Letter n°27

The Catch-Up of Southeast Asia

"The world is not sick, it gives birth" Teilhard du Chardin

These words from Teilhard du Chardin are useful for understanding the world, watering down the word crisis which is an obsession for the West and apprehending growth in other parts of the world. We focus too much on the G7 countries, but as ***Michel Camdessus,*** former Managing Director of the IMF observes in his book ***"Towards the World of 2050", "the G7 accounted for 57% of world production in 1960, 32% in 2015 and 15% in 2050".*** So, we have to look elsewhere to diversify investments and Asia is the most dynamic zone. The thesis of Singaporean **Kishore Mahbubani** in **"Has the West Lost it? A provocation"** has the merit of making you think. After recalling the dominance of China and India over the world economy until 1820, an assertion corroborated by ***Angus Maddison's*** work at the OECD, he analyzes European domination as a parenthesis in history; an "aberration" that is about to end. This term is provocative, but undoubtedly, Asia has been able to copy the Western world and the West is no longer the economic engine of the world. Education has led to a change in attitudes and encouraged people to take control of their own destiny.

Southeast Asia is not a homogeneous region. There are four religious identities (Islam, Hinduism in Bali, Buddhism, Christians) and various historical influences (Chinese, Indian, European). In Vietnam, the Chinese influence was deep-rooted; In Malaysia, it saw the migration of some fifteen million Chinese between 1881 and 1941 and similarly, the same for Burma, Thailand and the Philippines. Other countries were under the Indian sphere of influence prior to the arrival of the Europeans. We will not be delving into India in this Letter and will limit our discussion on Singapore as we will dedicate a future Letter to each of these countries.

Although it is difficult to compare small countries to large ones like the United States, in terms of GDP per capita on a purchasing power parity basis, Singapore is at more than 150% of US level, Hong Kong at 95%, Taiwan at 80%, South Korea about 75%, Malaysia at 45%; all far ahead of China at 20%. If we do not think in purchasing power parity terms, the GDP per capita in Singapore is now at 98% of the US GDP, Hong Kong at 76%, South Korea at 48% and Taiwan at 38%. Catch-up has been very rapid in recent decades.

The Covid crisis has shown the resilience of these economies: Taiwan has already returned to its pre-crisis GDP level with South Korea and Vietnam not far behind. Tourism-dependent countries, such as the Philippines and Thailand, are much more affected.

1. The Catch-Up of Asia:

As we saw in Letter 26, Deng Xiaoping and his epigones helped lift 800 million people out of poverty. Elsewhere in Southeast Asia, communism was contained and development was rapid under the prominence of the American "Domino Theory" that feared the proliferation of communism in early 1950s.

The take-off was not as strong as in China but it started earlier. Japan's rapid reconstruction took place as early as 1945, and was followed by South Korea, Taiwan, Singapore. In addition, the poorer countries like Bangladesh, Pakistan or Malaysia, also saw its middle class grow rapidly. These countries chose a model of capitalism that was initially based on a strong state and temporarily chose to sacrifice pure market mechanisms.

- A different model:
The American model is characterized by a distrust of the government, opposition to authority,

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encouragement of competition and the promotion of human rights.

Confucianism, as ***Samuel Huntington*** has pointed out**,** is based on "authority, hierarchy, the subordination of individual rights and interests, the importance of consensus, the rejection of conflict... the supremacy of the state over society and society over the individual." Historically, unlike Greek philosophy, Confucianism is not favourable to individual competition. In recent years, however, these countries have shown themselves to be effective.

The American model is a complete contrast of the Chinese model and the dream of convergence has dissipated. The cardinal value of the former is freedom, while the second is order. The United States believes in democracy, China believes in an authoritarian regime. The American time horizon is the interval between two elections, while that of the Chinese is 100 years, i.e. the number of years since the founding of the Communist Party. The rivalry is intensifying on the international stage because America does not intend to give up its spot and China, the initiator of the Silk Roads, intends to be at the center of the universe. The Chinese government has signed agreements with countries that together will control 60% of oil reserves and 80% of gas reserves, and has established agreements with Latin American countries, such as Brazil, that are traditionally close to the United States. Despite these differences and even antagonisms, US cooperation with China would nevertheless be beneficial for both, as China needs American food materials and even liquefied gas, while the Americans need Chinese metals.

