
<td>China</td>
<td>3.7</td>
<td>3.7</td>
<td>21.1</td>
<td>0.26</td>
</tr>
<tr>
<td>Japan</td>
<td>13.3</td>
<td>7.0</td>
<td>2.1</td>
<td>9.38</td>
</tr>
<tr>
<td>India</td>
<td>1.5</td>
<td>0.8</td>
<td>16.6</td>
<td>0.12</td>
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<tr>
<td>US</td>
<td>32.3</td>
<td>14.2</td>
<td>4.6</td>
<td>55.30</td>
</tr>
<tr>
<td>EU</td>
<td>19.6</td>
<td>36.0</td>
<td>6.2</td>
<td>17.14</td>
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<tr>
<td>Others</td>
<td>25.3</td>
<td>23.7</td>
<td>33.8</td>
<td>14.41</td>
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<tr>
<td>World</td>
<td>100.0</td>
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Second, unlike Europe, which is already a political unity, Asia is very diverse, politically, culturally and geographically. Asia comprises at least five different parts, varying from the very poor to the very rich. Japan is the economic and financial giant, the first Asian country to enjoy miracle growth,
accounting for 55% of total East Asian GDP and 60% of total Asian financial assets\(^2\). Japan is head and shoulders the economic leader in Asia.

Then there are the East Asian tigers and dragons, excluding China, which followed Japan in growth in the 1980s, ranging from the dynamic industrial powerhouses of Korea and Taiwan, the natural resource centres of ASEAN to the modern city economies of Hong Kong and Singapore.

The latest growth pole is Mainland China, growing at more than 8% per annum for the last 20 years. But China is only one quarter the size of the GDP of Japan, even though it has slightly over 10 times more people. Even though exports of China are growing fast, rising 30.1% in 2002, her exports are roughly equal to those of Italy and half that of Germany. Because China is one-fifth of mankind, it is already the sixth largest GDP in the world, behind France and only slightly ahead of Italy, but per capita GDP at current prices is less than US$1,200, less than 4% of that of Germany.

The fourth component of Asia is the other growth pole, the Indian subcontinent, also over a billion in population, growing steadily at more than 5% per annum for the last twenty years. India will become a major powerhouse of growth within the next decade.

And finally, the oil producing states of the Middle East and Central Asia are also part of Asia, important geo-politically, but economic growth has been problematic in recent years.

Unlike Europe, where France and Germany decided post-war to build a united Europe for peace, history and culture has divided Asia, and it is unlikely in the near future to contemplate Asia as a united political force. But Asia is a powerful image – it is portrayed, particularly China, as the next economic giant and competitor to Europe and America.

No Asian can forget that Japan [four times larger in terms of GDP than China] tried in the miracle boom years of the 1980s to take on a global leadership role and suffered 12 years of economic stagnation in the aftermath.

The law of large numbers suggests that anything you describe about China in global terms must either be right and wrong at the same time, because you are describing one fifth of mankind. To me, the miracle of the 21st century is not about technology, but about how nearly two-fifths of mankind, India and

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\(^2\) Asian 13 economies, comprising Japan, China, Hong Kong SAR, Taiwan, Korea, India, Australia, New Zealand, Indonesia, Thailand, Malaysia, Singapore, Philippines and New Zealand, end 2001 in USD.

\(^3\) Defined as total of bank assets, debt securities outstanding and stock market capitalization at end 2001 in USD.
China, are slowly but surely pulling themselves out of poverty and joining their rightful place in world affairs.

Yes, the markets of India and China are very large, which explains why FDI is rushing into these economies at the rate of more than US$55 bn per year, most of it into China. The major cities of China are already gleaming with glass and steel skyscrapers, but one tends to forget that over 870 million people live in the rural areas, where the net per capita real income per year is not more than Euro 250.

Europe and China

At the risk of over-simplifying the issues, because of time constraints, I shall give a personal perspective of the challenges of Chinese growth and comparatives with Europe. There are many issues relating to Chinese reforms that share common roots with the rest of Asia, and as I shall explain, with Europe.

