

“Asia’s Contribution to Global Economic Adjustment”
Keynote Speech by
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1. Introduction

It is a great pleasure to be here in Hong Kong to join you for the Third All China Economic Conference for 2010, organized by City University of Hong Kong, and to speak on the very timely issue of “Asia’s Contribution to Global Economic Adjustment”.

Since the global financial tsunami hit a little over a year ago, the world economy has been experiencing the worst global financial and economic crisis since the Great Depression. Over the past year and a half, we have witnessed the eruption of systemic financial crises in the United States and Europe, a simultaneous contraction of output, a dramatic shrinkage of international trade and investment, and rises in unemployment in these and many other affected economies.

The US subprime mortgage crisis that had emerged by the summer of 2007 spread to the entire US financial system and financial markets of other industrialized countries. Many European countries also had their own financial vulnerabilities. While investing in “toxic” assets created by US institutions, they were also exposed to investments in real estate and Eastern European economies as well as capital market funding and high leverage. With the failure of Lehman Brothers in September 2008, the crisis in the US and Europe moved quickly from the financial sector to the real economy. Real GDP contracted sharply in the US, Europe, Japan, and other economies affected by sudden stops—or even reversals—of capital flows and sharp declines in exports. Exports plunged across the world, delivering a major shock to even those economies that were little affected by the initial financial shock.

Most industrialized countries and many emerging economies that were affected by the crisis responded to it by easing monetary policy, resorting to fiscal stimulus, and providing financial sector support. The G20 summit, first held in Washington (November 2008) and then in London (April 2009) and in Pittsburgh (September 2009), has become the premier forum for international policy coordination to enable the global economy to recover from the crisis and put economic activity back on track to sustainable growth. As a result of these efforts, by the early summer of 2009, we witnessed signs of economic stabilization and recovery.

It seems so far that the world has been able to avoid the repeat of the Great Depression of the 1930s. There are essentially three reasons for this. First, all

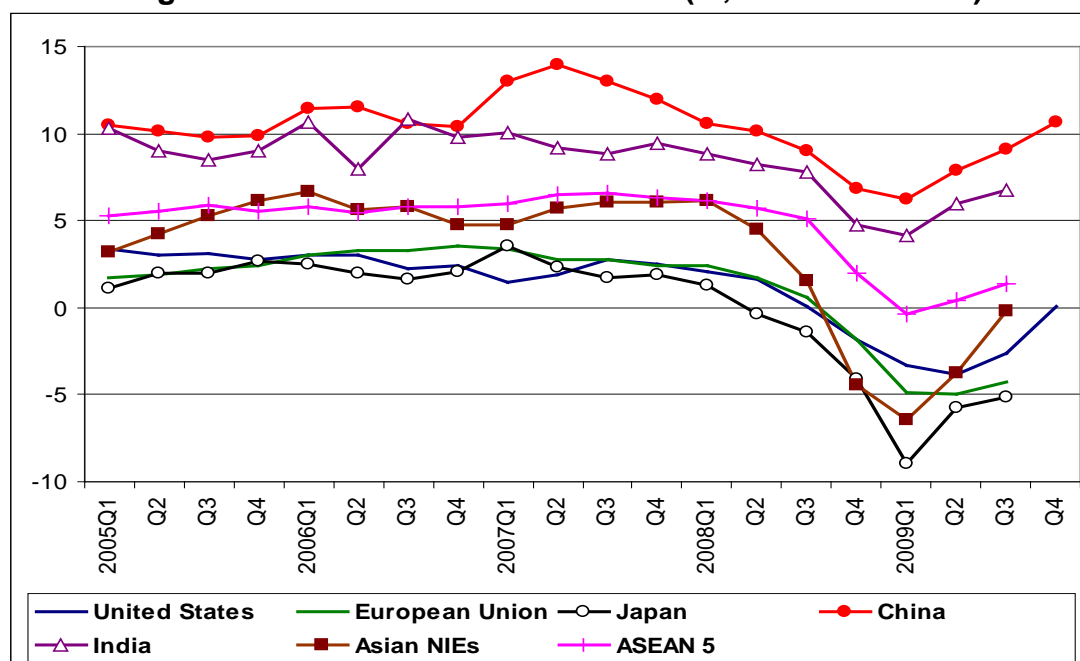
major economies pursued expansionary monetary and fiscal policy and financial sector support policies to contain the negative impact of the crisis. Second, international policy cooperation has been pursued vigorously through the G20 to avoid beggar-thy-neighbor policy and free rider problems. Third, the presence of growing, dynamic emerging market economies—like China, India, and Brazil—has provided support to the global economy.

