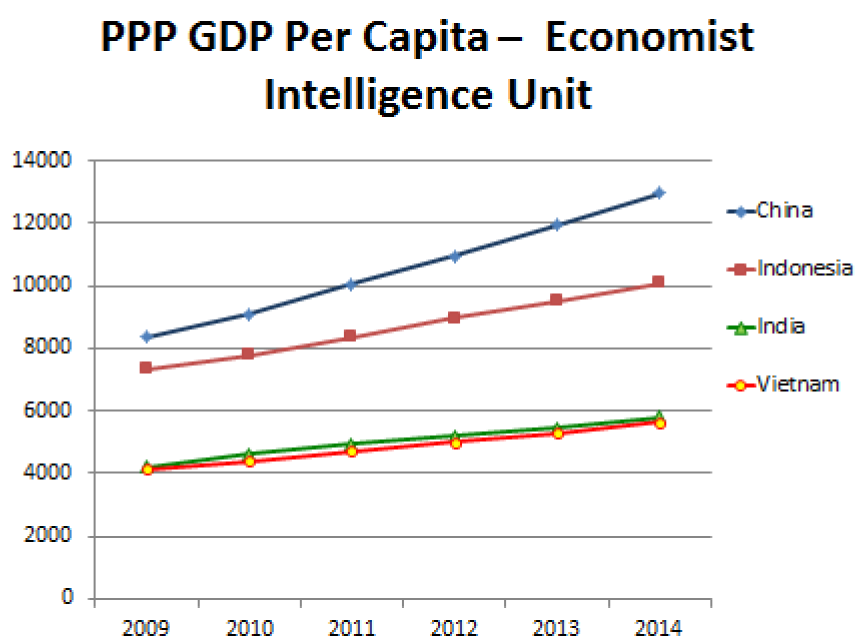
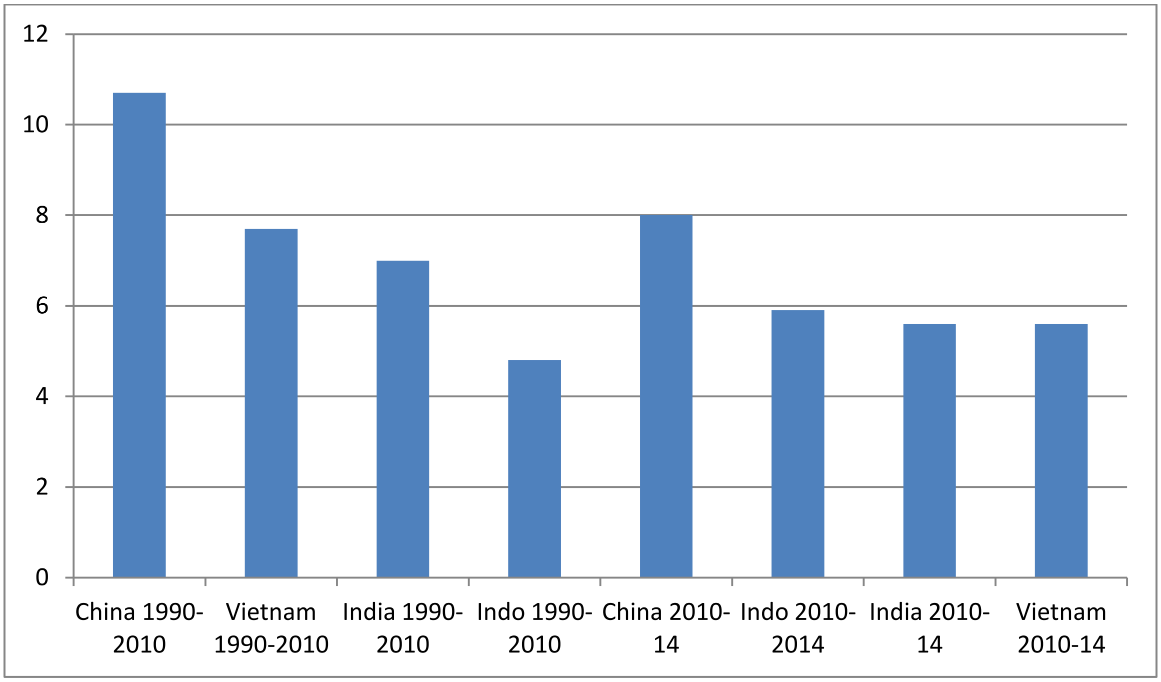
China, India, Indonesia and Vietnam: In the same League?

