CIGS Professor Jay K. Rosengard Seminar

The Great East Asia – Southeast Asia Divergence: Rich Asian Tigers vs. Asian Kittens Stuck in a Middle Income Trap

(Summary)

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When people talk about ASEAN, in aggregate there are substantial differences among the ten countries. Among those countries is the 4th largest country in the world, as well as Brunei, which only has about 400,000 people. In terms of GDP, Indonesia used to have a $1 trillion economy, and while that's changed recently due to global markets, as a part of G20 it is one of the largest economies in the world. Meanwhile, a country like Cambodia has a much smaller GDP per capita. Compared with the United States, Singapore is actually richer. Then you have very poor countries, Myanmar or Cambodia for example. In growth rates there is also a wide variety.

If you look at ASEAN performance in general, again in aggregate, it looks pretty good. It only becomes troublesome when you start to disaggregate. If you look at the size of GDP, ASEAN is number 7 in the world, about $2.4 trillion. If you look at real GDP growth from 2000-2013, it was number 3, collectively over 5%. If you look at volatility, it seems to be relatively stable, relatively less volatile than all of these above. If you look at share of debt to GDP in aggregate, very prudent. Inflation is very stable, collectively less than 3% in 2013, so it looks pretty good compared with the rest of the world. In terms of how many years it will take to double per capita GDP, the poorer the country, the less time it takes. There is great potential for growth in many of the ASEAN countries, and while so far they've done very well, it looks like they could be doing even better. There is a lot of untapped potential, and that's a challenge for ASEAN.

Cambodia is the only low income country in all Southeast Asia, according to the World Bank classification. Listed from poor to rich, the ASEAN countries are Myanmar, Lao PDR, Vietnam, Philippines, Indonesia, Thailand, Malaysia, Brunei, Darussalam, and Singapore. We will focus on the five countries which are the top of the lower middle income, that are trying very hard to become upper middle income.

If you look at all the countries in the world, roughly half, 55% are middle income. So what is a middle income trap? In theory, it means that when you get to a certain income level, you cannot break out of it and become a high income country. However, it is a difficult concept to define. When you talk about income, and closing the gap, are you talking about income convergence or absolute income level? How do you determine income threshold? What decides if a country's middle income, what decides high income? How often do you adjust these or index them? What is the right way to measure income? Is it GDP, is it GNP, GNI, or it is something else, is it growth per capita? These are some general conceptual questions that must be answered.

There are also other kinds of measurements. Bhutan has a Gross National Happiness Index, which lends itself to the idea that income isn't the best metric when you look at all sorts of other considerations in the country. How about the human development index, which looks at a lot of processes for development, health, education, and so on? Is there a correlation between the first set of indicators around income and non-income? In fact, there is, and in general, as economies develop, the non-income indicators also get better.

In terms of absolute convergence, the five countries are not on the trajectory to close the gap, either relatively or absolutely, with the current growth rates under the current economic policy. How does it compare with the four tigers? If you look at for example, Hong Kong, in terms of time required to cross the lower and the upper thresholds of upper middle income countries, it only took 6 years. Singapore took 10 years, South Korea 11 years, Taiwan 11. So on average about a decade more or less to go from lower middle income up to high income. The growth rates were robust enough for a long enough period that they were able to actually cross both the absolute threshold and relative threshold to become high income countries. What's interesting is looking at the years at which the tigers reached this point. South Korea in 2007, Taiwan in 2004, Singapore in 1990, and Hong Kong in 1962. Why does this look so different from the five Southeast Asian countries?

Three decades in a row, the average annual growth rate was around 8% or higher. South Korea was the same around 9% or 10%, Taiwan 9% or 10%. The richer countries are of course going to go slower because it's on a much higher base. But if you look at Malaysia, you're looking at between 3% and 6% on average, which is not going to make you higher middle income or high income. If you look at GDP aggregate, Malaysia is trying very, very hard to cross that threshold, to become high income and it's stuck. Then you've got Vietnam, Philippines, and Indonesia, all lower middle income countries, and they would like very much to first become upper middle income countries. This is a dilemma that we're looking at.

