China’s Growth & Implications for Southeast Asia

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Organization of Presentation
1. Growth of the largest Economies in Key Regions: *The Middle-Income Trap (Conditional Convergence)*
2. Obstacles to China’s Growth: *Ideology or Vested Interests?*
3. ASEAN: *Slowdown in Malaysia and Thailand*
4. China - ASEAN Relationship: *Some Scenarios*
1. Global Growth Pattern

Pattern in the Largest Regional Economies

- 5 largest from Europe: Germany, UK, France, Italy, Sweden
- 5 largest from Latin America: Brazil, Mexico, Argentina, Colombia, Chile
- 10 largest from East & South Asia: China, India, Japan, Indonesia, S-Korea, Thailand, Taiwan, Pakistan, Philippines, Malaysia

**Analytical lens: Catch Up Index (CUI)** = country’s standard of living / US standard of living (PPP data from Maddison, 2010)
The Middle-Income Trap: Latin America, Stuck at CUI=30%
**Why is European CUI < 100%?**

Decompose \( \frac{\text{GNP}}{L} \) into:

\[
\frac{\text{GNP}}{L} = \left( \frac{\text{GNP}}{[H \times W]} \right) \times (H) \times (W/L) \times
\]

\( \text{GNP} = \text{total output} \)

- \( L = \text{Population Size} \)
- \( H = \text{# hours actually worked per worker} \)
- \( W = \text{# people actually working} \)
- \( \left( \frac{\text{GNP}}{[H \times W]} \right) = \text{output per person-hour worked is very similar in USA & Europe} \)
- \( (H) \times (W/L) \) in Europe is about 73% of USA

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**Breaking Out of the Pack in Developing Asia: Malaysia and Thailand are the Miracle Economies according to World Bank (1993)**

GDP per capita (PPP) of Asia-6 as % of US Level

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<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>India</th>
<th>Indonesia</th>
<th>Philippines</th>
<th>Thailand</th>
<th>Malaysia</th>
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<tbody>
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<td>1962</td>
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<td>2006</td>
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2. The Vulnerabilities in China’s Growth
**Emergency Room Medicine in 2009-2010**

- 4 trillion yuan fiscal stimulus over 2 years @ 7% of GDP per year
- **To prevent waste**, bring forward investment projects that would be inevitably implemented, e.g.
  - Hard Infrastructure: roads, bridges, ports, high-speed train, telecommunications
  - Industries of tomorrow: develop alternative energy e.g. solar power
  - Urbanization: housing to accelerate rural-to-urban migration
- **Unlike in most countries, China’s macro-stimulus worked.** Masterful Keynesian countercyclical policy?

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**Woo’s Prediction, 17 Feb 2009, at US Congress**

- “China’s growth in 2009 is likely to lie closer to Premier Wen’s 8% target than to the IMF’s projection of 6.7% ... The state-owned banks (SOBs) will be happy to obey the command to increase lending because they cannot now be held responsible for future nonperforming loans. The local governments and the state-owned enterprises (SOEs) can now satisfy more of their voracious hunger for investment motivated by the soft-budget constraint situation where the profits would be privatized and the losses socialized. The stimulus package will [therefore] work well .... The price ... will be paid later by the recapitalization of the SOBs and a more depleted natural environment.”
- **Actual GDP growth exceeded Wen’s expectations: 9.2% in 2009 and 10.6% in 2010.**
The Soft Budget Constraint at the Macroeconomic Level:
NPLs threaten financial system stability and cause fiscal crisis

Soft Budget Constraint → Excess Capacity Galore
• High-Speed Train Project exemplifies poor planning: priority on completion within short time period led to huge capacity expansion in cement and iron without taking into account underlying long-run demand
• Urbanization based on Pudong experience that “build and they will come.” Emphasize development of small-medium towns & while restricting growth in coastal regions, especially of Shanghai and Guangzhou. Enthusiasm of local governments resulted in ghost towns in interior provinces
• In 2011-2013 period, China used more cement than the US did in the 20th Century
Excess Capacity Galore $\rightarrow$ NPLs