If one looks back in history, China at one point was the strongest economy in the world, but sometime in the 17th and 18th century, economic leadership passed to Western Europe. One common reason given by historians was the inward looking and self-centred approach of the Chinese bureaucracy, whilst Europe thrived through national competition, mercantilist devotion to trade, outward expansion and investment in science and technology.

Asia’s miracle growth was led by Japan, which mimicked European mercantilism, with openness towards trade, investment and technology. But its imbalanced dualistic approach to globalization – with a fully open trade sector in manufacturing and half-protected service and agriculture sector – sowed the seeds of its problems in the post-bubble period.

In reality, the Asian miracle was a growth endowment from a young and growing labour force, pushed by elites committed to political stability in an

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4 For recent historical analysis, see Albert Feuerwerker, “Chinese Economic History in Comparative Perspective”, in Paul S Ropp (ed) “Heritage of China”, University of California Press, 1990, and Angus Maddison, “Chinese Economic Performance in the Long Run”, OECD Development Centre, 1998. Professor Ray Huang, who has argued that China could not evolve into a modern economy because of the lack of appropriate monetary and fiscal instruments, had this to say relating to 1800 China “Unlike what happened in western Europe and Japan, where the adaptation of commercial practices could be started at the middle level, with the merchants playing an active role, in China it was to apply to thousands of bureaucrats and millions of peasants amidst a cultural tradition that paid little attention to the civil law, and where property rights had always been rendered ambiguous by the custom that gentlemen never spoke of profit.” “China: A Macro-History”, ME Sharpe, 1988. My personal view is that 18th century China could not evolve monetary and fiscal tools, because private sector property rights were never defined by civil law and therefore limited companies and capital markets could not evolve for such tools to work.
era of liberalizing world trade and openness to FDI. However, the Asian crisis demonstrated that Asia is now struggling with the structural problems of adjusting to globalization. Transparency and the move to global standards began to reveal the inefficiencies of the protected sectors through non-performing loans (NPLs) of the banking system.

China, and the rest of Asia, [which in turn mimicked Japan in the famous flying geese model] are now confronted with this challenge. Those who were not quite ready – and this included two recent members of OECD such as South Korea and Turkey – paid the price in terms of recent financial crises.

In other words, the Asian imbalanced model of growth – efficient external sector and inefficient services/protected sectors – is not sustainable under globalization. Sustainable growth requires complementary and balanced growth in all sectors, benchmarked to international standards.

My personal study of the Asian financial crisis and the Japan problems led me to conclude that there were four fundamental reasons why Europe overtook Asia during the Industrial Revolution. These are demographics, governance, institutions and environment. Note that contemporary Anglo-Saxon economic analysis treats all these four factors as given assumptions.

These issues remain to this day and are the key challenges facing Asia, and Europe to some extent, in sustaining growth. Let me explain.

*Demographics in Economic Growth*

After the second world war, East Asian economies emerged with many advantages: low wage and surplus labour, stable political environment with an educated elite, high savings rate and prudent fiscal management, demographic endowment of a young labour force (Chart 2), and declining trade barriers that opened up export opportunities.

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Just like Japan, which grew rapidly in the 1960s and 1970s, China is rapidly growing because of its large young labour force. China has the same demographic profile as Japan in 1975, when Japan was growing at double-digit levels. China’s working age population at 70% is amongst the highest in the world. But Japan is today the fastest aging population, followed by Western Europe. The fact that there are less and less younger people having to care for more and more aging population must mean slower growth, unless compensated by higher productivity per capita through improved technology and better management/governance. But there are also land and capital constraints.

It is the demographics of China that make it such a fascinating growth story. Consider the following:-
• 37% of the population is under the age of 36 years, of which 112 million are urban. Consumerism is only just beginning;
• The strength of the Chinese labour force is due to its huge flexibility and mobility. Between 1982-2000, over 109 million labourers moved from the rural to the urban areas;
• China is rapidly urbanising, with housing construction accounting for nearly one quarter of GDP growth;
• Automobiles are now the second most important part of household consumption, with car demand increasing by 60% in 2002. In 1997, there were only 2 cars per 1,000 population, compared with 15 for Indonesia and 90 per 1,000 world average;
• Physical infrastructure is improving rapidly – China already has the second longest mileage of interstate highways in the world, next to the US.

