



“Challenges for the Asian Economy in 2008 and Beyond”

Speech by

**President Haruhiko Kuroda
Asian Development Bank**

At

**Asian Development Bank Institute Symposium
8 February 2008
Tokyo**

I. Introduction

Good morning, ladies and gentlemen.

I would like to join Mr. Kawai, Dean of the ADB Institute, in welcoming all of you here today. I would also like to thank the ADB Institute, and ADB’s Japan Representative Office, for arranging this event. And of course, thanks to all of you for joining us to discuss some of the challenges we see on Asia’s horizon today.

In our limited time together today, I would like to focus mainly on three issues. First, I will provide a perspective on Asia’s strengths and vulnerabilities in light of current global economic realities. Second, I will touch on the need for, and progress toward, regional cooperation and integration in Asia and the Pacific. And third, I will share some thoughts on the ever mounting challenge of environmental sustainability and climate change. Following my remarks, I look forward to taking your questions and hearing your views.

II. Economic Prospects and Policy Challenges

As we all know, Asia’s record on economic growth and poverty reduction has been nothing short of stunning. The dramatic growth that has spread from Japan to the so-called "Asian Tiger" economies of Hong Kong, Taipei, China, Korea and Singapore; from the economic miracles in Malaysia, Thailand, and Indonesia to the People’s Republic of China (PRC), India and Viet Nam, has brought tremendous benefits to the people of Asia, and to the world.

For example, per capita income in developing Asia as a whole, grew in real terms, from less than \$170 in 1967 to over \$1,000 in 2005. During a similar period, the average life expectancy rose from 53 years to more than 67 years. In 1990, more than one third of the region’s people still lived in absolute poverty. Today, it is fewer than one in five.

Asia has consequently become a major contributor to global growth. And sustaining the high rates of growth registered in recent decades will be necessary to further increase economic opportunities and continue improving the lives of the poor. The question is: can this be done, particularly in light of recent developments in the US and elsewhere? I believe the answer is yes – but with some significant contingencies.

So far, the region's strong macroeconomic fundamentals have helped mitigate the impact of a US slowdown. The economies of emerging Asia will grow strongly, albeit at a somewhat slower pace in 2008 than in 2007. The most recent projection by the IMF indicates that although US economic growth will slow to 1.5 percent in 2008, the impact on emerging Asia is limited due to strong expansion by the PRC and India. This growth in Asia is a testimony of the region's resilience.

However, the region's economies are not totally immune to global market turbulence and negative developments. A significant slowdown in the US economy will most certainly affect the region's growth performance through trade, investment and financial linkages. With its unparalleled presence in world trade, investment and financial scenes, the US economy exerts significant influence on the global business cycle, including Europe and Japan. Often in the past, when the US sneezed Asia caught a cold, and when the US got a cold, Asia got pneumonia. Though such a strong impact of the US economy on Asia is long gone, a deep and prolonged US recession, should it ever occur could be accompanied by much slower growth in Asia.

Changing demand conditions in the world's major economies – that is, the G3 economies comprising the US, Europe and Japan – are still important to emerging Asia's export growth. Nearly 42% of the region's total exports are headed for the G3 markets. While the region's intra-regional trade share is growing, evidence suggests that a substantially large portion of this intra-regional trade caters to external demand. Indeed, when taking into account the share of intra-regional trade that is ultimately destined for the G3 economies, the share of G3 markets in the region's total exports rises to over 60%.

Global financial linkages are also strengthening, and emerging Asia's stock markets tend to follow the US market closely. As stock markets in the region have grown and become open to foreign investors, stock prices have become more sensitive to global financial shocks. And Asian economies have become more exposed to swings in stock prices through the balance sheets of both households and their financial institutions.