Asia’s contribution to global economic adjustment includes two aspects: the immediate policy responses to achieve economic recovery from the global economic downturn; and the medium- to long-term adjustments to reduce internal and external imbalances and set a course for sustainable growth. The key message is that we do not foresee a return to business as usual in global growth, and that Asia must contribute to global adjustment by promoting greater growth of final demand in the region.

2. Impacts on Asian Economies and Asian Policy Responses

Even though the crisis did not originate in Asia, Asian economies were hit hard by the downturn in export demand, and, in some cases, by turbulence in foreign exchange and capital markets as a result of a sudden stop in the inward flow, and/or the withdrawal, of capital. Exports virtually collapsed, industrial production declined sharply, and real GDP contracted steeply in Japan; in the newly industrialized economies of Hong Kong; Korea; Singapore; and Taipei, China; and in export-dependent middle-income ASEAN countries like Malaysia and Thailand (see Figure 1). Real GDP did not contract in China, India, or Indonesia but their growth rates slowed.

Figure 1: Growth Rates of Real GDP (% , Year-Over-Year)



Source: IMF, *International Financial Statistics*, online; and national data.

Similarly to the US and Europe, many Asian economies responded with aggressive measures to ease monetary and fiscal policy and to support national financial systems. Although it is difficult to estimate the actual impact of these packages, the Asian Development Bank estimates that fiscal stimulus measures taken by China, Malaysia, Singapore, and Viet Nam exceeded five percentage points of GDP in size, while those of Hong Kong, India, Japan, Korea, the Philippines, Taipei, China, and Thailand amounted to between two and five percentage points of GDP.

Combined with the fundamental resilience, Asian emerging economies are now leading global growth, having averaged 10% annualized growth on a simple average basis from April through September this year, a very impressive performance indeed. Growth was especially strong in Singapore, Taipei, China, China, India, Korea, Malaysia, and Vietnam. In view of its size, China made by far the largest contribution to regional growth, and perhaps the largest to global growth.

The fact that Asian economies were able to take aggressive policy measures underscored the dramatic improvement that had taken place in their macroeconomic and financial sector fundamentals since the Asian financial crisis of 1997–1998. A number of regional central banks had achieved low inflation, as a result of commitments to non-inflationary policy, while many governments had substantially reduced fiscal deficits and contained levels of public debt. Private sector banks and non-financial corporations had also achieved stronger balance sheets—including lower nonperforming loan ratios and higher capital adequacy ratios—and less exposure to adverse currency movements.

The rise in foreign exchange reserves in the region, which many had criticized as being excessive, played a key role in minimizing currency turmoil in the region, while greater exchange rate flexibility also provided a cushion in the face of turmoil. Notably, the global financial crisis did not force any country in the region to go to the IMF for financial rescue, nor even raise interest rates to defend the currency value. Although Korea faced unusually large downward pressure on its exchange rate and a rapid loss of its foreign exchange reserves in the fall of 2008, the country was able to stabilize the situation by using the US\$30 billion currency swap line established with the US Federal Reserve. Indonesia, another country whose exchange rate depreciated sharply, was able to secure US\$5.5 billion for fiscal support in standby loan facility—referred to as “deferred drawdown options”—from Japan, Australia, the Asian Development Bank, and the World Bank. Singapore also received a swap line from the Fed, although it did not need to use it.

