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A veteran's Asia reflections

This year my regular trip to Asia-Pacific took me to 16 countries and 23 cities. Political and security matters were high on the agenda. In Japan, the landslide victory of the DPJ has propelled the country into uncharted waters. The tasks ahead are plenty: from tackling ageing and maintaining competitiveness to avoiding losing valuable civil servants and preventing a deterioration in relations with the US.

The security situation in the Hindukush remains very fragile and it is spilling over into Pakistan and India. The return of skilled emigrants to Pakistan as well as signs of political stability in India and its prudent response to the Mumbai terrorist attacks give cause for hope. Further south in Sri Lanka, there are risks that the peace dividend from victory over the Tamil Tigers will be squandered.

Thailand and Malaysia face ethnic and political challenges. In Thailand, PM Abhisit's efforts to win over voters and promote regional integration are commendable. Malaysia must work hard to maintain its ethnic balance and avoid a brain-drain.

An Asian Single Market is a project worth pursuing. More integrated labour and capital markets will be needed given the demographic strains of Japan and (later) China. Region-wide standards would also greatly benefit Asian companies. Unfortunately, there is no visible pressure from the business sector in that direction. Specialisation of countries in certain sectors and industries – Hong Kong in finance, Vietnam in tourism, etc. – is the way to go.

The global economy will have a "triple-U"-shaped recovery. The first "U" is already behind us, the second will be driven by job losses and lead to weak growth towards end-2009 and the third will start when policymakers begin to exit from stimulus policies, towards mid-2010. The exact timing will differ from country to country depending on their cyclical and structural shape. The frontrunners will be some Asia-Pacific economies, while I expect the Fed to exit by Easter 2010 and the ECB not until later. The end of stimulus policies will put stock markets to a stern test.

In Asia, a resumption of endogenous growth by 2011 seems plausible. However, it is not realistic to expect the (unsustainable) growth trends of 2003/2007 to resume, in Asia or elsewhere. This scenario would still generate a sustained gain in GDP weight for Asia in the foreseeable future.

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On September 4, 2009 I left Tokyo for the 50th time to return to Europe. Ever since 1974 I have started each day in Tokyo with two laps around the Imperial Palace. On this day I saw a flattened Hotel Palace on one side of the gardens and a flattened LDP at the Diet on the opposite side of the Palace. Are these “creative destructions”, i.e. are they symbols of a new beginning? Or are they just the end of an era? These and many other questions popped up during this trip that lasted 41 days, taking in 16 countries and 23 cities between Karachi, Melbourne and Tokyo. The following reflections are not meant to be just descriptions, they often appear to be judgments, but in fact they are statements made to provoke discourse – as are Mark Twain’s “Innocents Abroad”, the report about his travels in Europe a good while ago!

The political and security agenda

Japan – new era or decline?

Into the unknown

Japan decided in a landslide defeat of the LDP to hand power over to an unknown quantity. The DPJ made three issues key during its election campaign: Wresting power from the hands of the bureaucrats, emancipating Japan from the US and supporting private citizens rather than business. This appealed to the electorate and played well with the international community, especially with the intellectuals and the journalists. First reactions are: Hope for a new Japan in Asia, sorrow at losing a useful ally in the US. The bureaucrats in Tokyo are stunned and shocked and they have not made up their minds. There is a big risk: if the talented experts feel unwelcome and leave, the new government will lack what made Japan strong over two generations: meticulous execution of policy. The DPJ would be very well advised to make friends with the people needed to implement their policies. Bashing the bureaucrats is outright wrong. Describing their role as to administer and not govern is fine. This must, however, be made clear soon to prevent bloodletting.

The time has come for Japan to free itself from the perception of being the 51st state of the US. Such a policy reflects an acceptance of reality – Japan has been the mastermind of Asia’s push towards internationalisation. FDI, trade and export of management methods are testament to this. But Japan must not alienate the US. The US is the only superpower; it sets standards in many fields and remains the number one market with the most sophisticated customers.

Facing up to an ageing population and staying competitive are Japan's challenges

Japan must, however, come to grips with its own challenges of ageing and staying competitive. The populist campaign slogans of the DPJ are of no help in this context. Being very precise on the extra money to be spent (child allowance) and on the taxes which will not be increased (VAT) and at the same being vague on how to limit government debt is not a good enough recipe for steering clear of ever bigger default risks. Any systematic answer to Japan’s challenges is going to mean pain for the electorate. Restrained government spending will most probably be the solution. The planned reduction of user fees – so popular before the election – has to be abandoned. Japan has no option but to fully utilise its potential. The young must work longer hours, female participation in truly gainful employment must be facilitated, older generations must be sent back to school and the retirement age must be raised substantially. None of these issues are effectively on the agenda.