The per capita income level and general economic performance of four countries is compared in this paper. The nations used in comparison with Vietnam will be China, India and Indonesia. All three have large amounts of labor, are in Asia, and have experienced periods of rapid growth with investment/GDP ratios of 30% or more. China is the richest, Indonesia in the middle and India and Vietnam the poorest of the group. National income per capita best compared at PPP (Purchasing Power Parity) prices. China, with nearly $12 thousand in 2013 is the leader, while Indonesia ($9260) is next and India ($5350) and Vietnam ($5030) are almost equal. Past growth studies suggest that it is easier for GDP to grow fast at relatively low per capita incomes than higher ones. A graph of these changes over recent years is shown below. The data for 2014 are estimates.



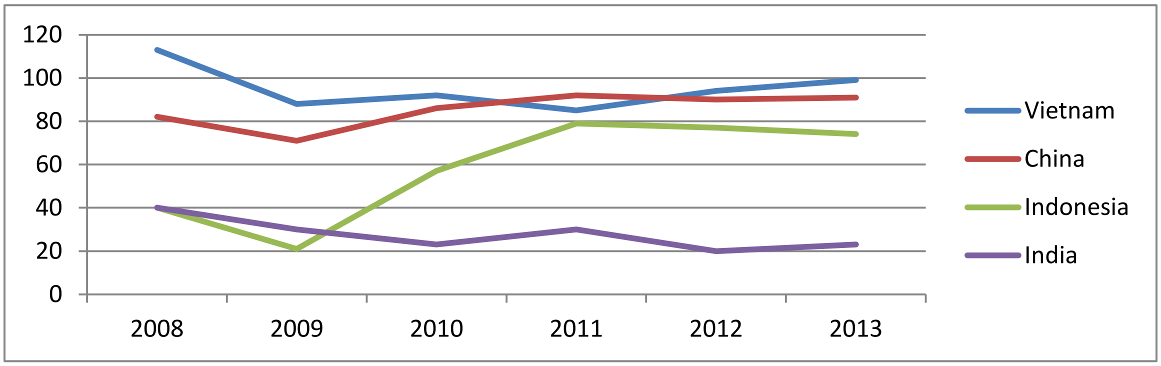
Vietnam grew quickly from 1990 to 2007 but then slowed down to the 4-6% growth typical of richer ASEAN economies, even though its income remained rather low. As suggested, the initial expectation is that India and Vietnam would grow the fastest; Indonesia would be in the middle; and China would be growing the slowest. This is not exactly what happened! The graph clearly shows that China grew the fastest in both periods, though it slowed down the most too – from 10.7% to 8%. Vietnam, though much poorer, grew only 7.7% in the first period and then slowed to 5.6% in the second. India also slowed from 7% to 5.6% while Indonesia actually accelerated from 4.8% to 5.9%. The slow early Indonesian rate reflects the huge 1997-98 crisis and output collapse. Given that Vietnam was just starting its reforms in the 1980's and then taking advantage of more trade and investment opportunities, it is not surprising it did well initially. It is more surprising it slowed down so much while Indonesia sped up. (To get per capita GDP growth, population growth rates need to be deducted from GDP growth. China's population growth is less than ½ of 1% now and the other three are close to 1%. A year.)

Annual Growth Rate of GDP from 1990-2010 and 2010-2014



One interesting statistic is the ability to attract FDI. In this respect, Vietnam had been doing well but inflows have slightly declined since 2008, while they rose sharply in Indonesia, gently grew in China and fell even more than Vietnam in India. In per capita FDI terms Vietnam is still doing well, as the graph shows. However, it is also the smallest economy and population, so higher per capita flows are expected in small and open economies. Three of the curves are fairly stable, but Indonesia clearly managed to attract a great deal more FDI than previously. (Source: World Investment Review 2014, Annex Table 1; population from the World Bank.)

