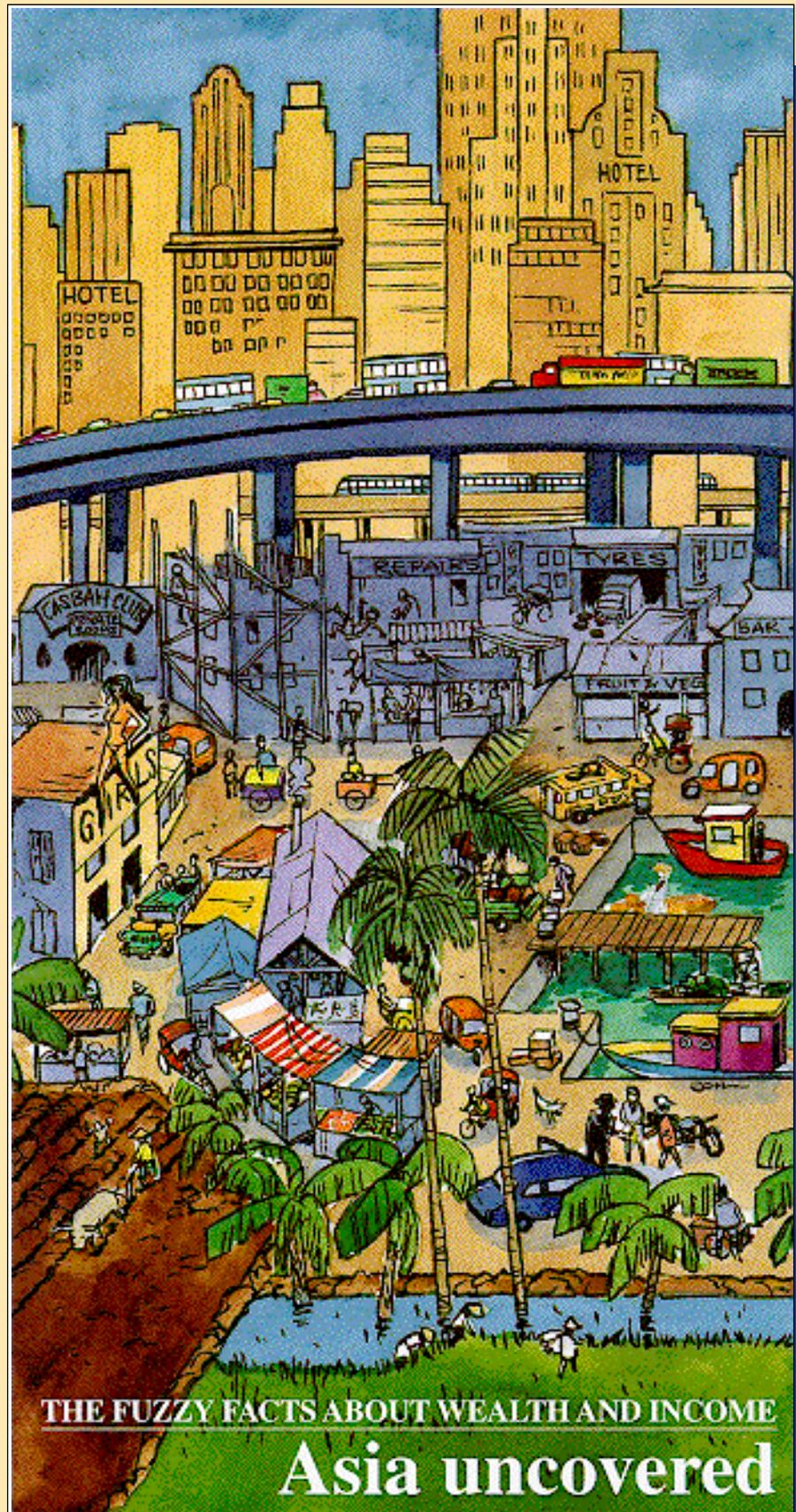


THE REAL MYTH OF
ASIAN GROWTH II



CONTENTS

"Into every tidy scheme for arranging the pattern of human life, it is necessary to inject a certain dose of anarchism."
– Bertrand Russell, **Sceptical Essays**.

"Patches and shades of gray are the two key ideas of fuzzy logic."
– Bart Kosko, **Fuzzy Thinking**, Flamingo 1994, (p.161).



GENERAL SANTOS: The taxi says it all about the Philippines' so-called "backwater"

ASIA UNCOVERED

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Jim Walker, 12 May 1997

THE EMPEROR HAS NO CLOTHES

"What really counts with fuzzy systems, the real value added, is the tie between words and sets and between knowledge and patches. Certain knowledge, small patch. Uncertain knowledge, big patch. No math model. That's the advance."

– Bart Kosko, *Fuzzy Thinking*, Flamingo 1994, (p.177).

TAIWAN PRODUCES national income growth forecasts to two decimal places. The Directorate General of Budget, Accounting and Statistics currently expects GDP growth of 6.20% in 1997 (the Chung-Hwa Institute, on the other hand, is looking for 6.26%). Newspaper articles are written and analysts comments are made on revisions of a few one-hundredths of a percentage point to these forecasts. The exercise would be laughable were it not so sad.

Taiwan also has one of the most active informal credit markets in Asia – academic articles have been written on its size and importance to the economy (all the more significant in view of the underdeveloped banking system). **Excellence**, a monthly magazine, in an article in 1993 estimated that the underground economy accounted for 40% of overall economic activities. According to official statistics, the underground economy formed 30% of GNP. The following quotation is taken from an article in **Business Taiwan** on 20 January 1992:

"In 1982, a delegate at a provincial meeting said that Taiwan has every underground activity except an underground railway."

Yet still the authorities insist on pinpoint growth forecasts – miraculously, they are rarely out by much. There again, economic accounts, like company accounts, can be massaged in a variety of ways (do not forget, national income accounts are unaudited). Spurious accuracy is one of the most pervasive and misleading aspects of economic analysis, especially in developing countries. In that respect, the economics profession does the investment community a huge disservice day in and day out, not just in Asia but in the developed markets too. Regardless, minute dissection of even the least robust data forms the basis of asset allocation decisions the world over.

But while the economist as emperor is a trifle exposed, his and her audience are well and truly party to the deception. The recipients of economists' forecasts and analysis – it would appear – willingly sus-

pend disbelief at almost every turn, possibly because no alternatives are on offer. The result, rightly, is a rumbling discontent with the economics profession for its failure to deliver what it so foolishly promises.

In this follow-up to last year's special report on *The Real Myth of Asian Growth (The Shapes of Things to Come: Geometry of growth*, May 1996) we wish to expose the weaknesses of economic data and economic analysis in Asia. And we especially wish to do so at this point of relative pessimism among many investment management houses about Asia's future. Why now, when the sustainability of Asia's growth 'miracle' is being questioned? It is precisely because the data are not clear, on many levels, about economic conditions in the region. For one thing, we can state quite bluntly that the economic data available to us understate Asia's true income and wealth as it stands today. In so doing, the data give rise to doubts about the region's ability to promote and sustain growth internally. Those doubts are misplaced.

It is our view – one that we outlined in the **Geometry of growth** and have summarised as Section Seven in this report -- that the Asian region is merely at the dawn of its growth upswing, not, as the bears would have it, approaching dusk. But our vision of Asia's future is of a relatively rich region reaching into its own hinterland in order to extend and exploit the Asian marketplace.

The internal growth engine, given appropriate liberalisation and deregulation policies, will replace the export-led growth policies of the last few decades. The huge challenge for Asian governments is in recognising the need for a policy re-orientation around this goal (this will be the subject of the last part of our trilogy on *The Real Myth of*

Asian Growth). The lesser challenge is for them to recognise the fact that Asia is already rich and diverse enough to support such a strategy.

Asia uncovered

OUR CONTENTION throughout this report is that our knowledge of Asian economies is characterised by big patches, in other words, uncertainty prevails.

This is true of income and wealth – which are understated systematically – as well as growth which, in some instances, is manufactured by economic managers while in others, it is inadvertently over- or understated.

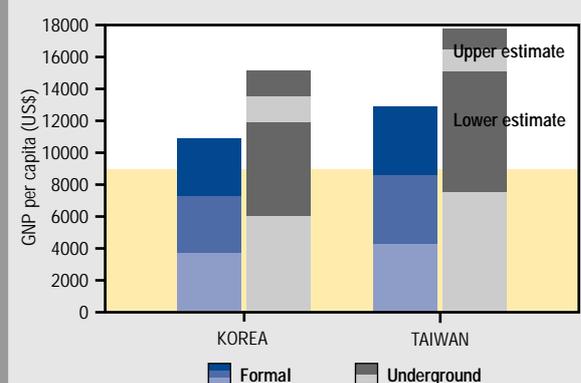
What is for sure is that the two-decimal place accuracy of Taiwan's planners is a bad joke and should be treated as such. Reality, no matter how patchy, is more appropriate always than spurious accuracy. Growth ranges and growth trends – the **pattern** of growth in other words – is about the best we can hope to forecast with our limited knowledge of Asian economic reality.

To graphically demonstrate the extent of our uncertainty, Figures 1 and 2 show, for the various countries where reported studies have been undertaken, the ranges associated with the underground or informal economy. Invariably this unreported aspect of reality adds to the measured-GDP numbers.

This is not a trivial point. In all economies - emerged and emerging - there exists an underground economy. Most estimates, even in the most developed countries, put it at around 15% of recorded GDP. Often, estimates have greatly exceeded that number.

The estimates of Asian underground activity range from 8.9% of GDP in Korea (even superficial precision sometimes

FIGURE 1: THE FORMAL AND INFORMAL ECONOMIES IN KOREA AND TAIWAN, 1996



Sources: Official country data and various underground economy studies

creeps into estimates of the informal sector) to as high as 70% in Thailand. Such restatement of GNP, on conventional GNP per capita terms, would shift Korea into the high-income country bracket and Thailand into the upper-middle income bracket as defined by the World Bank. But there is a more simple message. Throughout the region economies are richer than they appear at first sight. This comes as no surprise to those of us who have travelled beyond Asia's capital cities and tourist resorts (see Section V, a case study of such an area).

The message from these charts and the studies underlying them is that official GDP is a flawed measure of the Asian economies. This is true for three specific reasons which we will examine in more detail in Sections II and III but, to summarise, are: first, the informal economy is, by and large, more extensive in developing countries than in the mature economies. As a starting point we can add on average 30-40% to GDP estimates at the outset.

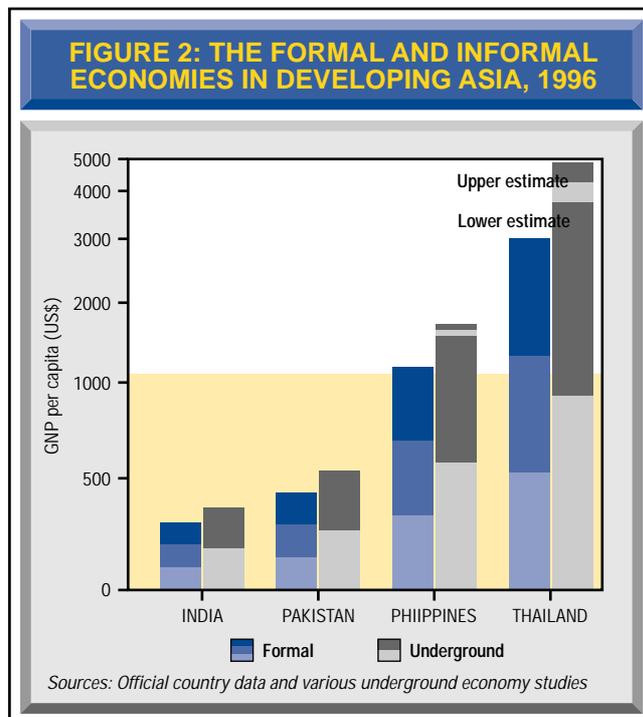
Secondly, the illegal economy - drugs, gambling, prostitution - also figures large in some Asian countries (although it is dwarfed in most instances by the remainder of the informal economy). Nevertheless, illegal activities can add up to 15-20% to GNP (as a Chulalongkorn study in Thailand recently postulated for that economy).

Thirdly, there is incomplete statistical capture. The problems of data deficiency and patchy statistical recording are addressed more fully in Section III. Suffice to say here that this further blurs the true picture of growth and income in developing countries.

What are the implications of our analysis of the underground and non-captured economies in Asia? First, the stark and easy conclusion is that wealth and income are understated in the region.

From the sketchy national studies that we have, coupled with an analysis of the body of literature on informal sector activities, we would argue that this understatement is greatest in China, Indonesia, the Philippines and Thailand.

A reasonable guesstimate would add at least 40% onto existing GNP aggregates



for these countries, possibly considerably more. We also believe that India and Pakistan should be added to this list although more formal estimates - one an IMF study - conclude that the informal economy is only in the region of 20% of GNP in both countries. In Section II we will present evidence that suggests to us that 20% is far too low.

