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ECONOMY

Asia's development rests on institutions

PORNALAT PRACHYAKORN

SINGAPORE (19 Nov 08) : While Asia's fundamentals should enable it to grow despite the global slowdown, its institutional and regulatory environment could set a cap on its long-term development, said Ilian Mihov, a professor of economics at the INSEAD business school.

According to research by Prof Mihov and Antonio Fata's, advanced economies - defined as having an income per capita above US\$13,000 - all have good institutions while no poor country has high-quality institutions. More importantly, there is no rich country with poor-quality institutions.

Prof Mihov said improving the institutional and regulatory environment would significantly affect the growth of developing countries. For example, it takes only two days to start a business in Australia but 152 days in Brazil.

Key factors for development are access to credit, observance of property rights and the ease of closing businesses.

Prof Mihov gave China as an example. Without improving its institutions, China would find it difficult to grow beyond US\$8,000 income per capita, he said.

However - despite the global financial meltdown - Asia's economy will continue to grow, mainly driven by underlying factors, said Prof Mihov.

"With or without the crisis, growth in Asia will continue, maybe not next year but in two or four years, because fundamentals for growth are still there," he said.

How far the Asian region will catch up with the United States is partly determined by population. This is linked to production and if Asian output continues to grow, economic power will shift from the West to the East, he said.

Currently, the US and other rich countries have an average income per capita of \$35,000 to \$44,000, while China has \$5,000 and India \$3,000.

"The gap is huge, which means that potential for growth is huge," he said.

But he stressed that this potential will be realised only if conditions for investment and a business-friendly environment overcome protectionism and

bureacracy.

He sees an opportunity for poor economies to grow fast by increasing their investment, knowledge and capital stock.

Research shows that countries such as China, South Korea, Japan and Singapore - which have built up their physical capital at rates of 30-45% of GDP every year - have high growth rates of above 6%. In China, the current rate of investment is about 45%.

These numbers mean that for each \$100 of income, an average of \$30-45 is put back in the economy in the form of new factories, new equipment and new infrastructure.

Countries need to invest at least 25% of their output back into the economy, said Prof Mihov, and those with investment rates as low as 10% become poorer.

He added that investment does not necessarily mean foreign investment. In most cases, including China, the argument that a rapid rise in the economy is supported by foreign direct investment (FDI) is mistaken.

Out of US\$747 billion gross investment in 2004, only \$55 billion was FDI. New structures, equipment and factories were mainly built with Chinese domestic savings.

Foreign direct investment, he believes, plays a role in growth through transferring know-how but not as the main financing vehicle for investment.