As for the subprime issue, the exposure of Asian banks to US subprime mortgages and related credit products has been, so far, limited and small, relative to the size of their total assets. Banks in many emerging economies in Asia, for example, have virtually no direct exposure. Where they have some exposure to structural credit products, this is relatively dispersed, rather than systemic, and small in size. Other banks—such as those in the PRC, Korea and Singapore—have reported slightly more significant exposure, but again, this represents less than 5% of total equity for most banks. Thus, there has been very limited impact on Asia.

However, spillovers from US and, eventually other G3 financial markets could be potentially large. The rapid transmission of financial volatility during the recent market sell-offs is a vivid reminder of the region's vulnerability to disruptions in the global financial system. With the region's trade, investment and financial linkages to global markets still high, potential

spillovers from a further tightening in global credit markets and a slowing in the US and global economies do pose a significant risk to the regional economic outlook.

Given this backdrop, Asia's policymakers need to take steps necessary to ensure confidence in the region's financial markets. They must continue to pursue sound macroeconomic management, strengthen prudential supervision of financial institutions, and improve structural resilience through deeper and more comprehensive reform efforts.

Fortunately, the Asian region has built substantial buffers against external shocks since the 1997-98 financial crisis, through accumulation of large foreign exchange reserves, reduction of short-term external debts, bank and corporate restructuring, and shifts to less rigid exchange rate regimes. Improved fiscal positions also allow some room for extra stimulus, if necessary. It will be important for emerging Asian economies to expand domestic demand. In several countries—such as the ASEAN countries—investment demand has not adequately recovered since the financial crisis. In other countries—like the PRC—consumption demand remains subdued. Broad-based policy efforts are necessary to ensure that future growth in emerging Asia is better balanced in terms of its domestic and external components.

While significant progress has been made, reforms have yet to be deepened in some areas. First, there is a further need for increasing exchange rate flexibility. This would broaden the scope for using monetary policy to achieve domestic economic objectives such as non-inflationary growth and financial sector stability, reduce the potentially costly sterilization operations by central banks, and help rebalance sources of growth away from external toward domestic demand without significantly harming countries' international price competitiveness. Second, further reforms are needed to promote more effective public debt management in order to secure options for fiscal action when appropriate. And third, continued structural reforms remain a policy priority for the region. It is important to improve the investment climate and the efficiency of financial intermediation in countries such as those of ASEAN, where ongoing current account surpluses largely reflect weak domestic private investment. It is important to strengthen social safety nets in countries like the PRC, where surpluses largely reflect excessive savings. These efforts underscore the need for deeper and more comprehensive reforms.

III. Regional Cooperation and Economic Integration

The region's progress and prospects will also be bolstered by continued and stronger efforts toward regional cooperation and economic integration.

Driven by the private sector, market-led regional economic integration has deepened, especially in East Asia, as value chains and production networks have grown. East Asia's governments have embraced economic cooperation through various informal dialogues and formal ministerial processes, whether in ASEAN or the ASEAN+3 frameworks, or in the growing cooperation in South Asia and the Central Asian Republics. And each success story builds a firm foundation for further progress, raising hope for the less-developed economies of Asia and the Pacific that they too could replicate the achievements of their high-performing neighbors.

Our experience at ADB has shown that a pragmatic, step-by-step, bottom-up approach to regionalism—rather than an idealistic, comprehensive, top-down pan-Asian “vision” approach as was done in Europe—is most appropriate as our economies increasingly work together. A “multi-speed,” “multi-track” approach is evolving, whereby a few countries start working together on selected common issues, with the option for other countries to join later, or appropriate new

issues to be added. Given the extreme diversity and sheer size of Asia and the Pacific, it is logical to begin cooperation at the subregional level, building outward to eventually achieve wider and more broad-based regional integration. We have seen this within ASEAN, for example, which is striving to achieve an Economic Community by 2015.