In the more mature Asian economies the informal sector is likely to be smaller, although studies in Taiwan suggest that this is only marginally the case. Official Korea Tax Institute estimates put the underground economy at less than 10% in that country although other agencies arrive at much higher figures.

There are no studies on Hong Kong and Singapore but the preponderance of international trade activity in both entrepôts suggest that domestic informal activities are likely to run at significantly lower levels, as a percentage of GNP, than elsewhere in Asia.

Likewise, we have found no published estimates of the informal economy in Malaysia but it probably lies somewhere between the mature and more developing Asian countries.

Secondly, our analysis calls into question the reported growth rates in Asia. In some instances, the Philippines for example, they are clearly too low. However, for other countries, economic growth over the last decade may well have been inflated. This is most especially true in countries where significant changes to the tax regime on domestic sales and foreign trade have taken place and where more sophis-

ticated data collection techniques have been introduced.

A process can be envisaged where hitherto informal sector activity is steadily captured in the formal economy. This increases the rate of reported GDP growth in any one year but may be at the expense of the size of the informal economy. The result is fast growth in GDP but slower expansion of the total national income - formal plus informal - of the economy. This, in turn, can have implications for corporate earnings potential and macroeconomic policy.

Thirdly, and following directly from the last point, policies based on flawed macroeconomic growth estimates are likely to be ineffective or positively harmful. The clear lesson here is that domestic policy frameworks must be designed with two things in mind: flexibility and simple nominal targets. Asian governments have to take the fuzzy thinking message to heart - macroeconomic data are characterised by big patches i.e., there is a great deal of uncertainty surrounding them. In order to best handle this uncertainty a rule-based policy framework which applies flexibly and which operates on a variety of signals is necessary. Fixed price policies - such as the quasi-fixed exchange rate system in Thailand - inevitably lead to fatal rigidities, no matter how impressive the early successes.

Finally, we believe that our analysis supports the conclusion made in the **Geometry of growth** last year, that Asian growth can be sustained in the future by the adoption of appropriate domestically-oriented policies.

These include the liberalisation and deregulation of internal markets and the steady absorption of the informal sector into the reported economy (which follows directly from deregulation). In this way more appropriate policy signals will be determined and Asia's reliance on OECD export markets will be reduced.

That we know less about Asia's wealth levels and its achieved growth rates than hitherto has been claimed is not an admission of weakness - it is a source of inspiration. So much remains to be discovered - uncovered - in Asia's economic emergence.

So much of the region's potential remains to be unleashed. But, at the same time, we must admit reality into our thinking; that means less precision, less emphasis on macroeconomic aggregates, more understanding of data deficiencies and more patience in realising potential returns.

THE INFORMAL ECONOMY: DRAG OR DRIVER?

“Recent studies have shown that microenterprises and the informal sector can be among the most dynamic and healthy sectors in developing economies. As such, they fill an essential role in providing jobs for large numbers of urban workers and adapting both to general patterns of economic growth and to negative shocks. Not only do the informal sector’s entrepreneurs survive in the face of government subsidized large-scale industrialization; their flexibility and adaptability have allowed them to provide essential goods and services on which large-scale, modern manufacturing enterprises depend, such as clothing, weaving, woodwork, repair services and production of small machines.”

– A L Chickering and M Salahdine (eds.), *The Silent Revolution*, ICS Press, 1991, (p.4).

THE UNDERGROUND economy. The name conjures up visions of illicit bargains and shady deals in the backstreets and cafes of most major cities. Now think of the jeepney driver in Manila, the motorbike taxi in Bangkok, the myriad dealers in the unorganised money markets in Taiwan, the street vendor in Jakarta, the Mom and Pop stores in every city, town and village in the Philippines, the odd-job man in Singapore, the bicycle repair workshop in Kuala Lumpur – retailers, money lenders, farmers, entrepreneurs, taxi drivers, couriers and a whole host of faces and activities that we are everyday familiar with. That is the bulk of Asia’s underground economy.

But there is more – small and medium sized enterprises, co-operatives, offshoots of state-owned enterprises in China, credit unions. They too form part of the informal economy. Then there is the sleazier side of life – the drug traffickers, prostitutes and gambling racketeers. They too operate underground – by necessity rather than choice.

In 1987 Hernando de Soto published a study on the informal sector in Peru called *The Other Path*. This study turned on its head the prevailing wisdom – as espoused by the International Labour Organisation – that informal markets were a dysfunctional part of the regular economy. Instead, he found that Peru’s underground economy was characterised by strong growth and enterprise.

Often the markets in specific products or services were highly organised in themselves although still operating outside the purview of the authorities (after paying the appropriate bribes, of course).

Certainly pay is low and conditions are poor – working hours tend to be long – but this part of the real economy exists largely because of the failure of the formal sector and government policies to ab-

sorb the great mass of the urban poor. In Peru poverty existed in the informal sector but so too did riches.

The informal economy studies contained in *The Silent Revolution* concentrate on Asia and the Near East. A similar pattern was found as in the de Soto book. Avoidance of taxation and, perhaps even more important, the avoidance of red tape and interminably long delays in setting up formal businesses, were the key reasons for the burgeoning informal sector.

As we shall see below, the informal sector is an important part of the Asian economic scene. How important can only be guessed at.

It is likely, however, that growth in this segment of the economy is faster than in the **domestic** formal sector which, in most economies, is still characterised by government protection, over-regulation and vested interest oligopolies and monopolies.

The scope and consequences of the underground economy

“After being ignored for many years, the underground economy has finally worked its way to the center stage of American public and official attention. The discovery of the underground (or subterranean) economy in the United States is attested by recent editorials and articles in leading newspapers and magazines, hearings by four congressional committees, reports by official agencies (Internal Revenue Service and General Accounting Office), coverage in popular television programs, and professional articles. In this discovery the United States has followed other major countries in which the underground economy has been the subject of official and unofficial attention and studies for some time.”

- Vito Tanzi, *The Underground Economy in the United States and Abroad*, Lexington Books, 1982, (p.69).

IT WOULD seem that just as quickly as the underground economy emerged as a topic in the early 1980s, it submerged again. Can we take this to mean that the ‘problem’ has been solved? The answer is a straightforward no. The fact is that the underground economy still exists in the developed countries as well as in developing nations. In 1976 three different approaches to measuring the subterranean sector (see the box in this section for a taxonomy of terms) in the US found that between 4-22% of official GNP was underground. In studies in Europe the informal sector was found to represent up to 30% of GNP.

However, the equally plain fact is that recognition of the underground economy’s existence complicates matters. It complicates GDP measurements and what these signal to the investment and policy management communities. Moreover, it complicates the policy response if the informal sector happens to be growing at a faster pace relative to the formal economy. Indeed, some researchers have even gone so far as to postulate that the existence of the underground economy is the cause of a number of theoretical and empirical mismatches i.e., that correct theories have been refuted as a result of data deficiencies (and vice versa).

One of the main reasons for the underground economy disappearing from view again – except in academic circles – is that no-one really wants to know. In the developed countries, while this is a pity, it is probably not too important for investment decisions. Indeed, as limitations on government’s role in the economy have increased over the last two decades – partly as a result of the Thatcher and Reagan agendas – the tax burden has grown much more slowly and, in some cases, even diminished. This ongoing process reduces the need to operate informally.

The result, in all probability, is that the underground economy has shrunk in the OECD generally in the 1990s (although the European Union’s Social Chapter may reverse that trend in western Europe).

Measuring the underground economy

BUT HOW can researchers begin to measure something which, by definition, is not recorded? A number of methods are available for estimating the informal economy. Direct survey-based techniques have been used in the US by various statistical bureaux, notably the Internal Revenue Service. These rely on alternative (control) bodies of data e.g., tax returns, being avail-

able to compare with the survey results. Audit sampling is also used to capture tax evaders. These are largely inappropriate techniques in the developing countries.

A second method is census based. It is assumed that small scale enterprises are the most likely candidates to go underground. Census of Employment data which detail firm size by employment level are used to define the reaches of the underground economy. This is an arbitrary approach which is dependent on the questionnaire design (i.e., what level of employment disaggregation it goes down to) and the sweeping assumption that companies with less than, for example, ten employees and self-employed businesses are invariably informal. Moreover, while this might be a proxy for the size of the informal labour market, it is less useful as a guide to the magnitude of the informal economy in income terms.

Developed country researchers have paid little attention to inadequate statistical collection techniques in their explanation of the size of the informal economy. This is unlike the developing countries where poor statistical capture undoubtedly compounds the holes created by the existence of informal activities. By definition, there is no way of estimating the shortfalls of statistical capture – the data aren't captured. (As we shall show in Sections IV and VI, it is relatively easy to identify where there are anomalies, however.)

In short, the underground economy is assumed to exist because of taxation and economic actors' determination to avoid the tax liabilities which recognition in the formal sector would bring. (The informal sector that most studies have sought to capture includes illegal activities within

the definition of informal. Neither the illegal nor the informal sectors pay formal taxes on their output but the latter encompasses activities - such as domestic help and street vendors - which are far from illegal *per se*).

Indeed, the main *raison d'être* of the underground economy (as stated above) is twofold: a) the avoidance of taxation, and b) the avoidance of the administrative costs of setting up small businesses or employing small numbers of people. It is the importance of the second of these reasons that makes the most popular method of underground economy estimation more questionable in developing countries. We shall detail the reason for this below.

For sure, informal sector activities are generally small scale. In developing countries that definition can encompass as much as 70% of the urban workforce. The other main characteristic of the informal economy - an assumption as much as anything - is that it is primarily cash-based (it being easier to avoid taxation in this way).

While this is a straightforward notion in the US, in less developed countries it becomes more complex. There is no reason to expect that informal activities will take place in local currency, especially if one of the motivating forces of underground participation is a distrust of the government.

But it is the cash-based assumption that provides researchers with the dependent variable in most empirical analyses of the underground economy: the ratio of currency-in-circulation (cash) to M2 (the currency ratio). Variations in this ratio over time are attributed to the development of the economy, the attractiveness of alternative liquid assets, financial deepening

and, most importantly, to the variation in tax rates over time. A multiple regression equation is constructed to isolate these effects. This is the approach developed by Vito Tanzi.

In effect, like all other monetary approaches, the Tanzi method is one of 'residual' measurement. After identifying an appropriate multiple regression equation that models the currency ratio, the tax variable is set to zero (or held constant over time) in order to estimate a currency ratio for the formal economy only. Once the formal economy currency ratio is identified it is an easy step to work out the amount of cash associated with the underground economy: it is the residual generated by taking the difference between the forecasts of the currency ratio in the unrestricted and restricted regression equations. This residual is then multiplied by the velocity of money in the formal economy (the somewhat questionable assumption of equivalent monetary velocities in the formal and informal economies is made) to yield an estimate of underground GDP.

This is the method used by the Korea Tax Institute (a unit of the Ministry of Finance and Economics) to estimate the Korean underground economy. It is also the basis of the approach used by the IMF in its 1995 study of Pakistan. For Korea, the latest Tanzi estimates suggest an informal economy of just 8.9% in 1995. The IMF study suggests an average underground economy level of 22.6% over the period 1974-91. We are unconvinced by the application of the Tanzi method in these economies.

Our attempts to model the Philippines using this approach were unsuccessful with

Underground, informal, parallel, black or what?

A VARIETY of terms are used to describe the non-official segment of the economy. Some are general and others are more specific. The following list is by no means comprehensive:

■ **Underground** – Despite connotations with crime, this is one of the most general terms encompassing all legal and illegal unrecorded economic activities. It is equivalent to the little used 'subterranean' term.

■ **Informal** – Is the most neutral description of the unrecorded economy although it gives an impression of casualness that is not justified. Informal markets are often highly organised and

highly efficient in their own right. Less emotive than other terms, it is the one most often adopted in academic research.

■ **Parallel** – More specific than either of the foregoing as it applies only to legal activities which are often unavailable in formal markets for one reason or another. A good example are the unofficial money or credit markets that are tapped in developing countries for the financing of agricultural investments or as capital sources for small and medium sized enterprises.

■ **Illegal** – Usually reserved for activities that are explicitly prohibited by law

- gambling in some countries, drug trafficking, the sex trade. Much of the informal sector is involved in another type of criminal activity i.e., tax evasion, but activities which result in this 'crime' are not in themselves illegal.

■ **Black** – The associations of this term are with wartime, petty crime and unscrupulous traders. In reality it is synonymous with underground.

■ **Fragmented** – Dysfunctional markets that exploit information inadequacies. Not really a subset of our study.

■ **Hidden, unrecorded, unreported and unofficial** are all terms used at times for the informal sector.

