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The Economic Outlook in the Far East* 6 pages

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*Excerpts of remarks delivered by Mr. Irvine at the 421st Meeting of the National Industrial Conference Board, San Francisco, California, on March 22, 1962.

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The Economic Outlook in the Far East 1/

The word "outlook" in a title suggests that the speaker is going to venture into the realm of prophecy, and I am not sure that economists are very skilled in this area. In any case, if we are going to try to look ahead, we must have a pretty good understanding of where we are now. I intend to concentrate chiefly on a description of some of the more important economic trends and problems in a few of the Asian countries, beginning with Japan--which is by far our largest customer, competitor, and debtor in the Asian area.

Japan

In assessing the Japanese economy, it is impossible not to be influenced by the impressive record that Japan has made over the past decade. Here is a country that succeeded in doubling its exports and more than doubling industrial production between 1955 and 1960--a feat that careful analysts would not have hesitated to label impossible had anyone dared to question them about the likelihood of such a development before the event.

Still the road to riches is never without its ups and downs, and even the Japanese, for all their impressive achievements, have not been able to avoid an occasional setback. The year 1961 ended up as a year of trouble for Japan, although it had begun with the rosiest glow of optimism. The difficulty stemmed from the balance of payments. The deficit on trade account, on the basis of customs data, rose to an astonishing $1.6 billion in 1961. The 1961 deficit was more than ten times that of 1959---and that is a rapid rate of expansion even in Japan. Japan has net invisible and other non-capital receipts of $500-$600 million a year, which means that last year the current account deficit approximated $1 billion. This was equivalent to 55 per cent of the total gold and foreign exchange reserves Japan held at the beginning of the year. A deficit for the U.S. of comparable size in relation to our gold stock would have been about $10 billion.

In comparison with the amount of concern exhibited in this country over our deficits in recent years of $2 billion to $4 billion, the Japanese reacted to this adverse turn of events with relative equanimity. This was partly due to the fact that the Japanese tend to center attention on changes in the gold and foreign exchange reserves and give little heed to changes in their short-term liabilities. Indeed, data on short-term liabilities are regarded as confidential by the authorities and are not published. The deterioration in the Japanese situation in 1961 was concealed for several months by a sharp rise in foreign indebtedness. The inflow of capital was such that in the first four months of the year Japanese reserves of gold and foreign exchange rose in spite of a very large current account deficit. Only when the reserves began to decline did people begin to get concerned, and then it took several months for the concern to build up to a point strong enough to prompt corrective action.

1/ Excerpts of remarks delivered at the 421st Meeting of the National Industrial Conference Board, San Francisco, California, March 22, 1962.

The corrective action required was something that would put a damper on Japan's fantastic rate of industrial growth. In the three years ending June, 1961, industrial output in Japan, seasonally adjusted, rose by no less than 95 per cent. This rate of growth, not unexpectedly, put some strain on Japanese domestic resources, both materials and labor. A substantial increase in the volume of imports was required to satisfy the growing demands of both producers and consumers. From 1958 to 1961, imports rose over 90 per cent in value and doubled in volume. Exports in the same period rose a little less than 50 per cent in both value and volume. The discrepancy between the trend of exports and imports was especially marked in 1961.

It would not be fair to say that the Japanese problem was the result of the failure of exports to expand sufficiently during this period, since their rate of growth was about double that of total world exports. It would be unreasonable to criticize that kind of performance. The problem has been chiefly the fault of burgeoning import demand arising from the phenomenal growth of production.

This is illustrated by the developments in the Japanese iron and steel industry. Last year Japanese production of crude steel exceeded 28 million tons, and Japan surpassed the U.K. in steel output to become the world's fourth largest producer. This is a matter of pride for the Japanese, but pushing output to this higher level required substantially increased imports of raw materials. At last year's prices, every additional ton of steel turned out cost Japan about $40 for imported coal, scrap steel and iron ore. Boosting steel production from 22 million to 28 million tons therefore added approximately $240 million dollars to Japan's import bill in just the direct cost of these three essential items. Exports of iron and steel declined somewhat, and so the increased foreign exchange cost was not offset by higher direct foreign exchange earnings. Apparently most of the steel went to meet domestic demand generated by Japan's feverish investment boom.