Per Capita Inflows of FDI from 2008 to 2013 ($ per capita)

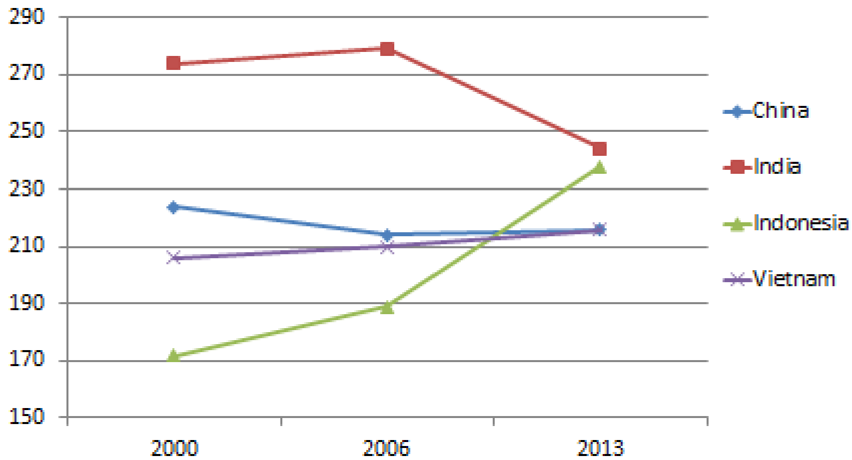


What determines flows of FDI? It is many things of course – raw materials (especially relevant for Indonesia), trained manpower (helpful in the Indian IT sector and for China's manufacturing) and the general business environment. This environment is often measured using the "Doing Business" surveys undertaken each year by the World Bank. The best numerical ranking of any nation was Singapore with an 88. Vietnam had a 64.4; China a 62.6; Indonesia was 59.2 and India was 54. This exactly matches the per capita FDI levels, suggesting that the ease of doing business is also a factor. These scores are based on the "distance to the frontier" or best rated country in each of ten categories.

Another way of thinking about the FDI inflows is to take Vietnam's change in FDI as a share of the inflows to Southeast Asia. The net change in FDI flows to Vietnam from 2008 to 2013 was a drop of $679 million for Vietnam and a gain of $75,000 million for all of SE Asia. That is the annual inflow for all of Southeast Asia rose from $50 billion to $125 billion and Vietnam participated in ***none*** of that expansion! Its share of the total FDI fell from 19% to 7%. This suggests there is more to the FDI issue than the ease of Doing Business.

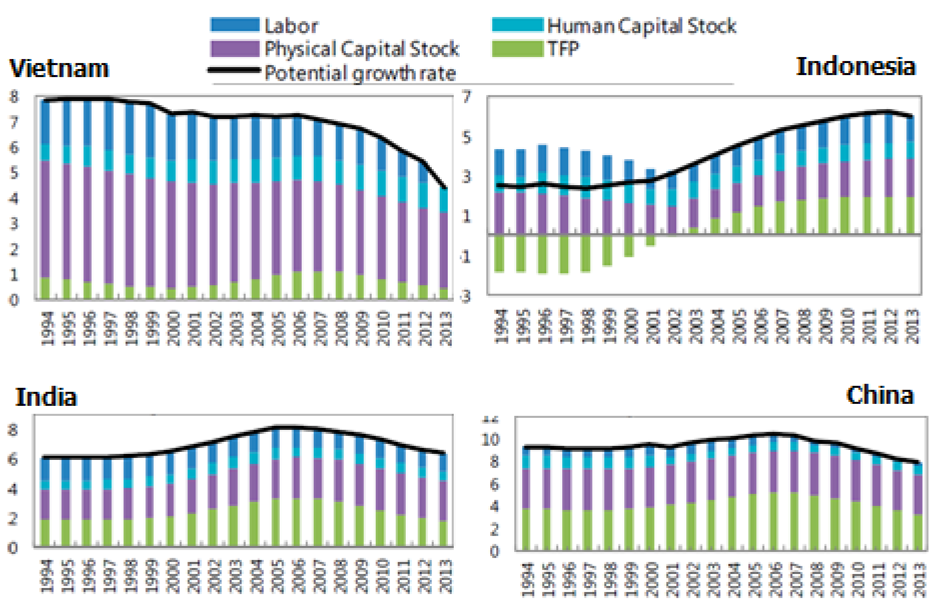
Perhaps investors also look at the governance of a country – how stable it is likely to be in the long run. If we add up the percentile ratings of six types of governance for 2000, 2006 and 2013, we see the following: China and Vietnam basically move sideways; India is falling and Indonesia is rising. To the extent that investors look forward, this pattern may predict the actual changes in FDI observed since 2009, especially with India'

Governance Changes Since 2000



An important part of growth analysis is to see where the growth came from. Basically, you can grow by increasing labor (including the quality of labor, not just the number of workers), capital, or productivity. The IMF looked at several Asian economies and found the following:

Estimated Contributions to Economic Growth



Source: IMF, Potential Growth in Emerging Asia, 2014.