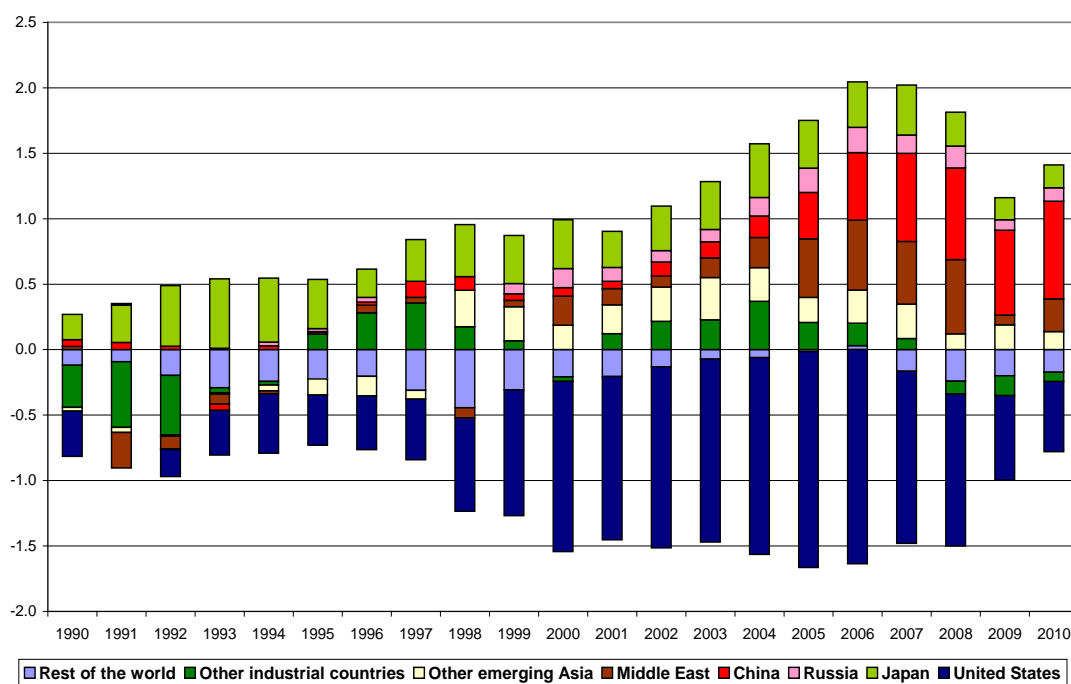
Finally, the low level of exposure to toxic financial assets and conservative financial regulatory regimes in the region helped to minimize losses of both the banking sector and private investors and corporates, thereby avoiding or at least minimizing the development of debilitating credit crunches. This allowed domestic demand to remain firm in the face of export shocks and to respond vigorously to monetary and fiscal stimulus measures.

3. Asia's Challenge of Growth Rebalancing

While achieving the goal of economic recovery, Asian policymakers need to focus on measures to restore sustainable medium- to long-term economic growth. This should not mean that Asia will simply go back to the pre-global financial crisis pattern of growth. I believe that this requires measures to reduce internal and external imbalances and lessen excessive dependence on export growth, targeted at the US and European markets. There are two factors behind this consideration.

First, Asian economies had benefited tremendously from export-led growth centered on US and European markets during the years leading up to the global financial and economic crisis. This growth model, however, can no longer be relied upon to sustain the region's economic growth beyond the crisis. The reason is that US consumer spending will likely remain sluggish over many years to come, and this will be a structural phenomenon, not a temporary one. US personal consumption was excessively large until mid-2008 because households had spent too much reflecting their inflated ability to borrow against the bloated housing equity created by the housing price bubble. This overconsumption in the US is now under retrenchment, forcing households to repay debt and rebuild wealth, a process which will last for some time. US (and European) consumers are unlikely to be the major source of growth for export-oriented Asian economies. In addition, the size of US and European potential GDP may have shrunk and their potential growth rate will likely be lower over the medium-term.

Figure 2: Global Payments Imbalance, 1990-2010



Source: IMF, *World Economic Outlook*, October 2009, database.