Sri Lanka – about to squander the peace

Government reaction entails risks

On the southern tip of the Asian continent a ray of hope emerged after the government forces' victory over the LTTE in Sri Lanka. But I have hardly ever observed such a clear case of squandering the chance to harvest the peace dividend. To me the reaction of the government vis-à-vis the defeated resembles the wisdom of the Versailles Treaty after World War I. The risk is considerable that hunting down the terrorists and keeping everybody remotely suspect in camps for a long time will breed more resentment and terrorism than a more liberal attitude would do.

Sri Lanka has a number of positive factors for its economic future, many related to its very loyal diaspora. Their strong emotional ties with the homeland should not be frustrated. FDI is needed to modernise capital stock and infrastructure, and international networking must be improved. If the peace dividend is not reaped and security concerns mount again, such cross-fertilisation will not take place. IMF help is transitory – it cannot be relied upon forever.

Thailand – in search of stable government

Thailand's political fabric has been fragile for a while. The king, an unquestionable factor for stability, is frail, and the succession is a cause for concern for many. The future of the monarchy is an open issue. The role of the military – for so long a source of stability – can no longer be taken for granted. Permanent ethnic/religious tension in Thailand's South plagues the country. The democratic structures and procedures are far from beyond doubt.

Former PM Thaksin's supporters have won many rural votes, but it is fair to say that this has often happened as a consequence of questionable methods and populist policies that are probably not sustainable.

PM willing to engage in democratic process

The current government of Prime Minister Abhisit Vejjajiva is more than a ray of hope. Its understanding of the complexities of the situation and its willingness to engage in a democratic process of winning over the voters is admirable. This prime minister is not only one of the best I have seen in Thailand; he could also become a leading figure to activate ASEAN's integration. He addresses the right questions – he understands the need for an Asian/ASEAN single market. He could be an architect of wider and deeper integration.

Malaysia loses cohesion

Ethnic balance in jeopardy

Is Malaysia on a path like Yugoslavia's after Tito? Of course this comparison is inappropriate, but Mahathir's departure as prime minister has created a vacuum: the capability to keep the ethnic groups in Malaysia in (some) balance is evaporating. Sharia law is being used as excuse for the re-emergence of a feudal fabric. The police and judiciary are sources of concern. Internal security is deteriorating. Talented Malay-Chinese and -Indians are alienated and looking abroad. I have seen many of them in places outside Malaysia, even in other Asian countries. This is already having knock-on effects on FDI. Such trends make for a particularly worrisome situation in a country that is being gravely affected by the international downturn due to its high-tech industry subsidiaries.

Security concerns from Mumbai to the Hindukush

Staying in Mumbai's Taj one gets a sense of the security concerns of the region all the way to the North and West. The question of

Terrorism is a daily fact in this region

religious warfare is on the table. Terrorism is a daily fact in this part of the world. America's commitment in Afghanistan and the involvement of the international community have not brought stability. Security threats spill over time and again into Pakistan. India, with a Muslim population as big as Indonesia's, is not isolated from this danger. These permanent worries are limiting social and economic development in one of the most populated parts of the world. Stabilising Pakistan would help more than 150 million people. Progress there would be much greater if peace and regional integration with India were to advance faster. The Kashmiri people, rather than being viewed as a legacy, should be seen as agents for integration in an economic region where ties are almost natural. Whether the international community can be of major assistance is an open question (see Afghanistan) but the fact that part of the region's diaspora is returning and is willing to take high political office (like, for example, the central bank governor in Pakistan) is a good sign of improvement. At the same time, India's political stability and its wise reaction to the terrorist attacks in Mumbai are evidence of its mature attitude to dealing with difficulties.

ASEAN to widen and to create single market soon

Asia could not be more varied – and that is its attraction. The continent certainly does not lack dynamism. The doctrine of development in the region has been openness to trade and investment. As a result, intraregional trade has prospered. At the same time, policies and regulation have remained national. And very little seems to be being undertaken to change that. The Chiang Mai initiative in financial markets has not really changed the relations between financial markets in Asia: The Asian government bond market is still in its infancy and the corporate bond market is far from mature. Standard-setting is not conceived at the pan-Asian level. Asia therefore rarely sets global standards. This is in stark contrast with the region's weight in world growth.