FIGURE 3: ESTIMATE RANGES, THE INFORMAL SECTOR BY COUNTRY

	Range(%)	Comments
Korea	9-42	A number of official studies have been published with attention now focussing on the Korea Tax Institute (which uses the Tanzi method). The same Institute which last published a 9% figure for the underground economy (for 1995) was involved in another 1995 study which estimated informal activities at between 37-42%. 9% would appear to be at the low end of the scale.
India	20	A commonly quoted figure although no formal studies appear available. Probably a huge underestimate.
Pakistan	22.6	IMF working paper from 1995 uses a variant of the Tanzi method to estimate the underground economy. Reliance on tax rates alone, as we have suggested above, is likely to bias estimates of the underground economy downwards in developing countries. Too low.
Philippines	25-50	The National Statistical Office admits to a quarter of the economy as being informal. Most other estimates range between 40-50%.
Taiwan	14.4-40	Official estimates range between 30-40% of GNP in the informal sector. Unlike many other countries the concentration of activities is in the money markets – forex dealing, stock trading and curb market lending.
Thailand	25-70	The latter figure (from a Thai Farmers Research report) appears far too large but a recent Chulalongkorn study put the value of illegal operations – drugs, prostitution, gambling, arms trading, oil smuggling and people trafficking – at 17% of GNP. More normal types of informal activities are bound to boost this figure towards the 40-50% mark.

none of the explanatory variables proving significant over the period 1971-94.

Why are we sceptical? For three reasons: first, and primarily, because of the importance of administrative costs as a reason for staying underground in developing countries. Changes in tax rates and the ratio of tax to GDP are relatively easy to model. However, even if tax rates do not rise the informal economy can still be expected to grow in societies where the bureaucracy insists on complicated and slow moving registration processes. Despite tax incentives for registered companies, tortuous procedures and bureaucratic corruption keep most small-scale businesses out of the formal sector in developing countries. Under these circumstances the tax variable in the Tanzi Method is likely to be flawed.

Secondly, official data only measure official taxes. We have commented in our *Infofaxes* in recent weeks on the growing burden of **unofficial** taxes in the Chinese economy. These are forcing some companies out of business and no doubt, many others to flee into the ‘hidden’ economy.

Likewise, bribes and corruption are an alternative form of taxation. In a study by Ruperto Alonzo (included as a chapter in *The Silent Revolution*), he found that one of the “agonizing” procedures official businesses in Metro Manila had to go through was water connection. Contractors normally required a ‘facilitation’ fee to provide the service or else a delay of some weeks would be experienced. There are no measures of this alternative ‘tax’ which can be included in the regression model.

Lastly, the Tanzi method requires a

benchmark period where the underground economy is thought not to exist or to be at a minimum. In developed economies the base period is usually chosen to predate the rise of Keynesianism when big government and big taxes became the norm. Data for such periods in the developing countries do not exist.

Asian evidence

GIVEN THE available data in the region, this leaves us with much less in the way of formal modelling procedures for estimating the underground economies in Asia.

As mentioned in Section I, there have been a number of specific country studies which have attempted to identify and place a value on the underground economy. Most of these we have been able to access only through media accounts.

The values placed on the various informal sectors range widely – from 10-70% of formal GNP. Figure 3 contains a summary of these estimates for six countries in the region.

The currency ratio itself is worth examining. The trend of the ratio of cash to broad money should yield some insights about the direction of change of the underground economy. Moreover, the size of the ratio might also yield some relative insights about the position of the various countries in the region.

In Figures 4-6 (*next page*) we have grouped countries into NIEs (Korea, Singapore and Taiwan), developing-ASEAN (Indonesia, Malaysia, the Philippines and Thailand) and the sub-continent (India and Pakistan). To act as a benchmark in each chart we have included the currency ratio in Japan (where we would expect cash requirements to be relatively small).

Interestingly, the Japanese currency ratio has been on a gradually rising trend in the last few years. Given the difficulties in that economy with the constraints on the financial sector in particular, it is not surprising to see cash activities rising. Informal sector activities are also likely to have become more important in the Japanese economy in this decade.

The results for the NIEs are somewhat surprising. Both Taiwan and Korea register currency ratios lower than Japan (not so surprising is the downtrend exhibited in all three countries in this sample). Yet both have underdeveloped banking systems (see our 1st Quarter 1997 *Eye on Asian Economies [Banks in North Asia: Underdevelopment exposed]*) and both are noted for active curb markets in unofficial finance. Perhaps the explanation – for Taiwan at any rate – lies in the fact that

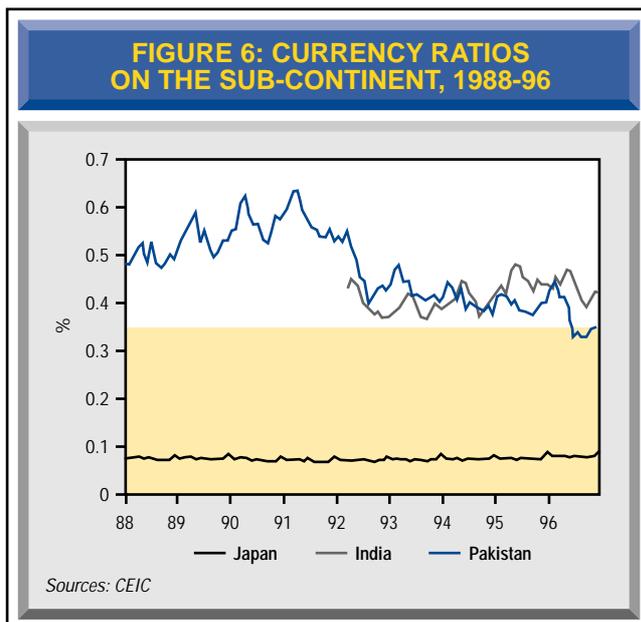
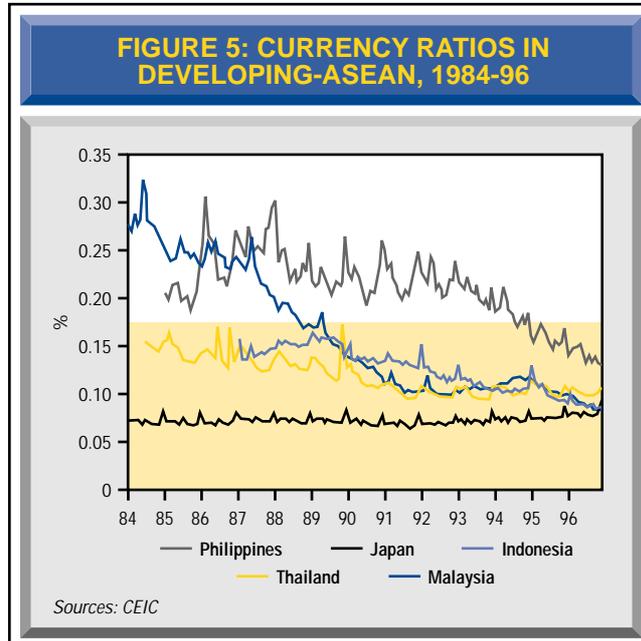
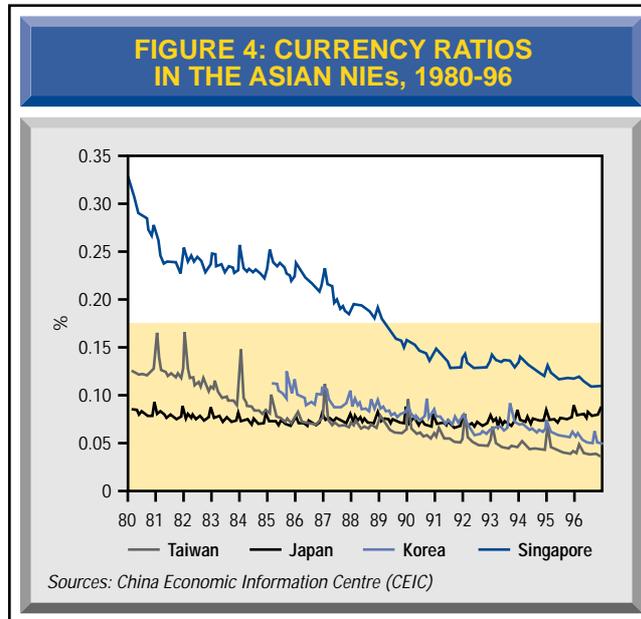
cheque discounting forms the main transactions payment method in the unorganised money market.

In Singapore the currency ratio has been declining over time as we would expect with a society where incomes are rising and financial deepening is proceeding apace. That said, Singaporeans' preference for cash is of the same order as Malaysia and Indonesia (Figure 5), something of a surprise.

The developing-ASEAN trend generally also suggests that the cash economy is becoming less important and, therefore, the underground economy is diminishing in size. This may well be true – assuming, of course, that the velocity of circulation of cash in the informal sector is the same as within the measured economy and that US dollars or gold are not playing an increasingly important role.

Cash activities in the Philippines remain distinctly higher than in the other developing-ASEAN countries - although well off the peaks of the troubled Marcos period and the early years of the Aquino government. Thailand has experienced an upturn in its currency ratio in the last year – a trend that may well continue as the economy hits even harder times.

Figure 6 shows clearly the importance of cash in India and Pakistan. Moreover, the ratios show no systematic tendency to fall. Currency ratios of 40%+



of GNP in either country. If anything, the underground economy is as low as 20%

wealth potential in both of these countries

is understated more than anywhere else in Asia.

In and of themselves, these charts tell us little about the informal economies in the region. Two broad conclusions can be drawn, however. For most countries the cash-economy is diminishing in importance – this is probably partly associated with a move of the informal sector into the measured economy. As we shall show in Section IV, this has implications for the reported growth rates in Asia in recent years.

Secondly, there is a broad hierarchy of currency ratio countries. The more developed tend to use less cash (although, as with Taiwan, it is possible that the underground economy is operating on slightly more sophisticated methods of payment) while the least developed - India and Pakistan - still view cash as king (in all probability actors in these countries have little alternative).

Unfortunately, the Tanzi method and measures of the currency ratio can do little to help us capture parallel currency markets in developing countries. Edgar Feige has pointed out that currency-based estimates of the size of the underground economy in the US may be biased upwards by the fact that a significant proportion of issued US dollar bills are held as stores of value and transactions media outside the US.

The corollary of this is that currency-based estimates of the informal sector in developing countries (where economic actors may have less faith in government's and the authorities' determination to protect the value of the currency) may be biased downwards.

Moreover, US dollars are not the only alternative transactions medium. In India and China gold is thought to play an important role in the informal economy.

Where does that leave us? In all honesty, still groping in the dark. We can safely assert that the underground economy exists. In India, Pakistan, the Philippines and Taiwan it is large. We suspect that this is also the case in China, Indonesia and Thailand. But is it a drag or driver of growth? Again, the evidence is patchy but recent studies have found that the informal sector is characterised by more vibrancy than is normally associated with the formal economy.

In China, where the state-owned companies can best be described as dinosaurs, the small and medium-sized operations which exist nowhere in the official data are undoubtedly the dynamic segment of the economy.

MACROECONOMIC MEASUREMENT: FACTS AND FANTASY

“The positivist’s claim that it is always the statistics that test the theory, rather than the other way round, suggests that the positivist always has more confidence in the data than he has in his own theory. There is the temptation to agree that his lack of confidence in positivist theory is justified. But it could be argued instead that positivist theory tested with statistical aggregates is a case of the blind leading the blind.”

– Roger Garrison, Introduction to Oskar Morgenstern, *National Income Statistics*, Cato Press, 1979

“Empirical macroeconomics is now a well-established profession. Respected academic economists are consulted by government and business for their views on macroeconomic policy, views which usually depend on analysis of official data. Journals are filled, and careers are made, by sophisticated manipulation of these same data. Theories of increasing complexity are tested using the data, and paradoxes of the data are explained by more refined theory. To suggest that the data are badly deteriorating does not provide comfort to academic macroeconomists.” (emphasis added)

– Peter Reuter, *The Irregular Economy and the Quality of Macroeconomic Statistics*, – Ch 8 in Tanzi, op cit., (p125).

“The fuzzy view was just common sense. It was daring and novel at the time because you first had to get your university degrees in the old black-and-white school and then doubt that school and rediscover what any layman could have told you about common sense – it’s vague and fuzzy and hard to pin down in words or numbers.”

– Bart Kosko, op cit. (p 161).

WE ALL know the jokes about economists: all the economists in the world placed end-to-end would never reach a conclusion; what do you get when you put two economists in the same room? Three conclusions, and so on. But there is a serious side to the inability of economists to agree on theory, on the interpretation of each new set of data and on the health of one particular economy or another. The simple fact is that economists, by the very nature of the subject matter, deal with shades of grey, not black and white.

The positivist approach towards economic science – what can be termed the neo-classical mainstream – has been in the ascendancy for over 100 years. Its plunge into the quagmire of macroeconomics was accelerated by the mathematician, John Maynard Keynes.

It should have come as no surprise that it was a mathematician by training that would attempt to portray the world of complex phenomena as a series of linear relationships and macroeconomic aggregates. It is just a surprise that so many students of the subject have been fooled into believing that this approach is anything other than a dead end.

The mathematical economist approach

ning, it was just the Austrians. Complex phenomena are not easily measured, they are not predictable and they are certainly not linear. The Austrians attacked the power of the positivists on the theoretical level – although the arguments are still valid and correct, the assault failed.