Shifting gears, when we look at the non-income development indicators for upper middle income countries, for example life expectancy, the upper middle income countries are ahead of what the US was in 1960, and closing in on where the US was a few years ago. The infant mortality rate is lower than the US was in 1960. School enrollment secondary is about the same. Physicians, better than the US was then, per 1000 people. Literacy rate is comparable. If you look at the non-income development indicators, it looks better, it's more encouraging than the income indicators. Which further begs the question that if the country is doing OK in terms of these indicators, what's happening with the income.

Are ASEAN middle income countries caught in the middle income trap? If you only look at the non-economic indicators, I would say there is no compelling evidence that the ASEAN middle income countries that are in pre-determined lower development path are caught in a middle income trap. There is nothing that says, it can't or shouldn't be growing at a faster rate. And if you look at the patterns of the four tigers, there's no reason why the ASEAN countries don't have the potential to do the same.

But whatever metric you use, their economic performance is disappointing. By the same note, while it's not fulfilling expectations, just because it's disappointing doesn't mean they are in a trap. That's the most important takeaway from this. Economic growth is slower than potential, the global economy has been more volatile and vulnerable than in the past, and the current model growth isn't sustainable in the future. I believe that mostly, the problem is basically poor policy design and poor policy implementation/bad execution.

Many experts both within and outside of ASEAN point to leadership issues. This has very disturbing political social consequences, and the key concerns are investment in hard infrastructure (roads, ports, power, communications), weak government and governance (soft infrastructure), and a neglect of human resource development. It's a human problem.

First, in terms of hard infrastructure, most ASEAN countries have infrastructure stock that's below the global average. In this case, Malaysia, Thailand, Vietnam, Philippines, and Indonesia can be raised as examples. In terms of infrastructure backlog, it's about a $7 trillion backlog in hard infrastructure, including housing. In terms of soft infrastructure, why has government and governance been so weak? The answer to the question is very qualitative, and there are many ways of measuring the quality of the government and governance. Logistics Performance Index means the price of shipping, transporting, handling goods, and it's expensive, it's a bigger part of the final price of your product, it means you are less competitive in the global markets. Another related indicator is ease of doing businesses, as the challenges in terms of ease of doing business means licensing, regulation, legal certainty, enforceability of contracts. It's another way of saying what some countries call a high cost economy, corruption, indirect measurement of corruption. In terms of human capital, workers from these countries are cheaper. However, the bad news is they are also less productive. When you take cost and productivity together, average daily output per wage, the cost savings are eroded by lower productivity.

If you look at Indonesia for example, it has to increase productivity about 25% just to maintain their historical growth rate. However, the country is not getting into a higher level of growth. It's an indicator that if the labor productivity doesn't improve, and your wages keep going up, you price yourself out of the market. If you're not making use of technology, not being very innovative, you will not go up the value added chain, which could justify higher wages.

What is behind labor productivity? I would say education and training. The problem for secondary schools isn't so much enrollment or access right now; it's the quality of education. The emphasis was on universal coverage and access, not quality. If you don't invest in higher education, you're not taking advantage of your human resources.

Let's focus on Indonesia, which is the largest part in ASEAN in terms of population and economy. Indonesia says they want to become an upper middle income country by 2025, so it's roughly a decade from now. That means over the next decade, they must generate an annual real GDP growth rate of 8.5% per capita. This number is roughly 7% real GDP growth rate. The population is growing at around 1.5%, so it will have to be real GDP per capita of 8.5% every year for the next 10 years. At the present maximum rate of 4.5% per capita, which means 6% roughly, it's come down since commodity prices have gone down. Not only will Indonesia fall well short of its objective, but it will continue to experience jobless growth, declining competitiveness, and rising inequality.