This points up the dilemma that the Japanese now face. The steel industry cannot go on producing 28 million tons of steel a year, much less increase output to the 48 million ton level projected for 1970, if imports of coal, iron ore, and scrap are not maintained at last year's high level. But last year's overall level of imports cannot be maintained unless Japan can find some way of obtaining approximately an additional billion dollars in foreign exchange annually. This would mean something approaching an increase in exports of 25 per cent over last year's level. The Japanese managed to secure export gains of even more than 25 per cent in 1954 and they came close to this rate of increase the following year. However, these percentage increases were on a smaller base, and Japan's exports have never risen more than $600 million in any single year. In spite of the proven Japanese ability to confound pessimistic prognosticators, no one imagines that it will be easy for them to boost their sales by as much as a billion dollars in as short a space as a year's time.

The measures that the Japanese have taken to solve this problem have been mainly designed to tighten the screws to reduce the level of domestic demand. It is not entirely clear whether the intention has been merely to reduce the rate of growth, to halt growth temporarily, or to effect a decline in production. It would appear that at least a cessation in the expansion of output would be required to give exports time to catch up to the present high level of import demand. If a reduction in imports is going to be required, a recession is unavoidable. This is what happened in 1957-58, when a billion dollar cut in imports was obtained at the cost of only a moderate recession. At that time, the seasonally adjusted index of industrial activity fell by a maximum of 7.5 per cent.

So far the Japanese have at most halted the expansion of industrial output. In September 1961, the Bank of Japan raised its basic discount rate from 6.9 to 7.3 per cent, increased reserve requirements, and the Government enforced certain complementary measures. Perhaps as a result of these actions, the seasonally adjusted index of industrial production showed virtually no change from November to January. Imports, also seasonally adjusted, turned down in December, and in the first two months of this year were at a rate 10 per cent below the final quarter of 1961. Exports in January-February were up slightly from last year's fourth quarter rate.

This suggests that the Japanese are on the right road, but they are still a long way from solving their problem. The trade deficit in the first two months of this year was still at an annual rate of $1.4 billion, compared with the $600 million they can afford if the international accounts are really to be balanced. Reserves rose in January and February by $28 million, but this was again the result of short-term capital inflows of substantial magnitude.

The extensive use of short-term borrowing has helped Japan finance her industrial and commercial expansion, and last year such borrowing was employed in the latter part of the year to help avert a crisis of confidence and give the authorities time in which to maneuver to solve the payments imbalance. There have been some beneficial results, but there have also been some less desirable consequences. It may be questioned whether the expansion was not allowed to go too far too fast largely because of the easy availability of foreign short-term credit. The Japanese may find that they are not able to increase their foreign exchange earnings sufficiently to buy all the raw materials which their greatly expanded plant requires to operate at present levels. The emergence of a substantial amount of over-capacity in Japanese industry might dampen down the seemingly irrepressible urge of the Japanese businessman to invest. This could put a big enough dent in the investment boom to produce a deeper recession than anyone now really expects.

Investment in producers durable equipment in Japan in the last two years has been between a fifth and a quarter of total GNP. If this country were investing at a comparable rate we would have spent over $100 billion on producers durables last year, more than four times the amount we actually spent. This very high rate of investment is obviously a key element in Japanese prosperity. The fact that it held up fairly well in the 1957-58 recession was important in keeping that downturn mild and short. The contraction of inventory investment was the main depressing element at that time. Now with equipment investment running at about 22 per cent of GNP contrasted with 17 per cent in 1957 and the possibility of over-capacity becoming a problem, it would not be surprising to find equipment as well as inventory investment shrinking substantially in the period ahead.

On the other hand, the strength of the drive to invest in Japan should not be underestimated, and it will take more than a mild setback to kill the optimism of the Japanese businessman. This has been richly nourished by the way in which investment has paid off. The investments made in new plant and equipment helped push output per man hour in manufacturing up by 47 per cent between 1955 and 1960. Against this 47 per cent gain in productivity, hourly wages rose only 29 per cent. As a result, corporate profits more than tripled. Corporate profits after taxes were equal to 10.4 per cent of national income in 1960, compared to just half that in 1955. The comparable figures for the United States were 5.5 per cent in 1960 and 6.5 per cent in 1955. While the Japanese rate doubled, the U. S. rate fell 15 per cent. The Japanese businessman has good reason to think that investment pays. The strength of this conviction may be great enough to sustain the level of plant and equipment investment even if the going gets a little rough in the months ahead.

The Philippines

Next to Japan, the Philippines is our most important trading partner in the Far East. The outlook in the Philippines is certainly for continued political stability. Economically the country has great potential. Its agricultural and mineral resources are substantial, and industrial development is proceeding at a fairly rapid pace, the index of manufacturing production having nearly doubled from 1953 to 1960. The rate of investment in the Philippines, foreign and domestic, has probably not been as high as the potentialities would justify. This, I am sure, has been due in large part to the fact that for the past decade the Philippines has been burdened with an unrealistic exchange rate structure accompanied by controls on imports and foreign exchange that have unquestionably deterred foreign investors. The official policy of discriminating against non-Filipinos in certain areas has probably also added to the fears of investors and may have driven capital out of the country.