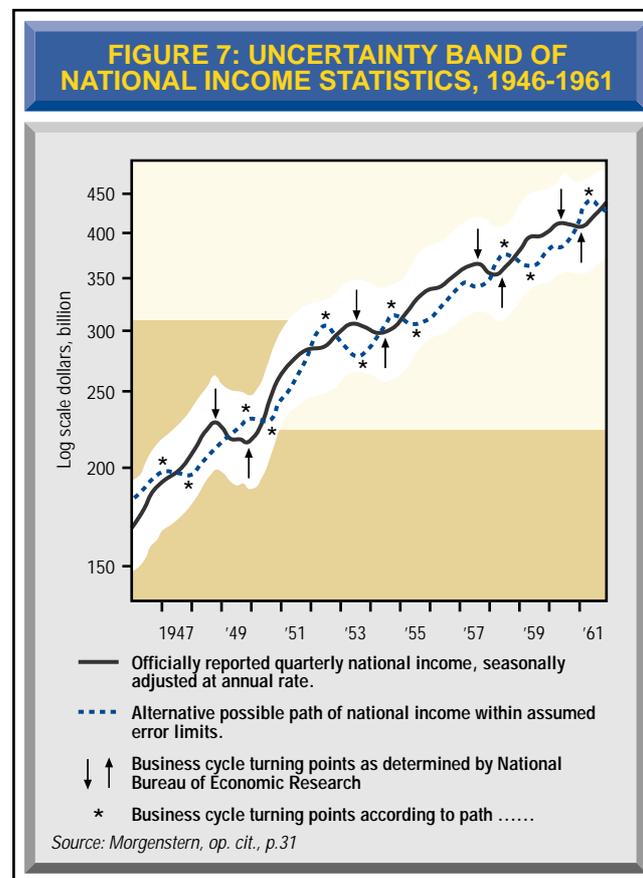
Oskar Morgenstern, an Austrian economist but primarily a statistician and best known as the co-developer of Game Theory with John von Neumann, undermined the whole notion of macroeconomic analysis and forecasting in his book, *On the Accuracy of Economic Observations* (1950, 2nd revised edition 1963). His approach was to point out the shortcomings of national income data – largely resulting from sampling errors, infrequent survey updates and poor statistical capture. He went on to criticise macroeconomic analysis on the basis that it was using fundamentally flawed data.

Morgenstern’s analysis was confined to the developed countries. Figure 7 is a perfect example of the problems he identified. This chart shows the path of officially reported national income in the US between 1946-61. The unshaded area represents the **officially admitted** error bands which can be calculated around the data. The dotted line is just an assumed alternative path that can be drawn within the error limits.

The worrying aspect is that business cycle turning points can easily be interpreted as a) either not a turning point at all, or b) a turning point in the opposite direction from that officially sanctioned.

In short, even in the best equipped country in the world for data collection, no clear interpretations can be placed on even historic series.

Observers may well argue that statistical collection techniques have improved over the last forty years. In a way this is true but cutbacks in government spending have ensured that statistical collection agencies are understaffed and under-resourced. The decline in the number of tax and ac-



and the neo-classical mainstream are now under attack from all angles. In the begin-

counting audits carried out in recent years by revenue agencies (an incentive to move

underground?) is a simple testament to this fact.

Indeed, the radical revisions to US economic data that continue to be made on a monthly, quarterly and annual basis clearly show that Morgenstern's criticisms of the statistics are as valid today as they were when he first wrote about them in 1950. (The current debate surrounding the validity of the US

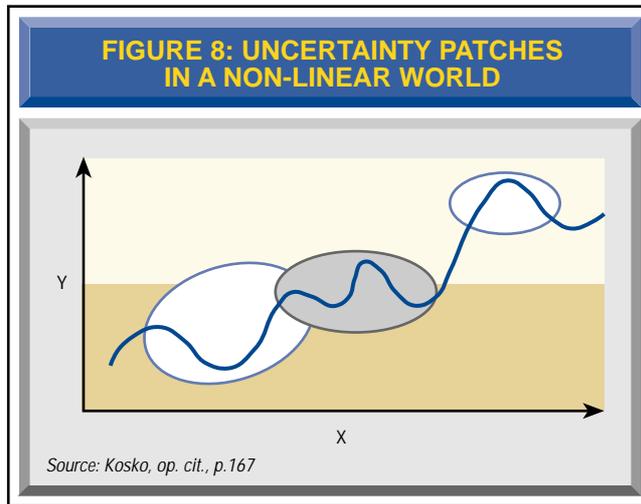
CPI measure is a perfect example.) In fact, all we have to show for progress over the last few decades is more computing power to process inherently flawed data.

Morgenstern's critique is given all the more power by Reuter's observations. Writing from the perspective of a researcher into the informal economy, he suggested that data quality in the US through the 1970s had been deteriorating, not improving. Later studies support the same conclusion. Pozo's collection of essays (S. Pozo (ed), *Exploring the Underground Economy*, Upjohn Institute, 1996) show that the debate is alive and well and just as concerning today.

In Asia, we can question the data quality much more comprehensively (as shown in the contradictions and anomalies we cite in the next section) and safely postulate that the underground economy plays a much bigger role in everyday life. The conclusion? **Asian national income statistics and the growth forecasts produced from them are nothing short of guesstimates with relatively large error bands.**

Finally, the attack on the application of natural science techniques to the social science area is coming from within. The development of Chaos Theory and, now, Fuzzy Logic are attacking the heart of the bivalent, linear world which modern philosophy and mathematics lives in. If Kosko is correct, that not just common sense but the world, including mechanics, physics, maths, is "vague and fuzzy", then new models of economic relationships and new frameworks for economic policymaking are urgently required.

Figure 8 is taken from Kosko's book and bears a striking resemblance to the Morgenstern chart published 30 years earlier. Certain knowledge, small patch. Uncertain knowledge, big patch. Never straight lines and never black and white.



The two economists in the same room that reach three conclusions? The real joke is that three is all they could come up with.

The fuzziness of Asian growth

Asia has been the fastest growing region in the world economy for the last ten years - fact or fantasy? Well, the macroeconomic statistics support that contention 100%. We also happen to believe it is true. But we are also convinced that the picture is a lot less clear than the data suggest.

Let us show by example how developments in the underground economy might have distorted the data. Let us assume that an economy exists with an informal sector that is 50% of reported GNP. Figure 9 shows how the growth rate in the formal economy compares with that in the total (formal plus underground) over a period of five years with the following assumptions made about the behaviour of the underground economy.

Scenario 1: Both the underground and formal economies grow at a steady 8% over years 1-5. 50% of the growth in the underground economy is transferred to the formal economy in Year 1. In each subsequent year the amount of growth transferred rises by five percentage points. This scenario can be likened to a phase where statistical collection techniques and official enforcement are improving slowly.

Scenario 2: Both economies grow at 8% but the underground economy is gradually shrinking as a result of deregulation and increased confidence in the government. Starting at 100% of the growth in Year 1, the percent-

age of growth in the informal economy transferred each year rises by five percentage points (at the end of the process the underground economy forms only 22% of GNP).

All of a sudden, with no organic acceleration in the formal economy at all, measured or recorded economic growth rates are seen to have jumped sharply. From simply being one of the fast growing economies in the world our hypothetical state could become the fastest growing country on earth - in macroeconomic fantasy terms.

Numerous examples can be imagined which simulate transfers from, say, a more exuberant informal economy to the formal sector or one-off deregulation events (such as the introduction of VAT to replace business taxes) which induce a significant shift of activity in one year from the underground to formal sectors.

Probably just as well. Fast growth in Asia appears to be an end in itself for governments. By concentrating on growth rates, especially in times of changing tax structures and economic deregulation, governments are in danger of missing an underlying malaise in the economy. More attention to the microvariables involved in deregulation and liberalisation in Asian economies is urgently required.

All this said then, at the level of the total economy conditions can be deteriorating, staying stable or improving - no-one can really be sure. However, among other things, and assuming that our thesis has played out to some extent in the region, this 'imaginary' growth in the recorded economy can help explain just why GDP growth in Asia has, from time to time, so little correspondence with corporate earnings growth. **In short, an acceleration in the official GDP statistics does not necessarily mean that the whole economy is growing faster than in the previous year.**

FIGURE 9: FORMAL AND TOTAL ECONOMY GROWTH RATES UNDER SCENARIOS I AND II				
	SCENARIO I		SCENARIO II	
	FE* growth (%)	TE* growth (%)	FE growth (%)	TE growth (%)
Year 0	8	8	8	8
Year 1	10	8	12	8
Year 2	10.1	8	11.8	8
Year 3	10.1	8	11.5	8
Year 4	10.2	8	11.3	8
Year 5	10.2	8	11	8

* Where FE=Formal economy and TE=Total economy.

ASIAN DATA DANGERS: INCONSISTENCIES AND ANOMALIES

"Economists are unique among social scientists in that they are trained only to analyze, not to collect, data. While psychologists are taught experimental techniques, sociologists learn of the vagaries of interviewing, and anthropologists devote much of their training to field work, economists are provided only with the tools for data analysis. one consequence is a lack of scepticism about the quality of data."

- Reuter in Tanzi, op cit., 9p.137)

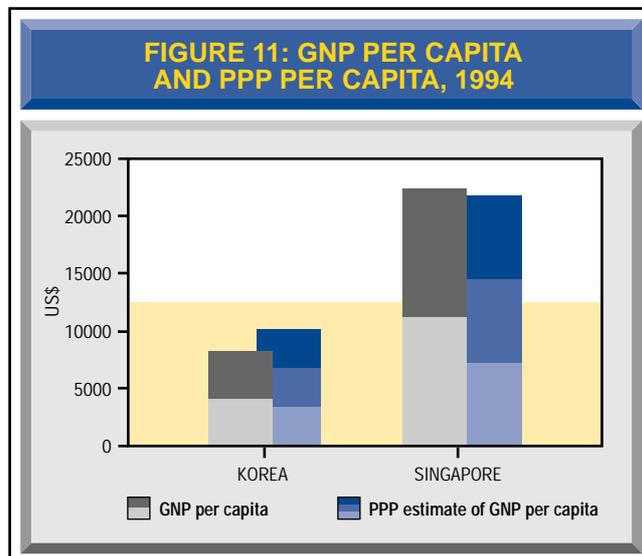
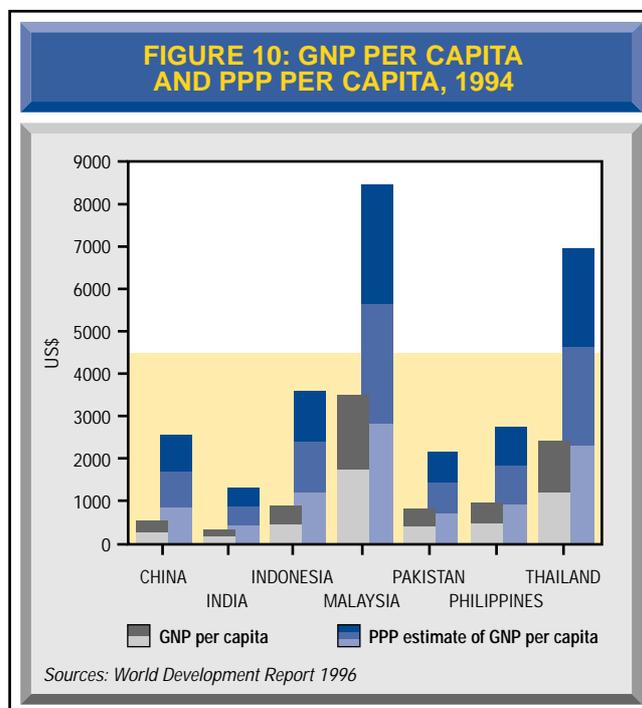
AT THIS STAGE, readers might legitimately pose the question: isn't this all old hat? We all know, deep down, that the data are distorted and that Asia, in all likelihood, is richer than the figures suggest. Indeed, no less an authority than the World Bank has been producing 'purchasing power parity' estimates of Asian GNP per capita for the last few years that show the region to be significantly richer than current dollar estimates. Or so it might seem to the layman.

In the 1996 World Development Report the PPP estimates of GNP per capita have been elevated from Table 30 to Table 1 (Basic indicators). Surely this is an indication of how important and relevant the PPP exercise is for comparison purposes? If so, then the World Bank is perpetrating a gross deception on its readers. While the PPP exercise does indicate that Asian per capita GNPs might be an understatement of true purchasing power (see Figures 10 and 11), its underlying estimates, especially for developing countries, should carry a health warning in three-foot high letters.

On average, the developing Asian economies (i.e., excluding Korea and Singapore) were reported as having GNP purchasing power

almost 200% greater in 1994 than current dollar GNP data would suggest. China's PPP-based GNP estimate is 370% higher than the corresponding per capita dollar figure. But what do these numbers really mean?

The idea is to compare a fixed basket



of products across countries and estimate the domestic cost of these products relative to each countries' domestic income levels. As the benchmark, a fixed basket of goods priced in US dollars in the US is taken. In this way, the purchasing power of individual countries can be arrived at without reference to an arbitrary international benchmark (the prevailing US dollar exchange rate). Of course, this exercise tells us nothing about the international purchasing power of individual countries as the PPP-estimate units are notional 'international dollars'.