Other clear indicators of these negative trends are the long term decline in the Total Factor Productivity, and more recent fall in manufacturing value added per employee, and steadily rising measures of inequality such as the Gini coefficient. All of these trends can be documented quantitatively. In terms of quality of education, the share of growth rates with middle school graduation or less fell from 78% to 65%, it actually went down. The PISA scores, this is an international test that looks at math, science, and reading, are very low, 75%-80% of the average. These are just some indirect indicators of something terribly wrong with the labor market in Indonesia and labor quality both.

Share of manufacturing in exports and GDP is a very good indicator of where you are on your development path. Again, the negative trend is manufacturing exports in share of exports, manufacturing as the share of GDP. These numbers should be going the other way. Manufacturing is important because it creates jobs, labor intensive industries create jobs. If you don't create jobs you have a lot of unemployed young men who become angry and radicalized. It's a huge sociopolitical problem as well as an economic problem.

Another indicator is inequality. The Indonesian government says how many people are above the poverty line and how many people are below, the idea being that over time, you want more and more people to cross the poverty line. However, the problem with that is that many, many Indonesians are right at the line, and they go up and down. Their income is quite volatile, and a small change in income, depending on where you draw the line, can dramatically change the poverty indicators. But in terms of overall distribution of income, it is highly skewed. If you look at income in Java versus off Java, it's becoming more unequal. Urban versus rural, it's becoming more unequal, even by gender, it's becoming more unequal. Again, in terms of sociopolitical stability, these are all very concerning trends. The problem is that Indonesia exploits neither the domestic benefits of being a large country nor its international dynamic comparative advantage. In other words, domestically, it has global economic fragmentation, and globally it's being marginalized.

A sum is greater than the parts. However, right now, the sum is worth less than the parts. Indonesia doesn't have a single national integrated economy. It's really disconnected from the regional market. One of the reasons that big countries can survive external shocks is that they have large domestic markets. Indonesia is not taking advantage of being the fourth most populous country in the world. What do we mean by economic marginalization in local markets? It's really not integrated into global value chains. It's basically dependent on commodities, it's very volatile and now there are very low prices, and all the industries are dying industries rather than new industries. In the new model, you don’t make something totally in one country, you make parts of it, both in and out, and up the value chain.

The key to addressing both domestic and international market problems is the same, namely investing in better hard infrastructure, soft infrastructure, and wet infrastructure. The same deficits we saw for ASEAN as a whole, apply to Indonesia. The economics, the finance is pretty straightforward, but the real challenge is the political economy, that is, trying to deal, in Indonesia for example, with relations between the executive and the legislative. For example, they’ve had massive decentralization program since 2000, which means a lot of the authority, a lot of resources are at the local level, not the provincial level, not the national level, but at the district or city level. In such a scenario, how can you manage your horizontal political relations between branches of government and your vertical relations between levels of government? It’s a difficult situation to be in.

The points and recommendations raised in my presentation must be addressed by Indonesia, Philippines, Malaysia, Vietnam, and Thailand, if they ever hope to grow and prosper like some of their regional neighbors.

[Question & Answer]

[Questioner 1]
In the 1970s there was a big discussion about economic development; export promotion versus import substitution. Import substitution policy was employed by Latin American countries such as Brazil, Mexico, and Argentina. I remember Argentina was one of the most affluent countries before World War II and even post World War I. And so, the performance in 1990s, through that the export oriented strategy was much better than I think import substitution. You mentioned the four tigers, Korea, Taiwan, Singapore, and Hong Kong; those are the countries which actually followed the Japanese model. The corruption and import substitution were tied together. That's my understanding. Those four ASEAN countries you mentioned, perhaps fall somewhere between the very corrupt Latin American countries I mentioned above and four tigers. What are your thoughts on this?