The combination of cheap and skilled labour force, good infrastructure, large potential home market and strong inflow of FDI means that China is today becoming an important manufacturer of light industrial and consumer goods. But 55% of China’s trade is in processed goods so that for every $100 worth of exports, there is somewhere between US$55-70 of imports, particularly from the neighbouring countries.

China is not running a huge balance of payments surplus with the world. Its current account surplus in 2002 was only 2.9% of GDP. In fact, service payments in outward Chinese tourism already exceed service receipts in tourism. In 2003, imports are rising at 45% per annum, considerably faster than exports growth of 35%.

Although China is currently benefiting from the endowment of a young and growing labour force, it has a large aging population, which will put pressure on the health, social security and pension burden, a factor already evident in both Japan and Europe. The high savings rate common in Asia from a relatively young population still flows largely to the bank-dominated financial system and nascent [but growing] capital markets. Globalization and benchmarking to international standards reveals inefficiencies in transitional financial systems in the form of high non-performing loans and price earning ratios. Asian financial systems therefore face a huge challenge in protecting the long-term real value of household savings.

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7 Hugh Peyman, “Leveraging the Chinese Consumer”, Research-Works, Shanghai, May 2003
They have a window of opportunity to clean up the inefficiencies, by using the high savings/high growth period arising from the demographic endowment effect. Otherwise, when the population ages, retirement savings accumulated in large public debt [e.g. Japan] only postpones the burden to either future generations or imposes taxation on a declining pool of productive labour force. How this is managed depends on the quality of corporate and public governance.

**Public and Private Governance**

Economic growth cannot happen without political stability and hence, governance at the public and private levels lie at the heart of economic growth.

Historically, China has been held together by a strong moralistic central bureaucracy, which has been instinctively, like most other bureaucracies, suspicious of the private sector. Whilst China has always had a tradition of strong family-based enterprises, China never evolved enterprises limited by shares, a European innovation that allowed private sector enterprise to develop as engines of domestic growth and development. This may have been partly due to the Confucian social hierarchy of putting merchants as the lowest of four social classes, behind scholars/officials, farmers and craftsmen.

Indeed, it can be argued that in catching up with the West, emerging Asia including China, had to deal with twin challenges of reforms in governance: -

- First, common to all public bureaucracies in developing and developed countries, how to evolve an efficient public sector that delivers public goods with minimal corruption and without excessive tax burden. In other words, a public sector that is both efficient and prudent fiscally without being either a burden on society through inefficiency or an obstacle to growth because of corruption and rent-seeking activities?

- Second, how to nurture a vibrant corporate governance culture, so that private enterprise can grow without rent-seeking activities that are harmful to investors? China must develop its own enterprise sector, firstly by commercialising state-owned enterprises to relieve them of their social burden for employment and social security, and secondly by developing a corporate culture in the emerging private sector that would avoid the excesses of “robber barons” that marked many economies in transition. Indeed, the dilemma is how to balance public and corporate governance at a level that mobilizes private sector energy as a domestic engine of growth, and a public sector that delivers effective social infrastructure (e.g. education, health and security) and regulatory services at reasonable cost. Corporate governance is one of the hottest issues in China today, since it lies at the heart of the emergence of the new entrepreneurial
class that could be an important agent of growth and change in the Chinese economy.

Both public and private governance issues have the potential to inflict considerable social losses on the economy. In the state-owned banking system, official statistics of non-performing loans are as high as 18% of GDP, whilst private sector estimates are considerably higher. As Enron and other corporate failures have shown, the losses inflicted through accounting and other corporate fraud can be large by any standard.

It should be remembered that, for the first time in Chinese history, China has constitutionally guaranteed private property rights in 2000, a landmark event that marked the changing balance of power between the state and the private sector, and signals China’s recognition of the need for private sector-led domestic growth, a factor almost taken for granted in Western Europe.

**Developing the Market Institutional Infrastructure**

The third factor holding back China’s road to a market economy is the development of the accounting, legal, judicial, regulatory and institutional infrastructure to generally accepted international standards that are necessary for an efficient market economy.

As the Russian experiment with the transition to a market economy showed, without such an infrastructure, there are considerable market abuses that can occur. China is rapidly building such an infrastructure. But it is also clear that such infrastructure, such as the accounting profession, the legal profession, the judiciary and regulatory bodies, and even capital market institutions, cannot be built overnight.