- Convincing results for Southeast Asian countries:

The 4 Asian tigers (Korea, Taiwan, Hong Kong and Singapore) started to rise to prominence in the 1980s but they were small, and few observers in the West were anticipating a take-off of China and India. The Asian crisis of 1998 reinforced this sentiment, but nevertheless the lines were shifting.

China and India are not talking as much about catching up as about returning to the natural order of the world because the Western domination is just a parenthesis that allowed for immense progress in the world. In 1980, according to ***Peter Frankopan*** in his book ***"The New Silk Roads"***, China's GDP based on PPP (purchasing power parity) was 10% of that in US in 2001, 39% in 2016, and is now currently at 114%. China now takes the first place with India in third ahead of Japan.

"Blind" – in the words of ***Kishore Mahbubani.*** Westerners did not understand that the end of the Cold War did not mark "the end of history" but instead it was the awakening of China and then India in 1991 under Prime Minister Rao. Secondly, the most important event in 2001 was not the Twin Towers attack but China's entry into the WTO. This resulted in the arrival of nearly a billion workers into the trades' system thereby weakening the Western middle classes and facilitating Trump's election.

Examples:

Japan : the Japanese economy accounted for only one third of the UK's GDP in 1951 but in the early 1980s, reached to a level equivalent to Britain plus Germany and France. From contributing just 3% of world GDP, it had risen to 16% at that time. In 1987, Reagan, faced with a growing Japanese economic power, imposed 100% tariffs on certain Japanese electronic products. The country suffered a severe financial crisis then and from which it has never fully recovered. Growth is now anemic and Japan's share of world trade has steadily declined from 10% to 4%, but the country retains its strength in several technology sectors.

Korea : the country had repelled the Japanese forces up till the 16th century but had to recognize Manchu Suzerainty in 1637 and was formally annexed by Japan in 1910. Although Japan endowed Korea with modern infrastructure, this came at the cost of extreme repression and exploitation. Following the end of World War II, independence was regained but the country was split into two different dictatorial regimes in 1953.

South Korea became a democracy in the 1980s and the 1988 Seoul Olympics symbolized a return to the international stage. Growth was initially fostered by a very proactive government that was eager to promote exports and the development of large conglomerates. Annual growth in GDP per capita was almost 7% per year between 1960 and 1997 thanks to technological catch-up. The government modernized agriculture, protected property rights and invested heavily in education. To businesses, it offered subsidized access to credit, protected domestic industries through currency devaluation, offered export aid and explicit or implied government bailout guarantees in the event of bankruptcy.

Exports have been a powerful lever for growth. Industrialization fostered urbanization and urbanization allowed for better leveraging of economies of scale in infrastructure. Most importantly, the government sought to reduce competition and the entry of new companies by regulating the entry of new foreign investors who cannot hold more than a quarter of a Korean company's shares.

In the space of 30 years, South Korea has become a world leader in the electronics and telecommunications industries. The weakening of these conglomerates during the 1998 financial crisis, such as the bankruptcy of Daewoo, stimulated the entry of new innovative enterprises and paved the way for structural reforms that allowed South Korea to enjoy significant growth after a brief period of slowdown. At that time, the IMF tightened antitrust regulations, imposed liberalization of foreign direct investment and encouraged Korean companies to accept 55% of foreign investors.

While in 1990 South Korea submitted 8 times fewer patent applications than Germany to the U.S. Patent Office, in 2012 it was 30% more, despite a population that is only half as large. After 1998, there was a rebound in productivity and an increase in the research and development budget that is now at almost 4% of GDP. 60% of Korea's GDP is generated from abroad and 30% of the spare parts imported by Korea come from China, its leading trading partner.

