

Ten Years After the East Asian Crisis: A Resurgent and Restructured Region

Homi Kharas, June 18, 2007

When the tenth anniversary of the East Asian crisis arrives on July 1, 2007, there will be a lot of congratulatory remarks about the speed of recovery in the region. Unlike Latin America, which lost a decade or more of development after debt crises in the 1980's, East Asia's crisis-hit economies—Thailand, Malaysia, Korea, Indonesia and the Philippines—rebounded fast. Korea, Malaysia and Philippines had regained or exceeded their pre-crisis income level by 1999. This took slightly longer, until 2003, in Thailand and Indonesia—the countries most seriously affected by the crisis. Since then, growth performance has been strong, albeit still a couple of percent below the heady years of the early 1990's. The growth of the region has helped each country grow.

What is less remarked upon, but even more remarkable, is the radical restructuring of East Asian economies that has taken place since the crisis. They are more sophisticated, flexible and innovative. They are more open. Tariffs have been cut in half and now average only 5 percent. There has been a shift from diversification to specialization in production. Local currency capital markets have grown up and diversified, reducing risk. Growth is smarter, with innovation playing a larger role relative to investment, driven by a huge increase in university educated workers. And social and political landscapes across the region have been transformed by urbanization, demographic shifts and far greater transparency and political dialogue.

East Asia's restructuring has happened as countries dealt with the financial crisis, adjusted to China's export juggernaut, and managed an unprecedented migration to urban areas. Any one of these challenges might have given policymakers pause to rethink the speed of global integration. Instead, they chose to accelerate regional integration.

Take trade. East Asia was always renowned for its export-led growth. And exports have led the recovery of many East Asian countries since 1997. Over the last five years, East Asian exports have averaged almost 20% growth in dollar terms. They now top \$2.5 trillion per year, compared to less than \$1 trillion in 1996. But the structure of exports is quite different today. More than half of all exports are within the region. Parts and components going from one country to another in complex regional production networks have transformed the type of exported goods in countries like Philippines, Malaysia and Taiwan. China has been at the center of this shift. It runs a huge current account deficit with the rest of the region, mirroring the surplus it has with the United States. Although China has become a serious competitor with some East Asian countries in developed markets, it more than compensates by importing intermediates. So when Chinese exports grow, exports of the rest of East Asia have grown in tandem. To adapt to this new reality of regional trade, countries have begun to specialize in what they produce and reap rewards from economies of scale.

Economies which specialize also need to innovate, or they lose competitiveness quickly. Malaysia and Korea, as well as Singapore, Taiwan, Hong Kong and China, have dramatically increased research and development spending, largely by corporations.

Patenting is growing, and East Asian researchers increasingly cite each others' research. Along with this, higher education has advanced rapidly. In Korea, for example, there are proportionately more graduates in the adult population than in Japan or Australia.

Prior to the crisis, one could say that the focus of attention in East Asia was on mobilizing finance to drive high rates of investment. Since then, the focus has shifted to the efficiency of resource allocation, the diversification of supply and the reduction of systemic risk. Before the crisis, East Asia was a heavily bank-dominated region which relied on external inter-bank credit lines for liquidity. This left them so vulnerable to global credit market conditions that Alan Greenspan commented that East Asia was growing with no "spare tire". Since then, financial depth has improved substantially. Equity and bond markets rival bank credit as a source of finance, with dramatic increases in Thailand, Malaysia and Korea. This has also supported innovation. Banks are notoriously reluctant to finance new ideas and processes, whereas capital markets tend to be more patient providers of capital. Along with record foreign exchange reserves and more flexible exchange rates, it is fair to say today that East Asia has a spare tire, but perhaps not yet a full-sized one.

These achievements are impressive, but it would be naïve to conclude that all is rosy in the region and that rapid growth has returned to stay. There are notable stresses building in social and political structures. On the social side, East Asia is witnessing one of the most rapid migrations in history from rural to urban areas: 25 million East Asians each year are moving to cities. This migration is all the more pronounced because it is urban

workers who benefit from trade, urban families who have the chance to send their children to university, and urban households that can tap into the new consumer finance and small business opportunities. Most of these migrants cannot move to the megacities of the region, which are already creaking with overpopulation. Instead, they are moving to small and medium sized cities of 1 million or less.

Mayors of small cities and other local officials are therefore becoming more important in East Asia. But often these officials do not have the experience to run fast growing cities, and can fall prey to the temptations of local corruption. It is hard to develop effective anti-corruption programs across a myriad of jurisdictions. So the transformation and restructuring of East Asia from the “rule of man” to the “rule of law” is only just beginning.

Rapid urbanization is being driven by a marked productivity difference between urban and rural areas. On average, an urban East Asian consumes three times as much as her rural counterpart. But increasingly, there is also a gap emerging within urban areas, between skilled and unskilled labor, and between well-managed and poorly managed cities. In some countries, inequalities within rural areas are also increasing. This is a new phenomenon for East Asia, long used to growth with equity. But it is happening systematically across the region and seems to be a common characteristic of growth driven by scale economies in a few industries.

Prior to the crisis, East Asian countries learned how to integrate globally and get the benefits of scale – they solved the demand problem. After the crisis, they learned how to integrate regionally, and get the benefits of specialization – they solved the supply problem. Over the next ten years, they need to learn how to integrate domestically and get the benefits of equity and transparency – in other words, they need to resolve the distribution problem.