<table>
<thead>
<tr>
<th></th>
<th>Capacity (million ton)</th>
<th>Utilization Rate (%)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2014</td>
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<tr>
<td>Crude Steel</td>
<td>644.0</td>
<td>1,140.0</td>
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<tr>
<td>Electrolytic Aluminium</td>
<td>18.1</td>
<td>38.1</td>
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<tr>
<td>Cement</td>
<td>1,870.0</td>
<td>3,100.0</td>
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<tr>
<td>Oil refining</td>
<td>391.0</td>
<td>686.0</td>
</tr>
<tr>
<td>Flat Glass</td>
<td>650.0</td>
<td>1,046.0</td>
</tr>
<tr>
<td>Paper &amp; Paperboard</td>
<td>89.0</td>
<td>129.0</td>
</tr>
<tr>
<td>Shipbuilding</td>
<td>28.8</td>
<td>39.1</td>
</tr>
</tbody>
</table>

Source: European Chamber (2016)

Over-Capacity Phenomenon Exists only for Large Countries because a competitive agent would be able to export without backlash from Rest-Of-the-World (ROW), i.e. China’s international environment is different from Luxembourg’s
Bank Recapitalization: Equilibrium Debt-GDP Ratio
• No explosive growth of (Debt/GDP) ratio when:
  \[ y > r \]
  where
  \[ y = \text{trend growth rate of real GDP} \]
  \[ r = \text{real interest rate on government debt} \]
• Steady-state (Debt/GDP) ratio when \( y > r \) is:
  \[ (\text{Debt/GDP})_{\text{steady-state}} = \frac{f+b}{y-r} \]
  where
  \[ f = \text{primary fiscal deficit rate} \]
  \[ = [\text{state expenditure excluding debt service} \]
  \[ \quad - \text{state revenue}] / \text{GDP} \]
  \[ b = [\text{increase in NPL in SOBs}] / \text{GDP} \]
  \[ \text{that the state} \]
  \[ \text{takes over in bank recapitalization} \]

Equilibrium (Debt/GDP) with SOB Recapitalization
Recent experience, \( y = 7 \) to \( 9\% \), \( f = 2 \) to \( 3\% \), \( r = 3 \) to \( 7\% \),
and bad loan creation, \( b=6\% \) historical average
EU requires its members to converge toward
Debt/GDP target of 60 percent
Optimistic Scenario: \( y = 8\% \), \( f = 2\% \), and \( r =3.5\% \)
• \( (\text{Debt/GDP})_{\text{steady-state}} = 178 \% \) when \( b = 6 \% \)
• \( (\text{Debt/GDP})_{\text{steady-state}} = 111 \% \) when \( b = 3 \% \)
• \( (\text{Debt/GDP})_{\text{steady-state}} = 67 \% \) when \( b = 1 \% \)
New Normal Scenario: \( y = 6.8\% \), \( f = 2\% \), and \( r = 3.5\% \)
• \( (\text{Debt/GDP})_{\text{steady-state}} = 242 \% \) when \( b = 6 \% \)
• \( (\text{Debt/GDP})_{\text{steady-state}} = 152 \% \) when \( b = 3 \% \)
• \( (\text{Debt/GDP})_{\text{steady-state}} = 91 \% \) when \( b = 1 \% \)
The New Normal definitely requires \( b < 1\% \) to be safe
The Soft Budget Constraint at the Microeconomic Level: Collapse in Technological Innovation threatens Economic Growth

Net TFP Growth = Aggregate TFP Growth \textit{minus} growth effects from the reallocation of Capital and Labour

Estimates from 2 Recent Studies

<table>
<thead>
<tr>
<th>Annual Net TFP Growth Rate</th>
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<tbody>
<tr>
<td>Lu Ding (2016)</td>
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<tr>
<td>1996-2000</td>
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<td>2001-2005</td>
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<td>2006-2010</td>
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<td>2011-2015</td>
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<tr>
<td>Harry Wu Xiaoying (2016)</td>
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<td>1991-2001</td>
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<td>2001-2007</td>
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<td>2007-2012</td>
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Two Questions about China

- Catching-up requires that China greatly limit the soft budget constraint. Can China do so without abandoning State Capitalism?
- Tolstoy (Anna Karenina): “Happy families are all alike; every unhappy family is unhappy in its own way.” Economic dynamism is more assured when there is social stability and good governance. Can social inclusiveness and responsive governance be achieved without substantially more democratization?