At ADB, our aim is to support this regional trend toward deeper integration. While promoting regional cooperation is part of our Charter, we took the initiative in 2006 to adopt a formal Regional Cooperation and Integration Strategy. The Strategy unifies efforts across our departments and offices, improves the quality of our lending and non-lending services, and strengthens support for trade, investment, and financial integration. It is a coherent, focused strategy that underscores four essential “pillars”:

- *Physical connectivity* through regional and subregional initiatives on cross-border infrastructure and the related software that ease the movement of goods and people;
- *Trade and investment cooperation* through liberalization and facilitation of cross-border transactions for goods, services, and capital;
- *Monetary and financial cooperation* through regional financial sector reform, bond market development, and exchange rate stability; and
- *Regional public goods* through improved environmental, health, and social conditions—for example, through the prevention of environmental degradation and communicable diseases, or promotion of energy efficiency.

Last year we established a new facility for mobilizing resources for this purpose—the Regional Cooperation and Integration Financing Partnership Facility. The Facility will use ADB resources, and will administer contributions from bilateral, other multilateral, and individual sources, specifically for regional initiatives. On this note, I am very pleased to report that the Government of Japan has committed 1.16 billion yen to the Investment Climate Facilitation Fund, established under the Financing Partnership Facility. The Fund will support a variety of projects, ranging from infrastructure to good governance, to support and promote a stronger, more integrated regional economy.

IV. Asia and Climate Change

I am equally pleased that Japan has committed 2.32 billion yen to the Asian Clean Energy Fund, established under ADB’s Clean Energy Financing Partnership Facility. And this brings me to my third and final topic today – that of environmental sustainability and climate change.

We all recognize that climate change presents a major challenge to global development. The Asia-Pacific region is central to meeting this challenge, because it will increasingly contribute to its causes unless economic, social and environmental patterns change – and it will also disproportionately suffer the consequences of climate change.

Back in the 1970s, the developing countries of the Asia-Pacific region accounted for less than 10% of the world’s energy-related greenhouse gas emissions. Today, their energy-related contributions account for about 27% of the global total, and when deforestation and emissions from landfills and industrial sources are included, the region contributes more than one-third of global emissions. The PRC’s emissions are already roughly equal to those of the United States, and are projected to expand rapidly. India is also a major source of new emissions, though per

capita levels remain low. Indonesia has been ranked third in emissions behind the PRC and the US in one estimate, based on the combined effects of its rapid deforestation and economic growth.

Shifting to a lower-carbon economy across developing Asia is crucial for reducing adverse environmental impacts at the local, regional, and global levels, and for enhancing regional and global energy security. With the price of oil breaching the \$100 a barrel mark at the dawn of 2008, energy issues are again – and will continue to be – in the limelight. Despite the threat of a global economic slowdown, oil demand continues to rise, underpinned by rapid economic growth in the PRC, India, and other large emerging economies, where energy intensity is higher than in their more developed counterparts. Improvements in energy efficiency or the expansion of locally-produced energy supplies will contribute to improved energy security while at the same time reducing greenhouse gas emissions.

This daunting challenge is accompanied by the need for equally significant adjustments to cope with the adverse impacts of climate change. Rising sea levels, heat waves, greater rainfall variability, melting glaciers and stronger and more frequent typhoons are just some of the predicted consequences. And Asia and the Pacific populations are among the most vulnerable to these changes.

Energy-efficient economies using diverse and indigenous energy supplies are remarkably resilient to external shocks. This strengthens the region's competitiveness and sustains high levels of growth. But fossil fuel will continue to be important for the growth of emerging economies because it is the more affordable option. Fossil fuels use in developing Asia is expected to account for over 84% of the overall increase in global demand between 2005 and 2030. Therefore, a foundation of Asia's sustainable future must be to expand the use of renewable energy sources and to make the region's economies as energy-efficient as possible.

There are plenty of emerging low-carbon and zero-carbon options. The incremental costs for biomass cogeneration, wind, geothermal, hydropower and solar water heating are declining quickly, and in many areas with rich renewable resources, such options are becoming quite competitive with fossil fuel costs. Demand- and supply-side interventions must go hand-in-hand to reduce greenhouse gas emissions. The most significant incentives will be created through the continued expansion of global carbon markets, which last year had transactions exceeding \$30 billion. This market is already shaping the decisions of government and corporations alike here in Asia and around the world.