Germany has the best experience with this transition, having provided huge fiscal resources to rebuild the social infrastructure of East Germany.

Indeed, the Japanese experience shows that the transition from a bank-dominated financial system to a fully balanced capital market requires an understanding that the financial system is a system to protect property rights of investors over the whole demographic cycle. For example, this requires companies and government to fully recognize in their accounting the pension burden of its employees.

What this really means is that an emerging market with a young population, under an able leadership, would be able to generate considerable savings because of the economic growth and the demographic endowment effect. However, every emerging market with an element of planning or state-ownership has by definition a large element of inefficiencies that become more and more marked to market as it opens up to globalization. These inefficiencies show up as non-performing loans or as fiscal subsidies or below-the-line deficits.
You will recall that some Eastern European transitional economies wrote off these liabilities through hyperinflation. Others are now cleaning up the bad debts through fiscal write-offs. If, however, these below-the-line fiscal burdens are not cleaned up during the high growth period, and may be worsened because of an asset bubble, then every economy will soon face the aging dilemma. During the slow growth period, with an aging population, there is a real danger that these losses can only be written off against future generations, either through hyper-inflation (which wipes out the real value of savings) through excessive public debt, including external debt, that drags down the economy even more or through devaluation (which passes the burden to its trading partners).

This is no different from the accounting dilemma of companies that have not contributed sufficiently to their employee’s pension funds. Inadequate provisioning during the high profit period may result in huge losses when provisioning has to be made during a profit downturn.

Consequently, every economy with an aging demographic problem must confront the problem of how to build its capital markets and retirement funds in a financially and fiscally prudent manner that protects the real value of pensions when its labour force begins to retire.

This is precisely the problem within Asia and perhaps Europe. Those economies that have not cleaned up their NPLs in their banking systems during the demographic endowment period and have not built up their capital markets to protect their real savings in the long run, will find growth slowing as the demographic burden begins to grow. Resistance to change over labour flexibility, immigration and rising health care burdens add to social costs.

**The Changing Environment**

Global warming, rising pollution, overcrowding and the recent SARS epidemic all indicate that we cannot pay attention to growth without considering the environmental costs. Asia has large population but limited arable land. The SARS epidemic has forced all Asian governments to think through what is a sustainable level of growth.

Again, we take our natural environment for granted, and certainly in our conventional analysis of GDP growth, we do not normally take into consideration the rapid depletion of natural resources and the costs of rising

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9 The high savings rate is illusory, if most of the savings are invested in domestic assets that earn zero or low returns, such as deposits in banking systems with high NPLs, public debt that has low bond yields, equity with high price-earnings ratio and real property in a bubble environment. Capital is a derivative of land and labour, but capital invested solely in a domestic economy with low growth imposes high market and concentration risks. Capital is real when it is a realizable claim on an independent entity.
pollution. The human race cannot grow infinitely given the limited natural resources we are endowed with. Nor can we pollute the air, rivers and seas and cut our forests without long-term health costs. As the most densely populated part of the world, Asia must pay even more attention to the environment. China occupies roughly the same geographic area as Europe, but with three times the population.

China has begun to pay considerable attention to tackling the environment. The SARS epidemic has also been a defining moment in pushing the Chinese government towards higher standards of transparency and attention to public health concerns. It is forcing all Asian governments to think through what is a sustainable level of growth.

But SARS and terrorism share one common factor – local risks can be global in nature. It reminds us that no economy is now an island – that we are all neighbours and have a stake in each other’s welfare. The poverty in one region can lead to disease or crime in another. Globalization means that borders are no longer barriers to mutual transmission of benefits or losses.

One of the catchphrases of the Asian crisis is that global gain equals local pain. But virus and terrorist attacks mean that local pain can mean global pain. Hence, one of the key objectives of globalization is that global gain must mean local gain. It has to be a win-win situation.