Future Relative Economic Strength of China

- China Relative Strength\(=\)\(\dfrac{GDP_{\text{China}}}{GDP_{\text{USA}}}\)
  \(=\)\(\dfrac{(GDP/L)_{\text{China}}}{(GDP/L)_{\text{USA}}}\)\(\times\)\(\dfrac{L_{\text{China}}}{L_{\text{USA}}}\)
  \(=\) (living standard ratio) \(\times\) (labor ratio)

- \(\dfrac{L_{\text{China}}}{L_{\text{USA}}}\) = 4.3 to 3.2 in 40 years

- Scenario A: Middle-Income Trap
  - \(\dfrac{GDP_{\text{China}}}{GDP_{\text{USA}}}\) = 0.3 \(\times\) 3.2 = 0.96

- Scenario B: Successful Catching-Up
  - \(\dfrac{GDP_{\text{China}}}{GDP_{\text{USA}}}\) = 0.8 \(\times\) 3.2 = 2.56

Even if caught in the Middle-Income Trap, China would have enough clout to enforce a regional security zone and for RMB to be a potential regional currency.
3. Why is Malaysia in the Middle-Income Trap?

Growth slowed down *before* the 2008-2009 Global Financial Crisis (annual, %)

<table>
<thead>
<tr>
<th>Actual Growth</th>
<th>Expectation in 2001</th>
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<tr>
<td>1970-97</td>
<td>1988-97</td>
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<tr>
<td>7.7</td>
<td>9.3</td>
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<tr>
<td>2001-2010</td>
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<td>7.5</td>
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Actual annual growth rate under each successive 5-year Malaysia Plan (MP)

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<tr>
<th>8th MP</th>
<th>9th MP</th>
<th>10th MP</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.5</td>
<td>4.2</td>
<td>5.3</td>
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The Socio-Economic Policy Framework since 1970

New Economic Policy (NEP) to redistribute income/wealth in favor of Malays (*bumiputera-ism*), e.g.:

1. **Target: Malays owning 30% of listed companies →** Industrial Coordination Act → 30% of shares of Chinese-owned companies sold to government-selected Malays upon listing,
2. govt established (a) investment funds to buy shares to hold on behalf of Malays, and (b) Government-Linked Companies (GLCs) to compete with Chinese companies; dividends of both benefit only Malays
3. Mahathir period: key GLCs privatized to selected Malays
4. Recently, GLCs buy up successful Chinese businesses
5. govt hiring & promotion biased heavily toward Malays,
6. govt procurement reserved for Malay firms
7. govt sets up special colleges, scholarships, and business loan programs exclusively for Malays

Outcomes of New Economic Policy

- **30% corporate equity not reached.** In 2008, Malay “ownership of share capital at par value” was 21.9%, target is 30% (*Mkini 2011-11-26*)
- **The Malays had sold the shares to others.** Up to 2009: “only RM2.4 billion [was] left in bumiputra hands after some RM54 billion in shares had been allocated” (*Sun, 2009-8-30*).
- Tax on Chinese firms & Non-Meritocracy → **Capital flight & brain drain** increased steadily since 1970 & accelerated in 2000’s
Capital Flight & Brain Drain

- Malaysia ranks #3 in amount of capital flight 2001-2010 (China, Mexico, Malaysia); and #1 on amount per capita in 2010: China $314, Mexico $456, Malaysia $2,275 (Malaysiakini, 2012-12-18). 85% of Francis Yeoh’s (YTL) business in 2014 is located outside of Malaysia (Malay Mail, 2014-6-3).
- World Bank (2011) finds, in last 2 decades, 20% of tertiary graduates migrated out (not counting migration of folks with vocational skills). Inflow of labor is low-skilled to keep existing production going. Outflow-Inflow pattern is incompatible with moving up the value-added chain.