The country has weathered the Covid crisis well with GDP decline limited to 1% in 2020, an unemployment rate of 3.8%, a budget deficit estimated at 4.5% and a current account surplus of more than 3% of GDP. The surplus is expected to increase in 2021 as in recent months we see that exports are growing strongly – up 70% in February. South Korean GDP per capita accounted for 9% of U.S. GDP per capita in 1950, but now stands at 48%. ***Amin Maalouf*** states in "***The Disruption of the World"***, the income per capita in South Korea was $130 in 1966 compared to $160 in Egypt. Today, the figure is at $31,000 in South Korea but less than $2500 in Egypt! While South Korea and Ghana had the same GDP per capita in 1960, in 2010, ***Joseph Stiglitz*** stressed that South Korea's GDP per capita had increased 23-fold while Ghana's had plateaued. And as pointed about by ***Chang*** in his book ***"23 Things They Don't Tell You About Capitalism"***, South Korea GDP per capita has grown from just one fifth of that of Argentina in 1960 to three times greater now.

Singapore : when the state regained independence in 1965, GDP per capita stood at only 5.4% of America's GDP per capita. The figure is now 98%. The success is spectacular and will be the subject of a future Letter. In addition to having rolled out a vaccination campaign faster than other countries in the region, Singapore's industry also benefits from the growth of the technology sector with 40% of industrial production, mostly lying in semiconductors, and 18% in bio-medical. The rebound in Singapore's GDP in 2021 will be more pronounced than elsewhere, especially if the borders open again.

Taiwan : annexed by Japan from 1910 to 1945 before returning to China and then emancipating itself, the island has a population of 23 million people. In 1952, the country was poor but industrial production increased by 10-fold between 1950 and 1970, GDP grew by 10%/year between 1963 and 1973 and the trade balance became surplus from the early 1970s – all of these factors clearly made Taiwan one of the famous Asian Dragons.

Taiwan today is ranked 21st with a GDP of $600 billion, placing it ahead of Sweden. The unemployment rate is low at 3.8%, the budget deficit is less than 1% in 2020, the current account is very positive at more than 12% of GDP at the end of 2020 and the country is very open to international trade. GDP per capita is $25,500, far behind South Korea and Singapore but ahead of China's GDP per capita of $10,000. In 1950, it represented 10% of the America's GDP but this figure has grown to 38%.

Taiwan shares close economic relations with China. It is the largest investor in China with two million of Taiwan's 23 million population working in China. In addition, Taiwan also receives many Chinese tourists each year. Xi who had spent 17 years (until 1992) in Fujian province, just across from the island, knows many Taiwanese entrepreneurs as China, especially the coastal cities, recruits Taiwanese graduates. The "China 2025" program offers public financing access to Taiwanese companies as to Chinese companies.

But in the 2020 presidential and legislative elections, the separatists retained power and are committed to the democracy implemented in the 1980s. In 1971, Taiwan was removed from the United Nations and this essentially means the state technically does not exist under international law and is thus somewhat isolated diplomatically on the international scene. Today, only 16 states recognize Taiwan, and the United States is proving to be a staunch ally. As ***Graham Allison*** recalls in his book ***"Towards War"***, when the Chinese were angered by Taiwanese separatists in 1996, they had sent missiles into the sea during the elections but had to back down after Bill Clinton sent in two aircraft carriers.

Hong Kong : in 1997, the island's GDP accounted for 18% of China's GDP but this figure has dropped to 3%. It should be noted that the island is smaller than Paris or London and has a population of only 7.5 million. The economic market is dynamic with nearly 9,000 multinational firms, almost all the major international banks and transaction volumes much higher than London. Unemployment that was 2.9% at the end of 2019 increased due to an estimated 9% decline in GDP in 2020 but remains moderate at 5.4%. The same is true for its budget deficit, which has fallen from a near-balanced situation at the end of 2019 to -11% in 2020. But the current account remains in surplus at 4% of GDP and assets under management have increased in 2019 to $1200 billion of which 40% comes from "mainland china" and 38% from the island itself. Hong Kong has some 1,300 U.S. companies, 85,000 U.S. residents and trade with the United States is equivalent to more than 10% of the island's GDP.