To sum up, my personal view about the fears of globalization, amongst which is a transmission of deflation, is that globalization has transmitted information faster than the ordinary person’s capacity to absorb such information. If more than half of mankind is lifting themselves out of poverty, it must be a good thing for the whole world. But at the same time, global competition is rising rapidly at the same time as overall productivity, as knowledge and technology spread to the emerging markets. Hence, the mature markets must work with the emerging markets to ensure that producers can also become consumers, so that mutual trade and investment is in the long-term interest of all concerned.

Any discussion of demographics, governance, institutions and environment must mean that we have to take a long-term view of development and co-operation. At the national economy level, global benchmarking of competitiveness must mean that painful restructuring must be done, nationally, sectorally and at the corporate and individual level.

In reviewing the lessons of the Asian crisis, I came to realize that those who reform fastest to the changing environment survive and thrive. It takes great leadership and vision to persuade the competing vested interests that it is in the national and self-interest to change. In this respect, Asia faces identical issues with Europe. Reform is painful, but delay is worse, because it only prolongs the pain. China is able to grow fast because its leadership understands
that this generation must bear the pains of reform in order that future generations will benefit.

Hence, despite all the exhortations of the IMF and domestic commentators, reforms all over the world – irrespective of Asia or Europe – move in zigzag fashion, sometimes moving forward, sometimes delayed or sometimes even reversed.

I realized that SARS is truly a global challenge, because it does not stand for Severe Acute Respiratory Syndrome at all – it means Severe Anti-Reform Syndrome.

The dilemma of all reforms is really who pays – either vested interests or the public interest. Even in the public interest area, whether the present generation or future generation pays. I am sure this is the political economy question which this Conference is hotly debating. Globalization means change or be changed.

Closing Remarks

I cannot end this without saying something about Hong Kong. In spite of the negative news because of the SARS outbreak, we are pleased to see that the WHO and CDC have lifted their travel advisory. Hong Kong was the first to detect the Corona virus. The SARS episode demonstrated once again that Hong Kong has world class health facilities. And Hong Kong bears global responsibilities, even though it is only a city of seven million people. In the avian flu outbreak of 1997, Hong Kong slaughtered 3 million chickens to prevent its spread globally. Of course we have been hurt by SARS, but like always, Hong Kong will bounce back. I welcome you to come and visit Hong Kong and see for yourself how the true heart of Asia is alive and kicking.

As an international financial centre and important services hub, with world class legal, accounting and services expertise, Hong Kong has played and will play an important role in the integration of Asian financial markets, particularly the Chinese market, to global capital and financial markets. Hong Kong is able to offer a world-class market and services infrastructure to assist the integration of China into the global economy. Europe has played an important part in this process, being one of the most important investments and trading partners in Asia. Hong Kong can be your important partner in that venture.

Thank you for your attention.

12 June 2003
Hong Kong.
South East Asia has played a major role in the world-economy. It has supplied key raw materials, provided markets for developed world goods, received investment and, most recently, multinational manufacturing. To a degree these roles have been sequential, reflecting the evolution of imperialism, the progressive incorporation of the region into the world-economy and the accompanying development of capitalist relations of production. Western recognition of South East Asia (map 1.1) as a distinct entity is comparatively recent. Until the 1940s a variety of terms were applied to these islands and The world economy continues to perform well, with strong growth and trade, rising but still muted inflation, and accommodative financial conditions, notwithstanding some increased financial market volatility in early 2018. Driven partly by the procyclical tax stimulus in the United States, near-term economic prospects for both the world and Asia have improved from the alreadyfavorable outlook presented in the October 2017 Regional Economic Outlook Update: Asia and Pacific. The economic outlook for Asia and the Pacific remains strong, and the region continues to be the most dynamic of the global economy. Near-term prospects have improved since the Regional Economic Outlook Update: Asia and Pacific in October 2017, and risks around the forecast are broadly balanced for now. China is the main locomotive of the world economy. Alexander Sivtsov. In this article, we will talk about the country of the Rising Sun, namely China, whose economy should be considered the main engine of world economic development. Anyone who does not even have an economic education and does not practice trading knows that Chinese goods are sold all over the world. The employment of the population in China is the main trump card of the economy of this country, since it was thanks to a huge resource of labor that the Chinese economy managed to reach current heights. According to recent data, the unemployment rate in China was 3.9% and continues to decline. Reduction of unemployment is due to migration of people from rural areas to cities.