[Answer 1]
In the Latin American countries there was import substitution, which was always supposed to be temporary and you were protecting maiden industries. But once you start you can't stop because of the vested interests and the corruption. The results, you've seen in Argentina, for example, are very sad. In Thailand, you can see the numbers are very good on export promotion, but they had a lot of political instability. On that note, I think TPP will help the countries to make some difficult domestic decisions, because they can blame it on TPP.

[Questioner 2]
Can you speak about the rise of Singapore in terms of its politics and economy?

[Answer 2]
When thinking about Singapore, first, it's important to go back to 1965 when Singapore decided to become independent. It's easier to govern an island state than a much larger, more dispersed country like Malaysia. In terms of providing the politics in Singapore with economic development, the starting point is the breakaway operation, and the insistence of the early leaders like Lee Kuan Yew to invest in three things like availability of infrastructure, an incredibly qualified civil service, and a strong health and education system. Singapore also doesn't have natural resources, and that forces them to rely on human capital and governance.

In terms of Taiwan and South Korea, the government was quite activist, but they were able to control the conglomerates, so that they did not become monopolistic. Compared to that, for example, in Indonesia the conglomerates have often promoted poor allocation for capital and there is rampant corruption. In South Korea, the conglomerates got preferential treatment, but they also produced the results and they were held accountable.

[Questioner 3]
Regarding Indonesian decentralization, I believe that we need to find a way to work within the current infrastructure in order to reap the economic benefits. What would be the most important point you would argue in order to help spur the Indonesian economy today?

[Answer 3]
Decentralization is a critical part of democratization. As part of democratization, modern Indonesia has vowed not to have so much power concentrated in the central government. There are two problems. One is that now roughly one third of the central budget goes to local government in one way or another, and around 26% through a formula, redistributive plans, and the tax sharing arrangements. Between revenue sharing and tax sharing, a huge chunk of the budget is going to local government, and they are having problem spending the money, partly because of capacity, and partly for fear that they will be accused of corruption. They have a very strong anti-corruption commission, and they are afraid of making mistake. If you take the aggregate budgets of lower governments in Indonesia and combine it with a small central government deficit, Indonesia is actually in surplus with left over money at the local level. Their national deficit is less than 2% GDP, but there's a composite surplus. There are all these resources for local government, and the quality of the local infrastructure and services is not improving, but is actually becoming worse.

There are local government leaders that are very innovative, and doing wonderful things. One of the advantages of decentralization is that you have over 500 experiments going on, and the idea is to encourage and recognize the innovations in good local governments. Part of it is this kind of nurturing of the good, but those are very practical problems as well. In the distribution of resources for local government, it's based essentially on need, the physical gap. The poorer you are, the more money you are supposed to get. This has ended up making local governments much more dependent on central government than before decentralization.

There is growing intolerance in Indonesia now of religion, gender, and other areas. The central government has not stepped in to say this is inappropriate, and the problem is it drives away investment, it drives away resources, the political instability.

Domestic and foreign investment has not recovered in Indonesia, not because of lack of opportunities, but fears at the local level of political and social stability, and failure of the legal system. It’s very difficult for outside investors to price uncertainty, especially legal uncertainty. If there’s a dispute, how is it resolved, do you have a reliable judicial system in Indonesia? No, in many of these countries, you do not. There are very specific things to be done, and it takes a long time to build confidence. The good news is that they are great, wonderful investment opportunities, as long as investors are comfortable about some of these other governance issues.

[Questioner 4]
How about geographical constraints related to Indonesia’s lack of fulfillment in terms of its potential? Singapore and Hong Kong are two centers of economy that are very well situated to take advantage of their unique geographic location. Many cities and areas in Japan have this problem. What is your thought on this?

[Answer 4]
Indonesians often use that as an excuse, I think. While the main economy and population centers are focused on the island of Java, Indonesia is urbanizing in a very rapid way, and they have about six large urban metropolitan areas, about half of which are now in Java. But these incredibly dense populations in Java and Bali are connected by ferry, and actually Java to Sumatra is not so far. They are constrained in moving goods into the outer islands, and that’s an issue with inter-island shipping and ports. Basically the thinking is that it’s more of an excuse than actual justification.