Compared to China, monthly wages in manufacturing in South Korea, Singapore and Hong Kong are almost 5 times higher. In Taiwan they are 3 times higher and in Thailand only slightly lower than that of China.

Indonesia : this country, with a population of 270 million people and a strong Muslim majority (just under 90% of the population), has an area of 2 million km^2 across 13,500 islands of which 6000 are inhabited. It is the third largest democracy in the world after India and the United States. From 1999 to 2016, it experienced rapid growth as GDP per capita increased by more than threefold, poverty was halved and the middle class grew. However more than half of the jobs are in the informal economy and inequality is high. 30 years ago, the income per capita in Algeria and Tunisia were higher than Malaysia's and Indonesia's. Today, it is the other way around. Compared to many emerging countries, Indonesia has little debt, a small budget deficit and moderate inflation in recent years. The country is strategically positioned because it controls the Strait of Malacca – a few kilometres wide between Sumatra and Singapore acting as a link between the Indian Ocean and the China Sea through which a quarter of the world's maritime trade passes, and is vital for transits to Japan and China.

After the successful take-off of the countries mentioned above, other countries in the region have begun to follow the same path. They are exploiting their advantage of low wages to attract factories that were previously established in other countries in the region. Let's look at three examples – Cambodia, Burma and Bangladesh.

Cambodia has been a prime example since the departure of Khmer Rouge in 1979 and has been developing the private property sector ever since. The population is young since two thirds of them are born after 1979 and is still predominantly rural.

Bangladesh has a population of 160 million, 85% of which are Muslims and 15% Hindus, where 80% of them are still nearly illiterate. Production costs are very low and many factories that were previously in China are relocating to Bangladesh.

Burma, an English colony until 1948, was a parliamentary democracy until the army took over power in 1962. General Aung San had liberated the country in 1945 from the Japanese occupation and his daughter was elected as stateswoman in recent years. However, she is currently placed under house arrest following the seizing of power by the military. This has discouraged investments.

2. Asian technological ambitions :

- *A handicap to overcome* :

The handicap here is an increasing ageing population, the fall in the birth rate and a shrinking working population. The working-age population is expected to decline in the coming years in Japan, Taiwan, South Korea, Singapore and Hong Kong. In China, the number of births fell to 10 million in 2020 from 14 million in 2016. In Japan, while there are now 74 million 15–64-year-olds, this will fall by more than two million before 2025 and by nearly nine million before 2030. The median age is 48, compared to 15 in Niger. The number of young people, aged 25-35 years-old, is decreasing by 250,000/year. Thus, Japan in 2060 would only have a population of 90 million, significantly lower than the current 127 million. The situation is worse in South Korea and the country could be the oldest in the world by 2050. In 2019, the number of children/women ratio has fallen to 0.98x while the replacement rate is 2.1x and this is a record low. The trend is not any much better in Taiwan and China too. Elsewhere in the region, population is expected to continue to grow, albeit at a slower pace.

- *The responses* :

To compensate for this handicap, these countries are investing heavily in robotics and artificial intelligence in order to achieve productivity gains. They hold strong positions in semiconductors, DRAM and NAND memories, related equipment, projection equipment, antennas etc. With the deployment of 5G, the development of autonomous car, the rise in electric batteries, there are many renowned and unavoidable players in Asia.

Many investors know of TSMC, the world leader in semiconductor production, but few are familiar with other companies in Taiwan that are also riding on the semiconductor trend. Some of these include MediaTek that has a market capitalization of $51 billion, UMC with a capitalization of $24 billion, Novatek that is valued at $10 billion, Vanguard that is worth $6.8 billion, Phison that is worth $3.2 billion and Chipbond technology valued at $1.7 billion. In Taiwan still, we must pay attention to Genius (valued at $2 billion) and ZDT (valued at $3.8 billion) which are suppliers of components to Apple products. Others to look at are companies in the PC hardware space like Quanta computer that is valued at $11.7 billion, Wiwynn Corp that is valued at $5 billion and Lotes Co that is valued at $2 billion.