Much potential for a Single Market in Asia

The logic for an Asian Single Market should thus be compelling. It is fair to report that ASEAN has an initiative to reach this goal by 2015. To me, this seems as realistic as the Gulf Cooperation Council's monetary union by 2010. Much more has to be done to achieve this. There is no doubt that China, Japan and India would have to take a strategic interest in the Single Market for it to fly. Also, it is high time to develop a more robust institutional set-up. To just rely on government cooperation is not good enough. The EU's concept of the European Commission as the engine of integration should be emulated. While I miss such an effort to build a "Brussels" for Asia I am still more puzzled by the lack of pressure from the business sector for regional integration and Asia-wide standard-setting. Asian companies often have strategies that will not work, since national markets – even the biggest in Asia – are not big enough for the necessary economies of scale. National regulation of minimum local content hinders meaningful specialisation and the generation of R&D clusters. Thus these often remain outside Asia, resulting in less revenue and/or less customer choice. While it is obvious that the old, the current and the future Asian leaders (Japan, China and India) have to play a decisive role in establishing this single market, it is equally obvious that this model will only be successful if the smaller participants feel respected. For example, selecting

Asian "Brussels" not in the cards

Demographic strains in Japan and (later) China require deeper integration

Putrajaya, Malaysia's seat of government, as the location of the single market institution would be a powerful symbolic act. I believe Asia would be well served if it were to seriously aim at achieving a single market by 2015, since the demographic strains on Japan and China after that date make it advisable to be ready for a deeper integration of capital and labour markets by then. I wish companies played a more constructive role in the intellectual process of "region-building". Academia should be at the forefront. For that, we need global centres of excellence. Asian universities must become more than just springboards for UK and US universities. Specialisation should take place: Hong Kong in financial markets, India in mathematics and pharmaceuticals, Vietnam in tourism, China in mechanical engineering, Singapore in logistics, Japan in health and the environment. If, on the contrary, Asia believes that it can have several international financial centres these in the end will be as important as the several locations we have in continental Europe! In my view, there will be only one truly international financial centre in the Asian time zone: Hong Kong or Singapore. If China makes the wrong moves, it will be Singapore.

Specialisation needed for excellence

Will Asia decide the path of the car industry's future?

Dynamic industry trends in Asia

Listening to the rumblings about the demise of the Big Three in Detroit, observing the woes of the European car industry and its overcapacities in a stagnating market and observing the vigorous growth of new factories in Asia, plus the efforts being put into new approaches (cheap car in India, lithium-battery car in China, electric car in Japan), one does wonder where the new dynamism is coming from in the car industry.

Asia biggest growth market for next half-generation

It is quite obvious that business as usual just will not be good enough. The future will not only be influenced by technical breakthroughs, which are difficult to predict, but probably equally so by changes in regulation. Concerns for the environment may play an important role. The path into the future cannot in my view be determined by the US or Europe alone; it will most probably have to be decided jointly with the biggest growth market for cars for the next half-generation: Asia.

Joint Washington-Beijing project – the electrical car?

I would not rule out that in the end Washington will opt for a leap forward rather than rescuing old Detroit. What if Washington and Beijing were to opt jointly for the electric car? This would turn the auto supply industry upside-down and it would have far-reaching consequences for commodities (copper prices, etc). Just think of the industrial policy of both countries if they went for this solution! Think of the environmental regulation they would potentially go for, if they were to make such a decision!

Europe-India-project – for a more reasonable transition

What would I do, if I were Europe or India? Would I just join them? Or would I bet that the next half-generation would be better served – considering the uncertainties and limitations of the electric car – by the internal combustion engine (i.e. its refinement in the direction of diesel and 2nd generation bio-fuels)? This would allow a better use of the existing capital stock in the car industry, of R&D facilities, and, equally important, of the capital stock in infrastructure (filling stations etc.). This would be particularly relevant as electricity for cars from renewable energy will not be available soon. Europe could take the lead in diesels (small-engines in Italy and France, bigger-sized in

Germany), with Latin America chipping in bio-fuels. How about India as big mass-market joining in this "south- transatlantic" cooperation?

A fascinating strategic competition

Wouldn't this be a fascinating strategic competition between US-China and Europe-India? I would bet on Europe-India in this case. Of course co-regulation has to be established to get this done. Germany's failed experiments with bio-fuel incentives should be heeded as an example of how not to proceed.