First of all, notice that the vertical axis of each graph does not top out at the same value. The peak value of China is 12% while for Indonesia it is 7%. Notice that the total potential growth (the top black line) is falling for all nations except perhaps Indonesia. Vietnam has the fastest decline from 8% in the middle 1990's to less than 5% now. Indonesia grew from 3% to more than 5% in the same period. While slower labor force growth is part of Vietnam's slowdown, there is also a slowdown in capital's contribution and a very low rate of total factor productivity growth. Indonesia actually switched from negative to positive TFP growth! A low TFP growth means that growth will mainly come from increasing inputs – and if labor growth is slowing and investment to GDP is dropping then there is not much to boost growth.

A lot of what looks like TFP growth comes from switching sectors. If people do not produce much in farming or petty services and do produce more in factories or higher level services, then switching workers from the low to the high productivity sector will boost growth, even if neither sector has increasing productivity. It will look like productivity is growing when mainly, people are changing sectors. If Vietnam has largely completed that transition, or if it will change only slowly now, then that source of productivity growth is lost.

It might be useful to simply tell a story about each country in terms of its past policies and future challenges and prospects. The purpose of a story is to fit many different facts into a single picture, much like putting pieces of a puzzle together helps us see the big picture.

China

China grew at double digits for decades and is now likely to slow down. The question is how soon and how much. The reasons for suspecting a slowdown are first, that most countries slow down at its current per capita income and second, it is hard to sustain many decades of such rapid GDP growth. Even the far smaller and more nimble economies of South Korea and Taiwan were only able to maintain fast growth for three to four decades. But more than that, the incentives for investment and production in China have been set by the Communist Party personnel system. If factories spewed pollution but local production increased, the head of the county or province would be promoted. If unneeded roads or buildings were built but GDP growth stayed high, promotion was likely even if banks or bondholders were left with losses that would have to be subsidized by the government.

Water shortages in the north grew severe as ground water was used up and local rivers polluted, so $60 billion was invested so more water could be brought up from the south. But the land over which the water flowed picked up so many heavy metals that even the southern water became polluted. Better water treatment or cement lining of channels costs money but does not deliver more water. Similar problems exist with air pollution. Money will have to be spent to maintain output rather than to increase it.

In 2008, the government began to boost its money supply to keep growth high. Money supply grew from $7000 billion in 2008 to $20,000 billion in 2014. This jump in money supply exceeded the money supply growth in the rest of the world! Yet the economy is slowing down while bubbles appeared in real estate, the stock market and various physical assets. While reported growth is 7.3% this year, electricity and car sales are growing half as fast and steel and oil growth are close to zero. Real estate sales are down 10% and import values are falling.[1]

The Chinese economists know this – they argue for a slowing down of growth and a rebalancing away from exports and property or industrial investment to consumption and needed public infrastructure such as pollution control. However, managing this transition will be tricky and the banks hold huge amounts of loans made for past shaky projects. As the population ages, it will want to draw down its savings but there will be too little "good" loans to be called in. Meanwhile, workforce size is already shrinking. This might explain the expected decline in the growth rate by the Conference Board to below 4% after 2020.

India

India has a growing labor force but historic problems of caste. While about ¾ of adults were said to be literate in the last census, an NGO tested those "census literate" people and found over half could not read the name of the destination city on the side of a bus! It is hard to move into value added production when a majority of workers are functionally illiterate. The falling levels of governance, poor infrastructure (worse than Vietnam or Indonesia), and sporadic electricity supplies make it difficult to sustain rapid growth without shortages, congestion and inflation.