[Questioner 5]
I have one final question. Does South Korea appeal to foreign investors more compared to other countries like Taiwan or Hong Kong?

[Answer 5]

It doesn't matter whether it's Japan or Korea, or Taiwan, or Indonesia. South Korea is very attractive in certain sectors, and it's less attractive in other sectors because its labor is expensive, so you are going to go to very high value. Korea then invests in Southeast Asia to lower costs of center. This is where you get the global supply chains, where you look at your iPhone, and you look at the components, and where is it made, in dozens of countries perhaps. There are no double standards for investors. I think, they ask the same questions everywhere. You saw those Asian metrics in the presentation. From the investor's lens, it's the same checklist. There was a dictator in South Korea, but everyone is saying for three decades it worked very well, but eventually the politics and corruption caught up and it became unsustainable. Back to Korea versus Taiwan, it depends on the sector, the nature of investment, and where the most appropriate venue is. The parameters for evaluating the answers will be different, and the answers will be different country by country.

[Questioner 6]
Can you speak about the influence of religion in Indonesia? In Singapore, Hong Kong, Japan, and South Korea, it's Confucianism. Malaysia is a country of Islam. In the case of Thailand, Buddhism is very strong, so it is very closely related with society, and individuals are not free. Then there are big countries that have been exposed to the culture and values of the United States. Some critics of Confucianism say that it is not good for innovation because in research centers, the older peoples are always inspecting and the young people are not free, so usually, young people are more innovative. What do you think of this conflict between religion/tradition and new economics and morals?

[Answer 6]
We have to be very careful to distinguish between correlations and causation. But I think it's a very good research question that somebody might want to look at systematically and rigorously. One aspect of Confucianism that has really helped in the tigers is the emphasis on education, which is investing in your human resources, and your people. If you look at international quality of universities, with the exception of Singapore, there are no leading universities. Regarding the influence of Islam and other religions, I think it's a legitimate question to look at, but I think it's probably much more nuanced than simply Confucianism or Buddhism or Christianity or Islam. There are elements of different religions, their commonalities, their differences, and how they interact with politics and economics differently. I caution on generalization about

religion as it is complex and nuanced. As a general topic, it’s one that’s good to explore, but it’s also extremely sensitive.

[Questioner 7]
What is your assessment of the current political situation in the US surrounding the November elections?

[Answer 7]
Just a couple of points. We have primaries, in which most Americans don’t vote. What you see on the Republican side is a very small number of Republicans who care passionately about traditions or candidates, and are pushing for the nomination of Donald Trump. He doesn’t reflect the mainstream Republicans who are now realizing they’ve lost control of the party. About two-thirds of Americans would reject him in general elections. The Republican Party now is looking at a possible landslide defeat. You have to separate the Democrats and Independents from the Republicans, and then the mainstream Republicans from the extremists.

The second leading candidate, Ted Cruz is from the Tea Party faction of the Republican Party. He is more extreme than Donald Trump. Then there is a third candidate, John Kasich, who is generally very bad, but looks very good compared to the other two. From the Democrat’s perspective, Donald Trump in the nomination would be a gift because a lot of democrats do not like Hillary Clinton. She doesn’t have a very strong popular base within the party, which means normally the people will just not vote. But if she is running against somebody that frightens people, an extremist as an opponent, would probably lead to a higher voter turnout for democrats and more votes for Hillary.

If the election were held today, Donald Trump will have the nomination, Hillary Clinton will have the nomination, and Hillary would probably win in a landslide if it were held today. November is a long time away. You never know what’s going to happen. There could be some scandal, there could be some revelations, and the other problem is that, Donald Trump now is starting to move more towards the center in his public statements. He is becoming more restrained, which again makes him look more moderate, more electable. Anything I could say can be proven wrong in November, and as all the polling has been proven wrong so far, we will have to see how things play out in several months’ time.