In reality, they tell us lots less than that. As with so many academic exercises the devil is in the footnotes. The whole concept is based on the Bank's International Comparison Programme (ICP) – a study aimed at generating more appropriate cross-country comparisons of income. In the 1996 World Development Report the latest available data, **for the OECD countries**, was based on 1993 comparisons. As the footnotes to the Basic Indicators table tell us, the results for India, Korea, Pakistan, the Philippines and Thailand were extrapolated from the 1985 ICP estimates. For China, which has never participated in the programme, the estimate is an internal one from the World Bank. In Indonesia, estimates are extrapolated from 1980 while in Malaysia they are from 1975. In Singapore, the PPP-estimates are based on a regression equation.

In other words, the methods of estimation and the base data used throughout the region are far from consistent. The results of the exercise might not quite be comparisons of apples and oranges but they are not far off. So, if international agencies are guilty of producing grossly misleading statistics, what hope is there for the national equivalents?

Let your watchword be: take care

THE FACT is that contradictions, inconsistencies and anomalies abound in Asian macroeconomic data. We try to point these out as and when they arise in our daily *Asianomics Infobox* but often catching the anomalies is easier than producing an explanation for them. In general, investors' expectations about the accuracy and validity of Asian data are just far too high.

Take Malaysia. Reported economic growth has been running above 7.5% since 1988. The unemployment rate has fallen steadily from 5% in 1990 to just 2.6% in 1996. Officials will tell you that even that number is an overstatement of true unemployment because it includes those "not actively seeking work".

In the meantime, wage growth per worker has been running above 8% for the last two years and M3 money supply growth has not fallen below 20% YoY since November 1995. Yet, from January 1995 to March 1997, consumer price inflation has ranged between 3.12% and 3.78% YoY. Believable? Not very.

Surely there are no holes in the economic data for Asia's model of efficiency, Singapore? Oh yes there are. According to official statistics, no trade is carried on between Singa-

pore and its largest neighbour, Indonesia. One explanation often cited is that the anomaly dates back to the political tensions between the two countries in the 1960s. Maybe.

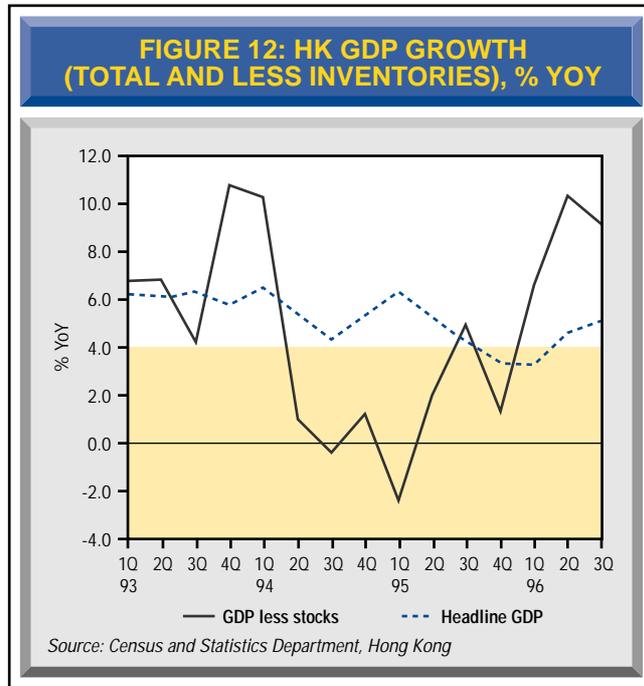
Or maybe the official trade flows would look strangely small for such close neighbours. A visit to one of the many construction sites around Singapore would uncover numerous workers smoking kreteks (clove cigarettes). A quick glance at the packs would find that most of these had been smuggled.

There again there is the national income data. All economic growth forecasts in Singapore are produced by analysts using the output-based measures in the national accounts (i.e., by estimating industry growth rates). Well, we hope they are. Because the expenditure side of the accounts (consumption, investment etc.) are incomplete. Singapore does not report constant price data for exports and imports. In the national accounts analysts are faced with the entry "Net Exports".

All forecasts of private consumption, government consumption and investment expenditure in Singapore are guesses, pure and simple. They are guesses because the biggest elements in the expenditure accounts, exports and imports, are unknown.

In Hong Kong the story is the reverse. GDP data are available from the expenditure side but are only released in current price terms on the output side of the accounts. Like most Asian countries, neither Singapore nor Hong Kong even try to produce national income data based on the income side i.e., wages, profits, interest and rent.

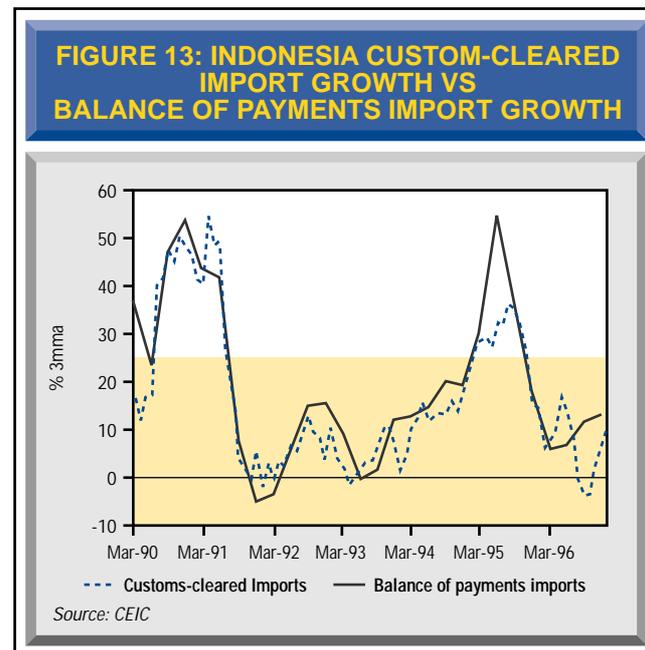
But let's stick with Hong Kong for a



moment. The above chart (Figure 12) contains one of the strangest data anomalies in Asia in recent years – the case of the vanishing inventories. Given the severe austerity programme that hit China in 1994-96, it might have been expected that the Hong Kong economy would slow down sharply. That did not happen, according to the official statistics.

As the chart shows, headline real GDP growth held up remarkably well throughout the period (although it did fall to a low of 3.3% YoY in 1Q96). The main reason for the sustained good performance in Hong Kong was the build up in inventories. In this, the most expensive storage site in the world, we are asked to believe that companies, people, government and whoever built inventories.

Without that stockpiling exercise GDP



growth would have looked much more like the second line on the chart. But growth rates of sub-4%, and even zero, would never have done in the run-up to the handover to China this year.

Certainly, the PADS project had some effect on the inventory levels in Hong Kong and we would also put some of it down to involuntary inventory build up due to the slow down in China (not that that slow down has ever been officially recognised in Hong Kong or Beijing) but the numbers still look strange.

Some numbers look strange elsewhere in the region, Indonesia for example. Figure 13 shows two data series for import growth in Indonesia. One is based on the monthly customs-cleared data (which most analysts and fund managers focus on as an early indicator of trade patterns) and the other is the quarterly Balance of Payments data. Apart from carriage, insurance and freight costs – which are a pretty constant proportion from year to year – the two series should behave in exactly the same way.

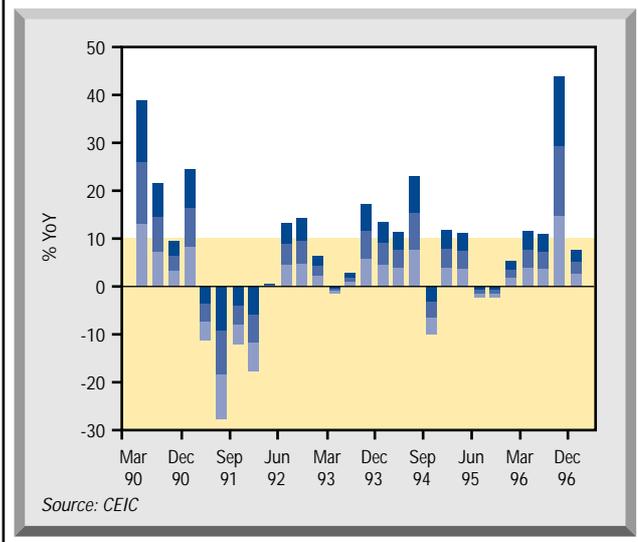
By and large, for most of the time period under consideration, they do. Only in the last year or so have they begun to show a quite worrying divergence. At one point in 1996 the customs-cleared data were signalling a contraction in import growth – a worrying sign for overall economic activity. A reason to sell the market?

Not if you had waited for the Balance of Payments data. Through most of 1996 this series was showing an accelerating trend – even against a higher base growth rate in the previous year. Imports signalling rising or falling economic activity? Depends on where you look.

The explanation for this anomaly is partly the result of the introduction of free trade zones in Indonesia. Customs data are not picking up the throughput from these. The result is confusion and, in addition, inconsistent signals on the all important direction of the trade balance (according to customs data it improved YoY in 1996 whereas the Balance of Payments figures now indicate a trade surplus deterioration). Fortunately, at the moment at least, investors are not awaiting anxiously the next trade release.

India suffers a very similar trade problem to

FIGURE 14: PHILIPPINES REAL GROSS CAPITAL FORMATION, % YOY 1990-96



that of Indonesia with the Reserve Bank and the Commerce Ministry providing substantially different estimates of the trade deficit each year. In each of the last four years the Reserve Bank's estimate has been close to double that of the government - political considerations playing a role or is it all just due to the exclusion of defence imports from the Commerce Ministry's figures?

For a final example of data inconsistency, we turn to the Philippines. Figure 14 shows YoY growth rates in fixed capital formation in real terms. The third quarter 1996 stands out like a sore thumb. What caused the boom in investment in this one quarter? Pent-up government expenditure? Perhaps part of the answer. A YoY base effect? Certainly there were weather problems in 1995 but these were mostly in the fourth quarter. No, the statistic just looks odd - as do the value and volume series for exports in the same year. Asian countries have a long way to go before data consistency is a term that can be applied with confidence.

Patchy data, patchy conclusions

WE COULD FILL a book with more examples of Asian data confusions and contradictions. The Philippines external accounts, GDP revisions in Thailand, the VAT effects on Thai exports in 1996, the remarkably steady growth of headline GDP in Taiwan, the weaknesses in FDI approvals data, everything in China (see Section VI). But what would be the point? Only to learn what we already know but rarely recognise; we are dealing with developing countries.

In the US, the largest bond and stock markets in the world often spin like ice

skaters with an unexpected data release.

The army of macroeconomic analysts dissect the latest retail sales numbers for clues as to the direction of the economy, prospects for corporate earnings, the state of the consumer and so on. A month later they do the same thing again while the number they reacted to 30 days previously has been revised out of all recognition.

Often, in retrospect, markets are found to have reacted in the most perverse ways to data

instead of rises. So much for the models of market efficiency and perfect information. How can the markets be efficient when the data are so wrong and so inaccurate?

All the more reason to treat the data cautiously when dealing with developing countries.

The Bank of Thailand was said to have 'lost credibility' in 1996 as a result of substantial revisions to export data releases. Tosh. The US Commerce Department produces just as large revisions to many of its widely watched series every month and analysts still await every release with bated breath.

Developing country data - apart from the immediately observable series such as exchange rates and interest rates - have large error terms. They are filled with uncertainty. The conclusions we infer from them should be seen in that light.

SECTION V

MINDA-WOW! THE NEW FRONT DOOR

FERDINAND MARCOS managed one in 20 years. Cory Aquino made it four times in six years. In the five years of his tenure so far, Fidel Ramos has done it 62 times! Done what? Visited Mindanao. We are some way off President Ramos' record but our two trips to Mindanao convince us that he is on to something big. There is a new star in the making in the Asian firmament.

Yet the popular perception of Mindanao is of the 'war capital' or 'kidnapping capital' of the Philippines. The US government still has a travel advisory out against visiting the island and, indeed, there are still areas which are unsafe for foreigners. Muslim groups, such as the Moro Islamic Liberation Front (MILF) and Abu Sayyaf continue their terrorist activities against government forces in areas of western and central Mindanao. Yet our experience has been of a peaceful thriving centre of agribusiness and industry.

Sensibly, we have stayed out of the troubled city of Cotabato which lies at the centre of the small area of Muslim rebel activity left on the island. To write Mindanao off because of the Muslim 'problem' is like saying Britain is finished because of the troubles in Northern Ireland. The relative sizes of the two 'insurgencies' are comparable.