The new Philippine Government on January 22nd of this year instituted a bold program of exchange reform which for the first time in a decade has given both Filipinos and foreigners complete freedom to buy and sell the Philippine peso without restriction. The Government has permitted supply and demand to determine the exchange rate for the peso, and it seems to be settling down at a rate of around 28 cents. This compares with the prewar value of 50 cents, which the Government mistakenly tried to maintain for so long during the postwar period in spite of the obvious wartime depreciation of the currency. Freeing the peso has been coupled with tighter credit policies and promises of firm fiscal policy. If the new administration can succeed in warding off inflation, we will see the emergency of a stable currency in the Philippines, which will go far to create an attractive climate for investment and growth.

Other countries

Time does not permit a country by country analysis for the rest of the area, and generalizations are dangerous since performance and problems vary widely from country to country. If forced to generalize, one would have to say that over the past decade most of the countries of the area have made genuine, though in many cases modest, production gains and that levels of living are improving. The outlook is for a continuation of this trend. It would be surprising if there were any sudden acceleration of the growth rate in most of the Asian countries. The efforts to force a more rapid pace of development by government planning in this area have not been crowned with much success. Indeed, the Annual Survey published by the Economic Commission for Asia and the Far East for 1961 finds that those countries that have relied most heavily on governmental planning and direction of the economy--India, Indonesia, Pakistan and Ceylon--have been the least successful in accelerating the growth rate. One detects in the ECAFE report a substantial measure of disillusionment with centralized economic planning growing out of Asian experience. It notes that the Asian countries have suffered from misdirected investment, that agriculture has often been shortchanged, that the so-called infrastructure has sometimes been given too large a share of the scarce resources available, and that priorities in industrial investment have not always been determined by proper criteria. Cost-benefit ratios for government projects have not been as carefully computed as for private ventures, and governments have often not subjected themselves to the discipline imposed by realistic pricing of capital and foreign exchange.

There is a growing realization that the key to economic growth in most of these countries is not so much the amount of capital that can be forced into the economic system, or that can be extracted by high taxation and forced savings. What these countries generally need are changes in institutional patterns that stand in the way of obtaining higher rates of output per man, given the capital that is already available. There is still too little attention given to this aspect of the problem. It is easier to get--and to give--foreign capital than to strive for the institutional changes that are so badly needed, but the latter will yield greater dividends in the long run and may be indispensable to any significant progress in raising living standards.

To illustrate, let us assume that we have a country with a population of 90 million and a labor force of 30 million, earning on the average the equivalent of 40 cents a day. If the labor force were employed an average of 300 days a year, its annual income would total $3.6 billion. If the labor force could be increased by 10 per cent, or if any combination of these conditions could be obtained, to increase output per man 10 per cent, its income would be increased by $360 million or more, a sum that compares very favorably with the amount of assistance a country such as this could expect to obtain from foreign aid. Note that this would be additional income, which would continue to accrue to the country year after year as long as the same amount of effort were put forth. A similar amount of money introduced as capital investment, on the basis of incremental capital output ratios computed for Pakistan and Ceylon on the basis of the experience of the 1950's, would generate only a third as much income. If income generated per dollar invested were no higher than India succeeded in realizing during the 1950's the country would find its annual income increased by an amount equal to only a fifth of its investment. 2/

This helps explain why the results of the efforts made to promote growth in the less developed parts of Asia have been disappointing to those whose expectations were high. The improvements in productivity that result from grafting a small industrial sector onto a predominantly agricultural economy affect too small a part of the working force. No less important is the fact that the introduction of modern machines will not guarantee the lifting of worker and managerial skills to the level necessary to the economic employment of the equipment. The promotion of industrialization in a number of Asian countries has had disappointing results because of the rewards going to both management and labor have been higher in relation to productivity than the ratios prevailing in other parts of the world. In simpler terms, much of the industry has not been competitive, and its development has led to an expansion of import requirements in the form of raw materials and equipment that has not been matched by an increase in earnings from the export of industrial products. This kind of development cannot be long sustained without some kind of external support, but the indefinite provision of such support may unduly delay the achievement of true competitive strength. In the long run, the lash of competition combined with the incentive of adequate rewards for individual initiative may contribute more to the progress of the less developed countries in Asia than protectionism, paternalism, and central planning.

2/ Economic Commission for Asia and the Far East, Draft of Economic Survey of Asia and the Far East for 1961, Part I, p. 1-51.