Similarly, everyone in South Korea knows Samsung, with its valuation reaching $437 billion, but many do not know of other players. These include SK Hynix – a competitor in memory semiconductors with a market capitalisation of $91 billion, Wonik IPS – a small company in the same sector that is worth $5 billion, LG Display – worth $7.1 billion; Naver – worth $54 billion, Kakao – worth $38 billion, and Zepeto and Coupang that joined the Internet and e-commerce scene this year.

The Intel Group has made the decision to relocate more of its production to Taiwan and South Korea, strengthening the position of these two countries.

In Japan, behind the big well-known groups, we can turn our attention to players in the semiconductor industry like Disco that is valued at $11 billion, Advantest that is valued at $16.4 billion and Tokyo Electron that is valued at $64 billion. Other significant players in the field include Sharp with a valuation of $10 billion in the smartphones industry and Renesas Electronics worth $19 billion in the electronics and electric car segment etc.

As we can see, the microcosm is diverse, the pool is rich and the opportunities are numerous but selectivity is essential.

Conclusion: ***"The sun is now my companion on the great road of life."*** **Mishima.**

We started this Letter with the evocation of the pessimism of many Westerners, but we end it with these words from Mishima that are useful to describe the journey in Asia.

- Reasons to invest:

In 1950, Asia (China, India, Japan, Indonesia...) accounted for 60% of the world's population but 14% of the world's GDP. In 2050, according to ***Michel Camdessus,*** the figures should be 50% of the population but also of GDP. In purchasing power parity terms, Asia contributed to 23% of global GDP in 2002. Today, it is one third of global GDP and enjoys a faster growth rate than the United States and Europe.

By 2030, 90% of the people who will join the middle class are expected to be Asian, which is one of the motivations to invest in this part of the world. As quoted by Thomas Gomart in "Invisible Wars", the Singaporean essayist ***Parag Khanna*** assesses Asia's growing place "in the cockpit of history as a natural destiny" but few Western leaders are aware of this progress in the world over the past three decades.

- Contrasting trends:

We focused on the most promising and attractive countries but elsewhere, on the periphery of the "Tigers," growth is expected to remain strong in Vietnam but slow in several others.

In the *Philippines,* we highlight the deficiencies in infrastructure, the weak fiscal support to combat the crisis, the admittedly high percentage of budget deficit at 8% of GDP in 2020 in light of a public debt at almost 55% of GDP and a high unemployment rate of more than 10%. All these factors could bring down the populist government in the next elections in May 2022. The only hope is that the Philippines may be able to resume remittances from Filipinos abroad in the United States, Singapore or Hong Kong.

In *Indonesia,* we consider factors like labor market rigidities, the officially high level of unemployment at almost 7%, a high budget deficit of 7% estimated in 2020, capital outflows, persistent dependence on external capital, higher oil prices, a resumption of imported inflation, and the prospect of a current account deficit that could temporarily weaken the country.

In *Thailand,* we are wary of political uncertainties over investment and a decline in tourists such that number of tourists have fallen from 40 million in 2019 (of which 30% are Chinese) to less than 7 million in 2020. These have adverse effects on the country that recorded a budget deficit of almost 7% in 2020. Overall, GDP will not return to its pre-crisis GDP until 2022. A supporting factor, however, is the rise in the price of agricultural materials as they account for more than 30% of exports.

Finally, the slow vaccination program as compared to Singapore, Taiwan, South Korea and Japan is hindering these countries from returning to normalcy.

- What are the risks?

The risk for these Southeast Asian economies would be a halt in globalization, but we do not believe in it. And as ***Kishore Mahbubani*** asserts, globalization will persist because the critical 12% of Westerners are opposed by 88% of the world's population who are in favor. The optimism of the Asian population should be mirrored against the pessimism of the Western population.

Another short-term risk is the rekindled Sino-American tensions, but we do not believe in it.

Another medium-term risk is climate change, a rise in sea levels, as Bangladesh, Thailand and Vietnam would be severely affected. But we will analyze this point in a future Letter.

Geneva, March 1st, 2021

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