But why would we visit the supposed

FIGURE 15: GROWTH IN MINDANAO AND THE PHILIPPINES, % YOY, 1992-96

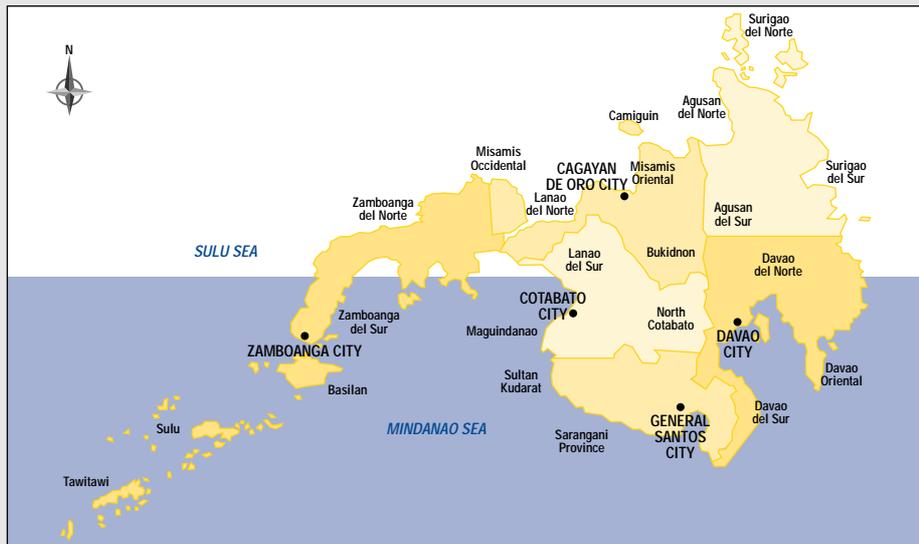
	Mindanao GRDP*	Philippines GDP
1992	-0.5	0.3
1993	3.7	2.1
1994	3.6	4.4
1995	4.1	4.8
1996	5.8**	5.5

Note: * Gross Regional Domestic Product
 ** Estimate Source: GEM and NSCB

'backwater' of the Philippines (Figure 15 shows the official growth rates for Mindanao against the Philippines as a whole) in the first place? Principally as a result of a chance conversation over dinner with a Philippines' corporate executive in January 1996. He was talking about their distribution business and how fast it was growing. "Manila the star performer?" I asked. "No way", he said, "Mindanao!".

We now know why. The photographs in this section are all taken in and around General Santos, the tuna capital of the Philippines (see map). It is a city of 400,000 people. It is booming. The picture on page 1 of this report is of one of the city's taxi companies, Boomtown Taxis. With an estimated 12% real growth rate and 6% population growth - mostly migrants from

MINDANAO - THE BREAD BASKET OF THE PHILIPPINES



Mindanao's trade taxes were lowered in 1995, Zamboanga City immediately experienced a P10m windfall in tariff revenues from smuggling activity that found it less expensive (no bribes) to turn legitimate!

General Santos and Davao are much closer to most Asian markets than is Manila. A three hour or less plane journey takes the passenger (or cargo) to Brunei, Jakarta, Hong Kong, Kuala Lumpur, Papua New Guinea, Singapore, Taipei and even Darwin (yes, the one in Australia). Mindanao is just a stone's throw from Sabah on Borneo. (In fact, it is now just a plane ride; Mindanao Express began a scheduled service from Zamboanga to Sabah in early May. Scheduled service from General Santos to Manado on

elsewhere in Mindanao, the Visayas and Luzon - it is not surprisingly the fastest growing city in the Philippines.

And that growth is set to accelerate. The new fishing port is due to be finished in late 1997 (but more likely, in early 1998). This investment will increase tuna handling capacity from around 400 tonnes/day to 4000 tonnes/day.

To the north of General Santos lies Davao, the largest city in Mindanao with a population of 1.5m. The visitor from Manila feels perfectly at home immediately in Davao because the traffic is heavy. Davao Light, the local electricity company, reports consumption growth of 12-14% for the last three years and is projecting 13% growth in 1997. For Mindanao as a whole, which houses almost 25% of the Philippines population and accounts for 40% of its agricultural production, the University of Asia Pacific (formerly the CRC) has estimated a growth rate of between 7-8% over the period 1995-98. This is faster than will appear in the official statistics but is probably, in itself, an underestimate.

But unlike so much fast growth in Asia, the Mindanao story is about agribusiness, not industry. The development of agribusiness in the mild climate south (the heavier industrial areas are to be found in the north of the island centred on Cagayan de Oro) is at the centre of the island's success. As we have argued in the past (*see Chapter 8 in the Geometry of growth report*), agriculture is the forgotten component of development in most Asian economies. This is distinctly not the case in Mindanao.



TUNA: Rich haul

ing of all for the visitor to the region is to learn that all the programmes and development plans are well aware of how important a clean environment is to this ecosystem. No heavy industry is wanted in southern Mindanao. The produce, equitable land tenure rights, trading links and the potential are there – all it will take are the right policies to unlock the new front door.

Unlocking the new front door

WHY 'FRONT' rather than 'back' door? Simple really. Mindanao is the ancient trading heartland of the Philippines. The Muslim population are descended from the traders who swept through Indonesia and Malaysia long before the Spanish conquests of Ferdinand Magellan. Trade ties between Mindanao, Borneo and Sulawesi have been thriving for centuries - they are now being formalised in the shape of the East Asean Growth Area (EAGA). Interestingly, when

Tuna (including sashimi for the Japanese market), pineapples, asparagus (65% of the Japanese fresh asparagus market from a standing start three years ago), corn, beef, hogs, bananas, coconut oil and rice are among the crops and produce that southern Mindanao is rich in. Okra growing is in the developmental stage. Most heartening

Sulawesi is also due this month.)

The market for Mindanao's agribusiness products is huge (Japanese airlines are trying to access slots to Davao), all that is required are the infrastructure links. That is where policy comes in. The deregulation of the Philippines' airways has already had a major impact on Mindanao's growth rate. Mindanao Express, a start-up company established with help from the GEM (Growth with Equity in Mindanao, a consultancy and investment bureau financed by US AID) project, not only flies passenger routes that criss-cross the island and into EAGA but is daily involved in cargo flights from Mindanao to the Visayas to Manila and to Subic Bay (and then back).

Grand Air, PAL, Air Philippines and Cebu Pacific all have daily (or more frequent) flights from Manila to Davao. One local businessman in Davao told us that he used to know all the faces on the single daily flight from Manila to Davao. Since airline liberalisation, he hardly knows any. Fares have tumbled as well. What is good for the airways would also be good for the shipping lanes.

At present this is Mindanao's biggest disadvantage. The cabotage policy in the Philippines is outdated and disadvantageous to outlying domestic suppliers. Transporting produce from Mindanao to Manila is more expensive than bringing it from Bangkok to Manila or sending it from Mindanao to the US. That just doesn't make sense. It also limits the market for Mindanao goods.

Open skies, open seas. New roads, new ports. The answers to unlocking the wealth



MAKAR WHARF: 8,500 dwt is peanuts for the new Gen San port



NEW TUNA PORT: Tuna landing capacity would rise from 380 to 4,000 tonnes/day



AGRI-EXPORTS: Asparagus for Japan



Okra planting, the next cash crop?



FISHING BOATS: Labour-intensive, low-tech and highly profitable

of Mindanao and putting it on the tables of Manila and the rest of the world are in the hands of Malacanang.

Peace and development in the southern Philippines

THAT IS NOT to say that the Malacanang Palace has not already played a major role in Mindanao in recent years. In its negotiations with the Moro National Liberation Front (MNLF) which resulted in the peace accord signed last year with the MNLF's leader, Nur Misuari, the Ramos Administration has done more to promote peace on the island than any other. However, as we have mentioned above, the Muslim insurgency is not a thing of the past yet - Abu Sayyaf and MILF groups are still operational in the Autonomous Region of Muslim Mindanao (ARMM). Bombings and kidnappings do still go on in the four provinces (out of Mindanao's 21) that make up the ARMM.

But with better economic performance has come a greater desire on the part of the rebels to integrate into Philippines society. One of the biggest investment projects brokered by GEM is a joint-venture between Sumitomo Corp of Japan and ex-MNLF guerrillas on the Tawi Tawi Islands. This project will become one of the region's largest seaweed producing operations within the next few years.

Stumbling blocks still exist to a permanent settlement. The promised Southern Philippines Council for Peace and Development, a region encompassing most of Mindanao and to be headed by Nur Misuari, has not taken off. Opposition to the appointed body in Congress and among local Christians is ensuring a rough passage for this non-elected quasi-government.

Yet Mindanao quite clearly goes from strength to strength. Law and order in Davao is distinctly more tightly enforced than in Manila and terrorist activities are confined to a tiny part of the island centred around the Muslim majority area (Mindanao itself is around 70% Christian). Londoners should be so lucky.

More importantly, with economic success comes a greater willingness for Muslims and Christians to co-exist - both groups benefit. With land costs in Davao (the most expensive city in Mindanao) at less than half the level of Metro Manila and electricity cheaper by 35%, the conditions are in place for the island to attract investment. As Asia's next growth hot spot - but different in that it will be a more environmentally-friendly one - that investment is set to pour in through Mindanao's newly-opened front door.

INTERPRETING CHINESE DATA: ECONOMIST OR DETECTIVE?

"It is a capital mistake to theorize before one has data."

– Sherlock Holmes in Sir Arthur Conan Doyle's, *Scandal in Bohemia*

IN OUR 1st Quarter 1996 *Eye on Asian Economies* we dropped all point forecasts for China's GDP growth rates. We replaced the numbers with three letters – U (up), D (down), F (flat). In our view, the quality of the data just could not support spreadsheet analysis. Sometimes it is a mistake to theorise even when one has data.

We expected a few complaints from clients (to expect a flood would have been altogether too vain given what we know clients do with most brokers' research). We have received none. On marketing trips, our explanations for dropping the numbers have been accepted with some amusement and much resignation.

But China should not be judged too harshly in this respect. While we feel that Beijing willingly accepts output data that are quite clearly inflated by local cadres or factory managers, we equally believe that it is misled just as often as the rest of us.

Remember, China is new to the national income accounting game. Prices are still not entirely free and measurement techniques and statistical collection procedures are rudimentary at best. The authorities there have a wall of obfuscation to climb in attempting to untangle the true picture of state-owned enterprises.

That said, Beijing does itself few favours. Releasing full year GDP growth estimates just before the end of the same year stretches credibility to breaking point. Not that this is always clear in analysts' reports. China's official GDP numbers appear to be swallowed hook, line and sinker by most economists in the region or to be accompanied with a warning about data quality. Of course, once the warning is given the analyst seems free to use the data as if nothing were wrong any more. Fund managers need to be more critical of this approach.

In our 3rd Quarter 1996 *Eye on Asian Economies* (After the hard landing: OUCH! Where next?) we examined the main Chinese data series and outlined the anomalies in them. As examples of how poor the data can be in Asia, there are none

better. The following is a reproduction of part of the Viewpoint section from that quarterly.

Flying blind

THERE ARE 88 industrial production categories reported in the official publication *China's Latest Economic Statistics* each month. In 1995 industrial output grew on average by 16% YoY. Figure 16 shows a broad classification of these categories by growth rate.

FIGURE 16: CHINA'S INDUSTRIAL PRODUCTION BY GROWTH BANDS, 1995

Average gross industrial output growth – 16%. Of which:

- 18 categories registered contractions
- 51 categories grew between 0-16%
- 14 categories grew between 17-32%
- 5 categories grew by more than 32%

Source: *China's Latest Economic Statistics*, January 1996

While it is possible that the fast growing categories (which include radio sets, motor cycles and micro-computers) could make up for contractions in areas such as energy production, the overall balance of growth rates in individual categories does not feel right when compared with average output growth.

Another series of anomalies which do not support the fast growth contention are contained in the external trade data, especially with respect to import

growth. Consider this: in 1995 China experienced its highest ever level of realised foreign direct investment, the economy grew at the fastest recorded rate in Asia (10.2%), export growth touched 23% YoY, food imports were at an all time peak and the renminbi appreciated slightly in nominal terms and strongly in real terms for the second year in a row.

All five of these conditions support rapid import growth. The result? Imports were up 14.2% YoY, the second slowest increase in the 1990s (behind 1994) and the lowest increase in Asia. But is the figure so unbelievable? Yes.

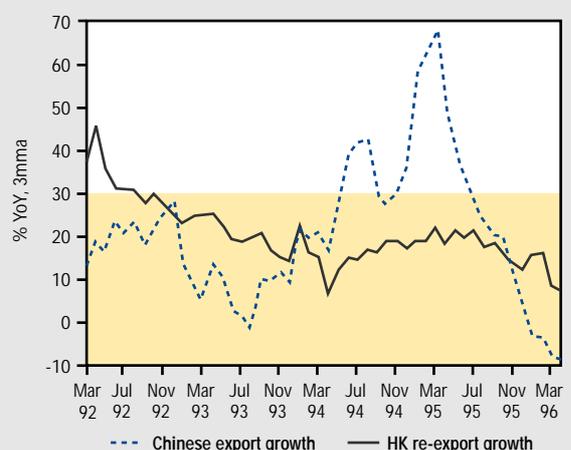
The import content of Chinese exports is conservatively estimated at 40%. The import content of FDI flows was calculated by the World Bank at 68% in 1994. Assuming that both of these proportions held in 1995 we would estimate the increase in imports from export and FDI sources alone to be US\$14.5bn.