The new Prime Minister has already ended fuel subsidies and allowed natural gas prices to rise. He may be able to make some headway against entrenched corruption among politicians and government officials. Many anti-poverty programs work poorly due to administrative theft. He has to improve those he keeps and take the savings to improve infrastructure so that job creation is easier. Cutting red tape might also help India attract more FDI – it gets very little per capita – only $20 or so a year or a quarter to a third of Indonesia's level.

Finally, India is perhaps the only nation in this group that has a widespread armed insurgency going on within its borders. Tribal people and leftists called Maoists or Naxalites [2] influence or control nearly a third of India, especially in its mineral-rich eastern portion. These groups, containing perhaps 40,000 armed fighters, have been fighting since the 1960's. It will be hard to get rapid and sustainable growth without dealing with these groups. If Prime Minister Modi can

[1] "Beijing cannot count on easy money to sustain its economic miracle" by Ruchir Sharma, Financial Times, December 17, 2014. The author is head of emerging markets at Morgan Stanley Investment Management.
[2] http://www.huffingtonpost.com/daniel-wagner/indias-naxalites-remain-a_b_3655315.htm

overcome these obstacles, then India probably can grow faster than the 5.5% projected by the Conference Board for at least a few decades. The advent of cheaper fuel and better low-pollution technologies would help India avoid some of the worst excesses of China. The advantage India has is that governments can and do change peacefully by election rather than by Party purges or outright violence. The problem India has is that the entrenched elites often make it hard for even a sincere elected government to make much progress.

Indonesia

Indonesia is a resource-rich country that has only recently broken away from the oligarchy left over from the Suharto era. It had grown 6-7% a year from 1967-1990, but then slowed down to 4-5% - burdened by a catastrophic 15% decline in output in 1998. It decentralized its resource taxes and administration in 2000 and has slowly dealt with some, but not all, of the constraints which have slowed it down. The list of problems includes huge and inefficient fuel subsidies (just adjusted), a poor educational system, an overvalued exchange rate, spotty electricity supplies and poor infrastructure. In addition, governance had been very poor in 2000 but steady progress has propelled it past Vietnam and China and almost up to India.

It is now nearing the end of its rapid labor force growth, though working age adults will continue growing but at a slower rate than previously. (The working age population will only grow by 1 million a year from 2015-2025 while past labor force growth has been 2 million a year and is approaching 120 million.) Much will depend on its ability to invest efficiently and improve the quality of its labor force. By removing constraints, attracting more FDI in manufacturing, and redeploying revenues away from fuel subsidies to infrastructure and electricity, Indonesia should be able to grow in the 6-8% a year range for some time.

The ability of its democracy to discipline corrupt politicians is uncertain, but the fact that Indonesians elected a candidate from a poor family over a retired general who was a son-in-law of Suharto and had billionaires backing him suggests there is hope. The ability of the Indonesian security forces to control and defuse extremist religious groups is also promising. Unlike Thailand's south, they managed to settle a long-running dispute in Aceh province. As of now, the prospects for the future in Indonesia look better than most other developing nations.

Vietnam

Vietnam is a country that did well for 15-20 years and then slowed down. The mystery is why. It has a better geography than Indonesia, which is spread over thousands of islands with many ethnic groups and languages. A single road and some ports connect most of Vietnam's population and production. Its agriculture has been strong. Its K-12 education system is better than most, especially at the top and middle, though this has not been established with international testing. Health statistics look good and pollution levels are lower than in China, due in part to less coal use. It is investing a third of or so of its income every year, enough to sustain 7-8% growth in the past. Its electricity supplies, while strained at times, have grown rapidly and now exceed 1200 kWh per capita, far more than Indonesia or India. It gets high amounts of FDI per capita and keeps its exchange rate competitive. Yet it is growing about the same rate as India (5.5% annually from 2012 to 2014) with its many problems and not getting any of the increased FDI flowing into Southeast Asia.

FETP economists have argued that economic policy in Vietnam is schizophrenic. It allows FDI but pours billions of dollars into inefficient state enterprises. It invests in infrastructure, but often allocates the projects in a political way that saps the investments of real efficiency. The Party still has reservations about private companies, fearing they will become a political force that might become politically active. The result is not stagnation, but a lack of focus. Given its many natural advantages, Vietnam lately has been a middling country with moderate growth. What is needed to realize its full potential? That is the third paper's topic!