Growing Mis-Governance, e.g. Over-Centralization

- **Over-centralization of revenue and administrative functions** (a) prevented local governments from building infrastructure to support growth of local industries. USM (local university) has budget bigger than of Penang State Govt → no competing centers of policy initiatives; (b) concentrated infrastructure investment in Klang Valley → unequal spatial pattern of development.
- Over-centralization despite “Federation” structure because of existential threats at beginning, Emergency in 1957 & Konfrontaksi in 1963. Local elections were suspended in 1965, Konfrontaksi ended a few months later but local elections not resumed. Municipal services managed from Putrajaya, e.g. Penang bus routes and stops on each route → poor delivery of govt services & prevented Jokowi-style political figures.
The Malaysian Puzzle: 7.7 % growth rate in 1971-1997

• High growth rate of 7.7% despite massive capital flight, brain drain & growing mis-governance. How was this possible?
• Positive External Shocks!
• The bath-tub analogy

Bath Tub Analogy of Malaysian Growth Engine
1. Level of water in tub is level of investment rate.
2. Capital flight and brain drain are the two leaks at bottom of tub.
3. Water inflow from 2 faucets: FDI and Oil Revenue.
   Before 2001, inflow larger than leaks, so Malaysia boomed
4. FDI slowed down since 2001 \(\rightarrow\) lower growth \(\rightarrow\) lower state revenue \(\rightarrow\) UMNO has lower amount of patronage power \(\rightarrow\) unraveling of the usual politics
5. Oil revenue down \(\rightarrow\) GLC investment down
6. FDI decline from (a) China’s WTO membership (b) no more cheap labor (c) post 9-11 Islam phobia (d) deterioration in governance
Post-2000 Growth Slowdown is from the Collapse in Private Investment

Composition of Investment by Ownership (% of GDP, current prices)

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<tr>
<td>Total</td>
<td>33.9</td>
<td>45.7</td>
<td>25.6</td>
<td>20.0</td>
<td>22.4</td>
<td>26.2</td>
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<td>Govt</td>
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<td>13.0</td>
<td>12.7</td>
<td>11.2</td>
<td>10.1</td>
<td>9.0</td>
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<tr>
<td>Private</td>
<td>21.9</td>
<td>32.7</td>
<td>12.8</td>
<td>8.9</td>
<td>12.3</td>
<td>17.2</td>
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New Economic Policy (NEP) was designed to be emergency room medicine to effect significant redistribution quickly. With prolonged use, NEP = No Economic Progress

The Collapse in Private Investment

• Since 2001, FDI was significantly diverted from Malaysia because
  - China joined WTO; and
  - post-September 11 Muslim-phobia.

• Can Malaysia end the institutionalized racism that is undermining domestic economic dynamism and social cohesion?

• Can Thailand break free of economic and political monopoly of the traditional elite aligned with the military?

• Can there be institutional reforms in ASEAN?
4. Scenarios of Sino-ASEAN Relationship

Context of Projections

• Assumptions
  – US will continue to be a leading economy.
  – China as a Middling Economy or a Dynamic Economy & ASEAN as a Middling Economy or a Dynamic Economy

• China’s objectives
  – Economic prosperity
  – Security via sphere of influence

• Some outcomes for ASEAN
  – Allied to USA? Allied to China? Equal member in blissful ménage à trois?
  – Type of regional trade and monetary order
One Subset of Plausible Projections

• The shadow over all scenarios is the level of conflict in US-China relationship
  – low-level: benign neglect toward ASEAN
  – medium-level: US and China come bearing gifts [present situation]
  – high-level: Cold War with ASEAN members as proxies [ASEAN must prevent escalation to this level, Woo (2016)]

• Indonesia’s attitude toward ASEAN and toward US-China rivalry will shape any meaningful ASEAN response

References


• Woo, Wing Thye, 2016, ASEAN integration can keep region above US–China fray,” East Asia Forum, 4 April 2016 http://www.eastasiaforum.org/2016/04/04/asean-integration-can-keep-region-above-us-china-fray/