In the event, imports increased by only US\$16.4bn for the full year. This would leave very little scope for import growth given real economic expansion of 10%+ and increased food imports. The figures just do not add up unless it is realised that China's borders are extremely porous and that official data collection is not that reliable.

Again, this time on the export side, one of the contributory factors to China's supposed 10.2% GDP growth rate in 1995 was a 23% surge in nominal export growth (even as the real exchange rate was appreciating rapidly). Figure 17 shows China's export growth since 1992 plotted against Hong Kong's re-export growth.

While Hong Kong's dominance as the

FIGURE 17: HK RE-EXPORTS VS CHINA EXPORTS



Sources: *Census and Statistics Dept., Hong Kong and China's Latest Economic Statistics*

trans-shipment centre for Chinese exports is gradually being eroded (as activity on the mainland becomes more robust around Shanghai in particular) it is still in that position at present.

How then do we explain the pattern of export and re-export growth depicted in the chart? Three main points are worth stating:

- Hong Kong data are of better quality than Chinese data,

- Changes to the VAT rebate system for exports in China resulted in front-end loading of reported exports in 1995. Paperwork was completed for exports before physical movement was effected in order that companies would receive 17% rebates rather than 13%.

- The incentive to under-record exports in China has diminished. This last point is the most important. During 1993 in particular there was every incentive for Chinese exporters to under-invoice exports in China and realise earnings externally, particularly in Hong Kong. In turn, this earnings flow could either be re-routed back into China (in the form of FDI with all the special privileges that FDI attracts relative to domestic investment) or just parked in US dollar-based assets.

So, while Hong Kong re-export growth in that year was around 20% China's export growth meandered along at a supposed sub-9% rate.

In 1995 the reverse story was the case. Chinese companies had an incentive to move money back into China – and the only official way of doing so is in the form of export receipts – either to finance internal operations because of the scarcity of bank loans or to take advantage of high interest rates in the unofficial money markets (where returns in excess of 25% on capital could be achieved).

Hong Kong's 17% re-export growth sits uneasily with the reported 23% rise in Chinese exports. Moreover the pattern of export growth bears little resemblance to the Hong Kong data.

China's fast export growth in 1995 was just as fictitious as its slow export growth in 1993. However, at least this makes the slow growth in imports somewhat more believable since 'real' i.e., actual, exports were undoubtedly significantly less than the figure reported for the year. In turn, this allowed for greater import growth to satisfy real demand and food requirements.

So, where does that leave us on the economy? Over the last two years we believe that the Chinese economy has been through a much rougher patch than the official figures would suggest. Individual

data series paint a very flawed picture of the ups and downs of the economy. However, taking a broader view of the data we believe that economic growth was somewhere in the range of 5-8% in 1995. Five factors lead us to this conclusion:

- The collapse in corporate earnings in the listed A, B and H shares suggested a high cost economy with falling volume growth which induced a major margin squeeze on the business environment. Furthermore, the collapse in recorded inflation last year is not indicative of 10%+ growth but rather of sharply falling demand and overcapacity in the economy.

- Hong Kong's economic growth fell to sub-5% YoY. This is a direct result of slower growth and poorer profits in China for the HK-owned companies based there (much of whose output is actually destined for the domestic Chinese market rather than export markets).

- The 14% import growth does not sit

easily with a developing economy apparently growing in double-digits and experiencing record levels of foreign direct investment.

- The data and commentaries from senior politicians point to industrial output growth being overstated.

- The institutional framework, which allows for the positive accounting of worthless output in national income statistics, builds in an upward bias to official GDP growth. In other words, stockbuilding (which accounts for over 20% of GDP) is in part made up of goods which, if produced in a capitalist economy, would be valued at zero. In the Chinese 'socialist market' economy shadow pricing techniques are used to apportion values to goods which will never be used. GDP growth is biased upwards as a result.

Endnote: And all that was before we started researching the underground economy!

SECTION VII

OPTIMISTIC ECONOMICS REVISITED

"System complexity exceeds subsystem complexity. That still baffles atomic physicists who use big chunks of matter to study and puzzle over the finest divisions of matter. It baffles medical students who cut up cadavers and wonder where the motion and emotion went. It baffles econometricians who try to predict employment and interest rates with simple linear models of an economy. As Bertrand Russell said, every man has a mother but mankind does not have a mother."

– Kosko, op cit., p.108

"For the whole economy increasing returns are the rule. To think otherwise is to commit the fallacy of composition in applying to growth theory a concept appropriate only to microeconomics."

– Lauchlin Currie, *Implications of an Endogenous Theory of Growth Based on Allyn Young's Macroeconomic Concept of Increasing Returns, History of Political Economy*, (forthcoming - Fall 1997)

"The dynamic element in growth is not saving but the increase in real demand which in the longer term is dependent on improvements that reduce real cost or improve quality. The latter increases the supply and offer of goods which in turn becomes the demand for other goods, which in turn generates the profits to finance the relatively small amount of capital necessary to maintain the current rate of growth."

– Currie, ibid.

LAST YEAR, in the first part of *The Real Myth of Asian Growth*, we developed the idea of endogenous growth – where growth causes high savings and in itself is the driving force for more growth. It is not a simple concept and is widely rejected by the neo-classical mainstream stuck in their linear world.

Fuzzy thinking is all about non-linearities, complexities and surprising discoveries. Last year we used de Bono's

notion of lateral thinking to ask clients to unlock the 'concept prisons' that conventional macroeconomic approaches have placed them in. The rest of this section revisits the Young thesis of growth begetting itself and underlines the Kosko conclusion that system (macroeconomic) complexity exceeds subsystem (microeconomic) complexity.

Optimistic economics restated

IN THE TWELVE months since our first

look at Allyn Young's optimistic growth model some things have changed. (Allyn Young died in 1928. He was an economist in the Classical tradition.)

The most reported of these is a series of studies, one from the IMF, which suggest that the original analysis of total factor productivity (TFP) growth in Asia was wrong.

These new studies suggest that TFP, the residual increase in output not explained by increases in the inputs, has been much higher in Asia than previously thought.

We do not intend to enter that debate. After our comments about the data quality in Asia in Sections II-IV it is our strong belief that the estimates emanating from the growth accounting technique (which, like all neo-classical models, are extremely data hungry in the testing phase) could be massaged to tell us anything. In our view it is better to stick with theory and decide whether or not the macroeconomy is a macrocosm of the microeconomy and that the same rules apply.

We think the fuzzy logic people and Chaos theorists would put more credence on Young's thesis than on the growth accounting analysis. So do we.

What is the endogenous growth theory then? Unlike conditions prevailing in the microeconomic world of the firm (where diminishing marginal returns exist), in Young's macroeconomic world **increasing returns** are the norm. Here, natural growth in output leads to greater demand. Why? Because the act of producing more reduces the cost of any good **in terms of other goods**.

This last point is key. Young's endogenous growth world does not rely on a benevolent central bank which injects ever increasing amounts of liquidity (the Austrians have effectively dynamited that flawed route to growth in their analysis of the business cycle). It is purely the fact that the demand for most goods is elastic and that, as more of any one good is produced, its price will fall relative to the price of other goods.

In turn, this will increase the effective demand for the good and for all others. In order to improve profits the producer must offer more of the good at a lower price (the technological revolution of recent years being a prime example of this).

With higher growth, supply increases and prices fall – not the model the US Federal Reserve believes in at present but there again, its senior members (with the exception of Greenspan) represent the ultimate in mainstream neo-classical econo-

mists. It is, however, either implicitly or explicitly the model of the pro-growth lobby in the US.

The crucial concept in the Youngian thesis is an old one – specialisation through the division of labour. It is the process of specialisation that raises the prospect of further gains to existing resources (with specialisation comes more roundabout processes of production which not only add to the complexity of the economy but also to the productivity of existing labour resources).

Within this process – and this world view incorporates time and the notion of development as a process, not the static equilibrium paradigm of the growth accountants – increasing returns are the rule. There are three main tenets to the endogenous growth model:

■ Growth is self-generating in character. Left to the free play of the market it will expand continuously.

■ Traditional factors of production are not the source of growth but, rather, inputs of capital and labour are a consequence of growth itself. This has important, positive connotations for the Philippines (*see below*).

■ Endogenous and exogenous elements interplay with each other. In this way growth rates can be enhanced by policies which facilitate access to new markets e.g., open trade policies, trade tax liberalisation etc.

What are the implications from these tenets? First, policies and events which act to extend the market will prolong and promote growth in and of themselves.

As economies open up and infrastructure development takes place the whole process will be enhanced, if not accelerated. This takes place because of the increased opportunities to specialise and divide labour.

Secondly, with growth **independent** of factor inputs, efforts to explain the phenomenon in terms of labour and capital (then apportion the residual to what is known as productivity or technological advance) are wrong-headed.

TFP measures are meaningless (even when they are not calculated with flawed data). Moreover, investment does not explain growth but rather, is explained by it. That is not to say that Young's theory denies any importance to investment. His argument is simply that investment would be neither profitable nor efficient if the end market for the products of such investment did not exist in the first place.

In the context of the Philippines, this is important. Criticisms abound about the

country's low savings rate relative to the rest of Asia.

In Young's eyes there is no surprise in the difference – the Philippines has been growing much more slowly than the rest of Asia over the last 10-20 years. However, this will change.

The evidence is widespread in the development economic literature that, as economic growth accelerates, the incomes of the high saving segments of societies rise faster than the average. Savings rates increase because the incomes of the savers rise relative to national income. The springboard for financing growth will take care of itself.

Thirdly, international trade and government expenditure can be viewed as exogenous growth generators i.e., they are not dependent on growth itself.

Consumption and investment, therefore, are consequences of growth – whether it be endogenous or exogenous. Public investment programmes, especially where they facilitate future growth by providing infrastructure to extend the market, can be viewed as promoting endogenous growth as a second round effect. Liberal trade policies are exogenous growth promoters.

Putting this theoretical construct in the empirical Asian context would lead us to conclude that far from being at the late stages of the growth process, Asia has merely scratched the surface so far. The most important points in this respect are that growth in the region to date has been concentrated in limited geographical centres, among a small percentage of the region's population and has been largely dependent on external sources.

As the internal market extends – with substantial help from domestic deregulation and liberalisation policies – the prospects for further division of labour, and hence specialisation, in Asia are enormous.

But isn't this process limited by the transfer of existing technology? No. The technological frontier is being pushed out constantly. In the 15 years to 1982 one study identified 2047 equipment innovations in that oldest of industries, textile making.

The microchip revolution has turned a river of new processes, products, inventions and innovations into a flood.

Specialisation and innovation know no bounds. They are governed not by the dynamics of mechanics but by the infinitely more complex phenomenon of human inter-relationships. Demand and growth are limited only by the market.

ASIA UNCOVERED: THE FUZZY LESSON

“As far as the laws of mathematics refer to reality, they are not certain. And so far as they are certain, they do not refer to reality.”

– Albert Einstein, **Geometry and Experience.**

WHAT HAVE WE truly uncovered about Asia in the course of this report? First and foremost, that we know a lot less about the region than we pretend to. Secondly, that sizeable underground economies exist that lead to a systematic understatement of income and wealth in the area.

Thirdly, we know that the macroeconomic data are not only flawed as a direct consequence of the existence of the informal sector but are also inadequate as a result of poor statistical measurement, inconsistent accounting classifications and a shortage of data collection resources (both physical and human). If countries in the region cannot collect taxes from their richest inhabitants, what chance have they of collecting the type of information that make up national income accounts. More than that, the more fool us for believing that they can.

Fourthly, assuming that the underground economy is gradually being ‘formalised’, economic growth rates – which always refer to the measured or reported economy – are being exaggerated as a result. Asia is richer than it appears at first sight but the overall economy (underground plus formal) may have been growing more slowly than has been suggested for the last few years.

Finally, this last point underlines the dangers for macroeconomic policy makers. If governments and central banks are running policy on the basis of growth targets and, at the same time, are using past experience as the benchmark for what is and what is not possible, then painful mistakes are possible if not likely. If, for example, the absorption of the underground economy into the measured sector has accounted for 2-3 percentage points of GDP growth over the last five years, then assumptions made about the growth-inflation relationship or the growth-external balance relationship over this period are unlikely to hold when the absorption process stops.

The fuzzy lesson: hierarchies of uncertainty

AS EINSTEIN said, reality is characterised by uncertainty. But more than that, reality

is characterised by a hierarchy of uncertainties in all areas of study. Take philosophy to begin with.

The laws of the ‘hard’ natural sciences such as physics, chemistry and maths are more certain than the laws of astronomy, medicine and biology which, in turn, are more certain than the laws for complex social phenomena such as economics, history and psychology. The laws of thermodynamics are characterised by small patches whereas those of economics are characterised by large patches, sometimes very large patches.