German industry well prepared for challenges

Pune's car companies would be an interesting focal point for such a brave new world of automotive industries, with their suppliers and accompanying infrastructure. Are we ready for a fast move towards the next generation of cars and fuels – are strategic investors in banks and capital markets educated enough to do the proper due diligence? It was very encouraging to see Germany's contribution in Pune and very reassuring to see the German auto supply industry in Asia up and running and completely alert to the above-mentioned challenges.

Exit from stimulus policies?

Concerns about the role of the USD as reserve currency

Jackson Hole, the Kansas Fed Annual Conference, addressed this question. Warren Buffett, as well as the Chinese and Russian authorities, is worried about the future store-of-value quality of the world's reserve currency, the US dollar. My talks at central banks and ministries of finance as well as with academia centred around the questions of when and how to exit from stimulating monetary and fiscal policy. My proposal to do this in a coordinated way and taking into account exchange rates was mostly rebuffed. National answers will prevail. Therefore, unwanted side effects are likely, i.e. undesirable exchange rate movements.

Exit timing will vary across regions

The timing of the exits will follow – for good reason – the different cyclical and structural conditions. Since a number of Asian countries are less affected by the international crisis or faster at compensating for it, they will exit before others. Australia, China, India and Korea may already consider moves in the latter part of the year, mainly with monetary policy. The big western economies will not follow until 2010 – my view is that the Fed may act by Easter 2010. The ECB will follow suit, if the Euro exchange rate does not change or even depreciates. Such an FX outcome is, however, not my bet. I believe the saturation of appetite for USD-denominated government assets in Asia, the GCC and Russia will contribute to a weaker dollar, while a Euro appreciation – albeit not warranted considering the weak EU economy – may happen. Hence, the ECB would have to delay the increase in interest rates. Japan, meanwhile, will not exit from its zero-interest policy any time soon, considering the persistent deflation.

Fiscal containment to start in 2011

Fiscal deficits will stay very high throughout 2010, mainly due to execution lags from 2009. Thus, pressure to scale back will mount towards 2011. The adjustment will take place mainly via a reduction in discretionary spending, which will raise the political pulse. The prospects for governments to survive in office will deteriorate. However, I believe current public debt increases are indeed unsustainable and must be addressed. The exit from stimulus policies will put stock markets to a harsh test, since it is unclear whether by then – i.e. in a year's time – economic fundamentals will already be strong enough to support stock prices. Let's keep our fingers crossed!

Cyclical perspective and growth trend after 2010

A "triple-U" recovery

Economic sentiment has been very volatile over the past few months. In the spring pessimism was abound. Then “green shoots” caused a resurgence of optimism. Now “cash for clunkers” is misleading analysts into talking about recovery. To be sure, Q3 GDP numbers will indicate an upswing (4% saar globally) but they will merely reflect a hiccup at the cyclical bottom! We will in most countries have a “triple-U” shaped cycle. The first “U” is already behind us, the second “U” will be initiated by the shedding of labour in many countries (due to insufficient recovery of demand). This will imply lower household income and weaker retail sales during the Northern Hemisphere winter. The third “U” will be initiated during Q2 and Q3 2010 when most central banks start exiting from monetary stimulus, thus threatening stock prices.

Growth trends of 2003/7 not set to return

In Asia, while a number of countries will find it difficult to start tackling their structural adjustment needs by 2010, many economies will gain considerable domestic momentum. Thus a resumption of endogenous growth by 2011 seems a plausible baseline forecast. However, expecting a resumption of the growth trends of 2003/2007 is not realistic for most economies. India, Indonesia and a few other tigers may be the exception to the rule. But unsustainable growth will not return to the US (2¼% instead of 3¾% in 2003-7), UAE/Dubai (5% instead of 10%), Spain (1% instead of 3½%) or the UK (2% instead of 3%). China will devote more time and resources to cleaning up its local environment and will thus have lower headline GDP growth (7% instead of 10%).

Asia will gain considerable weight in world's GDP

While (in Asia) some disappointment cannot be avoided with such outcomes, it should be understood that this scenario still generates a sustained gain in GDP weight for Asia in the foreseeable future. The subdued growth trend is partly the hangover from unsustainable growth until 2007. However, it also reflects a lack of reform-mindedness. The latter can be overcome if discipline is accepted and international cooperation is revived. This is not impossible: Yes we can!

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