Even with ambitious mitigation measures, however, the world is already locked into a significant degree of climate change, and this threatens to undermine many of the hard-fought gains in poverty reduction across the region. The Stern Review estimated that under the best-case scenarios of international action to keep greenhouse gas concentrations low, the need for adaptation measures will still cost developing countries \$10 billion annually just for the infrastructure adjustments to floods, storm surges, water shortages, cyclones and other increased risks. Most of these impacts relate to changes in hydrological conditions, and they will only exacerbate the already acute competition over scarce water resources in the region. Furthermore, the need for "climate proofing" of project investments will become part of our everyday business, because these impacts will affect the underlying assumptions behind the design of hydropower, water supply, irrigation, flood protection and even sanitation projects. While concessional financing will remain central to climate change adaptation actions, particularly in low-income developing Asian and Pacific countries, we must also act to unleash

private sector capital and insurance markets as part of our collective response to this important new threat to the region's development.

I believe we should seek ways to build up a pool of funds to help dampen the financial impact on countries that may be called upon to accommodate large populations displaced by climate change. No single country should have to bear the burden of climate-driven refugees on its own. Simultaneously, we must start forming a legal framework so those people can receive the most basic protection if and when the time comes.

Multilateral development banks like ADB have a key role to play, collectively and individually. Together with others in the development community, we are working across the full range of sectors in which we operate to identify ways to better combat climate change. Under the framework of its clean energy and environment program, ADB is helping its developing member countries prepare new policies and programs to promote greater energy efficiency, to widen their access to carbon markets, to introduce less carbon-intensive patterns of urban development and transport, and to begin the long process of adapting to the already unavoidable impacts of climate change. We have supported analysis in the Pacific to help low-lying countries understand how their coastal infrastructure can be made more resilient to the impacts of climate change, and we are working with the World Bank and the Japan Bank for International Cooperation to examine adaptation costs in the major coastal cities of developing Asia, including Bangkok, Ho Chi Minh City, Jakarta and Manila. We are also looking at the impacts of climate change on agricultural production and on forest ecosystems in the Greater Mekong Subregion. Such considerations will become commonplace over the next two decades, and we need to be good partners to our developing member countries as they adjust.

Given the scale of investment required, ADB is increasingly directing its resources to help leverage the flow of private capital into climate change mitigation and adaptation measures. And we are paying close attention to the need for continuity in these capital flows beyond the end of the current global climate change framework in 2012.

That was a principal objective of the "Bali roadmap," signed at the UN Climate Change Conference last December. This was, of course, a positive step along the path to define the next global regime to combat climate change. The roadmap should lead to a new agreement in late 2009 that will move beyond provisions of the Kyoto Protocol, which end in 2012. We are pleased to see the leadership being exerted by the global community through the UN Framework Convention on Climate Change (UNFCCC) in this regard. We hope for a productive and comprehensive outcome to the negotiations under the UNFCCC which should generate a new set of arrangements at the global level that will reshape the way economic growth is achieved so that it is environmentally sustainable.

V. Concluding Remarks

Ladies and gentlemen, today I have touched on only a few of the issues facing the Asia - Pacific region – and particularly its developing countries. Overall, the region has come a long way, and the stage is set for yet more progress in the years ahead. But, as I have outlined, there are large challenges that must be tackled at all levels, national, regional and global.

As Asia's partner in development, ADB continues to work with developing Asian economies to turn those challenges into opportunities. Our new long-term strategy to support the region's evolution to higher levels of development is now under discussion with a particular focus on such key areas as inclusive growth, environmental sustainability, and regional cooperation and integration. Ultimately, a stronger, cleaner, more inclusive and more integrated Asia will contribute proportionately to our world's increasingly globalized economy.

Thank you.