Our own predisposition to the Austrian school of thought, where the idea of the immeasurability of complex social phenomena and the folly of positivism is at its strongest in economics, leads us to favour pattern predictions rather than point forecasts. Convention among fund managers demands ever increasing amounts of the latter.

Staying with the economics subject area, let us move to the sphere of macroeconomic data. We can think in terms of a hierarchy of uncertainty of economic measurement. In theory, identification of the extent of the formal economy should be better in the OECD countries than in the developing countries. In turn, the more mature developing countries, for example, the NIEs of Asia, should produce more certain economic estimates than, say, the low income countries such as China, India and Pakistan. Country size can also play a role.

With this in mind, we can return to estimates of the informal economy in Asia. Given the evidence from the literature on the black economy, indications from the currency ratios shown in Section 2, estimates from reported studies around the region and just what we know ourselves about the Asian economies, we can arrive at a hierarchy of potential underground economies in the region. Figure 18 contains our subjective ranking of the underground economy hierarchy in Asia and the extent to which we believe the informal sector might exist.

Are these estimates too high? We don’t think so. In an article in *The Economist* (3 May 1997) a recent study of the ‘shadow’

FIGURE 18: HIERARCHY OF POTENTIAL UNDERGROUND ECONOMY CONTRIBUTIONS IN ASIA (% OF GNP)

- China, India, Pakistan
50-60%
- Indonesia, Philippines, Thailand
30-50%
- Korea, Malaysia, Taiwan
20-30%
- Hong Kong, Singapore
10-20%

economy in the OECD countries was outlined (the study used the Tanzi method described in Section II). On average, the author found that the underground economy accounted for 15% of GDP in the rich countries – ranging from about 7% in Switzerland to 26% in Italy. For us to place Singapore and Hong Kong around the average of the OECD countries seems, if anything, conservative.

Taking the mid-points of these ‘underground ranges’ and grossing up 1996 official GNP numbers would result in an aggregate gross national product for Asia of US\$3.8 trillion, 40% higher than the reported total and just over half the size of the (formal) US economy. Japan, the second largest economy in the world, had an official GDP of around US\$4.6bn in 1996 (which would now be US\$4bn at the prevailing exchange rate) – only 21% higher than the Asian ‘total’ economy. In the underground economy study for the OECD both the US and Japan were found to have informal sectors amounting to around 10% of GDP.

To say the least, the Asian figure represents a sizeable internal market. It should be noted that we have excluded most of Indochina (Burma, Cambodia, Laos and Vietnam) from the exercise as well as Bangladesh and Sri Lanka. The prevailing mindset, despite much of the political bravado, is one of dependency rather than economic independence. Yet the policy emphasis in Asia remains outward looking.

While the export-orientation is not counter to Young’s thesis of endogenous growth, this type of strategy opens economies to the vagaries of international demand swings and diverts attention away from the easiest growth source, the internal market. (Of course, market constrained economies such as Hong Kong, Singapore and, to a lesser extent, Malaysia are forced to adopt primarily exogenous growth strategies).

There is a worrying twist to this observation. In de Soto’s work on Peru he even-

tually concluded that there had been almost no capitalism in Peru. Instead, protection for domestic industries – for example, retailing, distribution, banking, steel production, cement production, and so on – had resulted in a *mercantilist*, formal private sector, not a capitalist one. In his view, the only true capitalists in the country were the informals and the poor.

It is very easy to think of examples in Asia where liberalisation of trade policies has outstripped deregulation of the domestic economy – Korea, Taiwan, Indonesia, Thailand, Malaysia, China, India, Pakistan and, above all, Japan. Indeed, it is also the case that, apart from multinational enterprises, the small and medium sized company sector tends to dominate the export market in most of developing-Asia (this is not true of Korea).

The acid test for Asian governments is whether or not they are willing to crack open the hard nuts - the vested interest groups, the connected families, the old money and the 'big hands' that control and operate domestic industry and services throughout the region. For its efforts already in the telecommunications, oil and airline sector we have left the Philippines out of the list in the preceding paragraph. The government there would be the first to admit that there is a lot further to go.

Policy lessons and investment rules

IF THE REAL WORLD is characterised by multivalence and shades of grey; by fuzzy facts and hierarchies of uncertainty, then so too is the world of economic policymaking, economic analysis and asset allocation.

The Washington-based Institute of International Finance stated in a press release on 24 April 1997 that:

“Emerging markets are showing continued improvement in the area of data transparency, a development that promises to sustain private capital flows to these regions.”

Later in the same article we find out that the report examined the timeliness and comprehensiveness of data coverage but not the quality of the data. So there we are: in a data hungry world, moulded by the philosophy of positivism and its prevailing wisdom of simplified models and testable hypotheses, all we need are lots of quickly released economic data points. The fact that they might be garbage or subject to 10% or 20% or 50% error bands doesn't matter. Well, in our book, it does matter.

The first basic step in handling emerging country macroeconomic data is to recognise the extent of our **unknowledge**.

Daily observations of the exchange rate against the US dollar or swap or money market interbank rates are characterised by high degrees of certainty. It is, however, all downhill from there. The monetary statistics should be relatively accurate assuming that the central bank has properly defined and classified all of the entries in the accounts. That is a big assumption.

Moreover, since monetary data are collected by survey we have to assume that the survey is well designed and not open to interpretation by completing banks and financial institutions. There are standard international guidelines on monetary surveys but they are not always followed in the less developed countries. Of course, even perfect monetary data leave us with the next question - which series are relevant and why? Even monetarists can't agree on that one.

Trade data are not as accurate as observers might expect. Scams to avoid taxes or attempts to claim back more VAT than is due can result in either under- or overstatement of exports.

Likewise with imports. The existence of free trade zones, as we have shown in Section IV, can distort the monthly customs-cleared data if the authorities' collection procedures are adequate. The Balance of Payments data are fraught with even more problems.

For example, in few countries are comprehensive data collected on foreign company retained earnings. In principle, these should be recorded twice in the external accounts, once as an investment income outflow (through the current account) and then as a foreign direct investment inflow (through the capital account).

For investors stuck in the conventional macroeconomic wisdom that the current account balance is an all important stock market indicator, this accounting principle (which at no point results in a flow of money to or from the country) should help them lose money. Malaysia watchers take note.

There is so much confusion over the accounting for overseas contract worker remittances in the Philippines that it can safely be said that no-one is clear about what is going on. The gloom-mongers can interpret the holes negatively while the optimists (of which we are one) see the discrepancies in much more benign light. There is no guaranteed benchmark of who is right or wrong; only time will tell.

The GDP accounts are the ultimate in the large-patch, uncertainty hierarchy of macroeconomic measurement in the LDCs. We have shown in Section III how

changes in the underground economy over time might distort official GDP growth rates. Add to that all the other uncertainties mentioned in the statistical measurement context and we arrive at a set of data that should be handled with extreme caution.

For policymakers the rules are clear: keep policy flexible and choose targets that are relatively easily observable. Inflation rates could qualify as one of the more certain indicators but this is entirely dependent on the government's attitude to controlling prices.

Alternatively, there is the exchange rate. A fixed exchange rate certainly anchors policy but it also neuters one of the most important price signals in the economy. When this particular price is fixed, the leeway in domestic monetary and fiscal policy is constrained dramatically.

We have never hidden the fact that we believe this to be a particularly bad policy option. More flexible exchange rate targeting - particularly when it avoids mispricing capital for long term investments - is worth considering, however.

What about credit growth or base money targets? Certainly these are relatively easily monitored but the question of the appropriate target range within specific economies is more difficult to resolve. Assuming that money supply growth targets are set to support a given level of nominal GDP growth, governments have to be clear in what they are dealing with in respect of the latter? Is it formal economy GDP growth or total (formal plus underground) economy GDP growth? The difference might well be enormous and lead to all sorts of unintended distortions if the targets are set inappropriately.

So where does that leave us as investors? Completely in the dark? No. The conclusion of this report is a positive one: Asia is richer than we think and more capable of self-sustaining growth than is commonly believed. To that extent, the monthly, quarterly and annual data don't really matter. **The invariably important investment criterion in developing countries is the direction of policy.** Here are our five golden rules for investment in Asia.

Rule 1: The government is moving forward on liberalisation and deregulation policies. This is particularly important in the domestic sphere where the greatest potential lies. The Youngian thesis of growth begetting growth will take over as the market is extended. From this, the returns to investment will flow. Trade liberalisation policies are also good but may

send a misleading signal if they are not supported by domestic deregulation. A combination of exogenous and endogenous growth stimulation is required (*see Section VII*).

Rule 2: The government is operating flexible, rule-based policies. Rules can and should be fuzzy, along with everything else. In the light of our (and the authorities') unknowledge, flexibility is paramount. In a world increasingly characterised by global capital flows fixed price policies of one sort or another (especially the exchange rate), will inevitably lead to distortions and eventual policy breakdown. Moreover, the quality of data do not support rigid policy models.

Rule 3: The role of government in the economy is diminishing. This process can take a number of forms such as the move towards balanced budgets or surpluses, decreasing levels of public expenditure as a percentage of GDP, privatisation of government monopolies and a general trend towards market signals replacing government direction of resources. (It is this latter feature that has made us more positive on China over the last twelve months.)

Rule 4: Microeconomic evidence confirms macroeconomic data. Do bank loan growth data, retail sales, electricity sales, industry sales revenues and business survey evidence support official data releases? If not, believe the former and discard the latter. The uncertainty patches are smaller the more disaggregated and direct the data.

Rule 5: Think long term. Investing in developing economies cannot be about quarterly performance. The depth and industrial variety in these markets are just not there to support such a strategy. Understanding the trend in development and the emphasis of policy is paramount in emerging market investment. Identifying policy weakness yields good early warning signals but too much faith in flawed data results merely in violent market fluctuations as investors panic about nothing.

Fuzziness is a fact of life. In investment terms, the degree of fuzziness increases with underdevelopment. That requires a different investment mentality from that followed in the mature economies. Policy direction is paramount – appropriate policy actions will ensure that the flow of returns in the economy increases but not necessarily overnight.

The trick for investors once they have picked their long term winners is to be positioned in the right stocks – fortunately, this aspect isn't one of the economist's direct responsibilities.

SECTION IX

THE MESSAGE REITERATED

IN THE FIRST section of this report, we said that we wanted to raise the issue of the uncertainty surrounding Asian macroeconomic measurements particularly at this time – when everything is doom and gloom. From our vantage point we see confused investors, besieged fund managers and asset allocators sharpening their scythes.

But the message we have is ultimately a positive one because there is a way out of the current impasse for Asia – the endogenous growth route of Young's optimistic economics. We have to admit, however, that there will be a few fund manager coronaries along the way if Asia decides to take our preferred path.

Endogenous growth is about governments in the region rejecting their **implicit** dependency on the OECD and looking to the development of their own markets as the key to future growth. It is about unlocking domestic opportunities and tackling vested interests. De Soto's study in Peru found the domestic formal sector to be mercantilist, hooked on government protection, not capitalist. His conclusion: the only true capitalists were the informals.

This segment of society makes up 50-70% of the urban labour force in developing countries and a much higher proportion in the rural areas. Asia is populated by capitalists who do not have a dependency culture because their economic survival is all about living in the real world and not about state protection.

Our plea to Asian governments: empower them, learn from them, make life easier for them. That, in turn, means liberalisation.

The escape route from the gloom in Asia is in the hands of policymakers. The strategy has to switch from exogenous (export-led) to endogenous (domestic market extension and deregulation-led) growth.

The mainstream economic wisdom is that Asian growth is export dependent and that is the way it must stay. If exports slow, growth dies and investment funds must leave.

In our view these funds will be leav-

ing at just the point in history that economic forces are turning Asian countries to their most profitable market – the internal, Asian market.

So, is the Asian growth story over? As we argued in the **Geometry of growth** last year, the Asian growth story is far from over, indeed it hasn't even really begun. But to unleash the forces of strong domestic growth governments around the region have still to realise just what their economic strategy must be. That strategy consists of abandoning the export and investment-led growth models of the World Bank and IMF (Malaysia and Singapore are exceptions in this respect) and of focussing on domestic conditions.

This is by no means an advocacy of protectionism, quite the reverse. Governments in Asia have to crack open the vested interest groups. They have to reject the mercantilism that permeates the region.

For sure, this will mean that some favourite 'core holdings' of fund managers will have to be ditched. Sometimes the economist's agenda and that of investment managers does not always coincide. But it is our strong contention, and we believe the irrefutable evidence for this is staring us in the face, that production for the domestic market is inherently more profitable than production for export. That is the history of the developed, albeit Western, countries.

We equate domestic-led growth with profits. Johnson & Johnson, Ciba-Geigy, Nestle, IBM, Motorola, General Motors and the next 500 largest companies in the world obviously see exactly the same thing. It would do fund managers no harm to follow their strategy. Overweight the domestic plays. Seek out and buy the consumption stocks. That is where the next wave – and it is a tidal one – of growth is coming from.

In the meantime, the countries which are leading the pack in policy momentum (whether by luck or design) are China (incorporating Hong Kong), India, Indonesia and the Philippines. These are our macro market picks for the future.



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