Second, the view is widespread, although controversial, that the global payments imbalance contributed to the global financial crisis by fostering

reverse international capital flows from the surplus to deficit countries, which led to the development of asset price bubbles around the world, most notably in the US housing market. I am somewhat skeptical about this view. To be sure, accumulation of large-scale foreign exchange reserves by several Asian and other economies may have contributed to low long-term interest rates in the US and elsewhere. However, the main responsibility for the development of housing price bubbles and excessive financial risk-taking rests with the relevant domestic monetary and financial sector authorities. There is ample evidence of a wide range of policy and regulatory failures in the US and elsewhere. Perhaps the most persuasive piece of evidence is that Canada, which faced long-term interest rates very similar to those of the US during the past decade, managed to avoid a housing bubble mainly as a result of much more prudent financial sector regulation. Australia, which faced signs of incipient housing bubbles, managed to reduce the buildup of financial vulnerabilities due to its prudent monetary policy. Nonetheless, I believe that the reduction of the global imbalance can constitute a key policy agenda for stable global finance and sustainable global growth.

Asian economies need to adapt to this difficult environment and to take up the challenge of rebalancing growth toward greater reliance on domestic and regional demand. This presents a new development paradigm for Asia so that the region will not only remain the world's factory of manufactured products but also become a new source of global demand. This would require a series of domestic structural reforms in Asia and intensive regional policy coordination.

It is recommended that Asian policymakers focus on five priorities:

- A regional policy framework needs to be established to coordinate monetary and fiscal policies, to monitor risk factors such as financial market vulnerabilities and capital flows, to provide hard currency liquidity when needed, and to promote more coordinated exchange rate movements.
- The demand side of each economy needs to be strengthened. In some countries—such as China—household consumption needs to play a greater role, which requires both household income and the propensity to consume to be higher. In other countries—such as ASEAN countries and India—where the ratio of investment to GDP is low, investment needs to be encouraged.
- The supply side should be stimulated by focusing on investment, innovation, and deregulation in areas of future potential for long-term growth. This includes investment in human resources, knowledge activity, physical infrastructure, and information and communication technologies, and promotion of services sectors and green growth. Small and medium-sized enterprises (SMEs) often play a significant role in these areas.
- Regional market integration is essential to encourage regional trade in goods and services, foreign direct investment, and financial

intermediation, thereby enhancing the potential for long-term growth in Asia. Regional financial integration is crucial to mobilize the high level of regional savings for productive investment within the region.

- An increase in the reach of the Asian voice in the reform of the global financial architecture is essential given the rising economic weight of Asia in the global economy and finance. Asia needs to provide ideas to strengthen economic surveillance of systemically important economies, to reduce the risks of future crises, and to deal with large and complex financial institutions on a consistent global basis.

While the challenges are substantial, the crisis could be an opportunity for Asia to fundamentally restructure its approach to development and bring about a more sustainable, balanced growth. Without intensive economic and financial cooperation among Asian economies, this growth rebalancing cannot be achieved.

Let me discuss these priorities in more detail.

Policy coordination, exit policies, and exchange rate management

Perhaps the next task of Asian policymakers is to achieve a coordinated and orderly exit from the extraordinary fiscal and monetary stimulus measures adopted over the past year. At the very least, increased communication among Asian finance ministers, central bankers, and financial supervisors and regulators could make an important contribution to a smooth adjustment process. To this end, establishment of an Asian Financial Stability Dialogue (AFSD)—which can evolve into an Asian version of the Financial Stability Board—could prove an important step forward in regional financial surveillance and policy coordination. This forum could also serve to promote longer-term financial market development and integration, establish standards for governance and transparency, and improve investor confidence.

Once global financial stability is restored and growing Asian economies begin to tighten monetary policy, one can expect the resumption of large capital inflows into Asia. To manage such capital inflows and maintain macroeconomic and financial sector stability, it will be important to allow sufficient exchange rate flexibility while preserving relatively stable intraregional exchange rates.

As growth rebalancing will likely be accompanied by a weaker US dollar, a challenge is to avoid intraregional currency misalignments. This requires coordinated exchange rate management to allow greater rate flexibility vis-à-vis outside currencies—particularly the US dollar and the euro—and exchange rate stability vis-à-vis regional currencies. To facilitate such exchange rate policy coordination, it would be useful to introduce an Asian Currency Unit index as a monitoring indicator. The ASEAN+3 countries—the 10 ASEAN member states plus Japan, China, and Korea—could work together toward such currency cooperation.

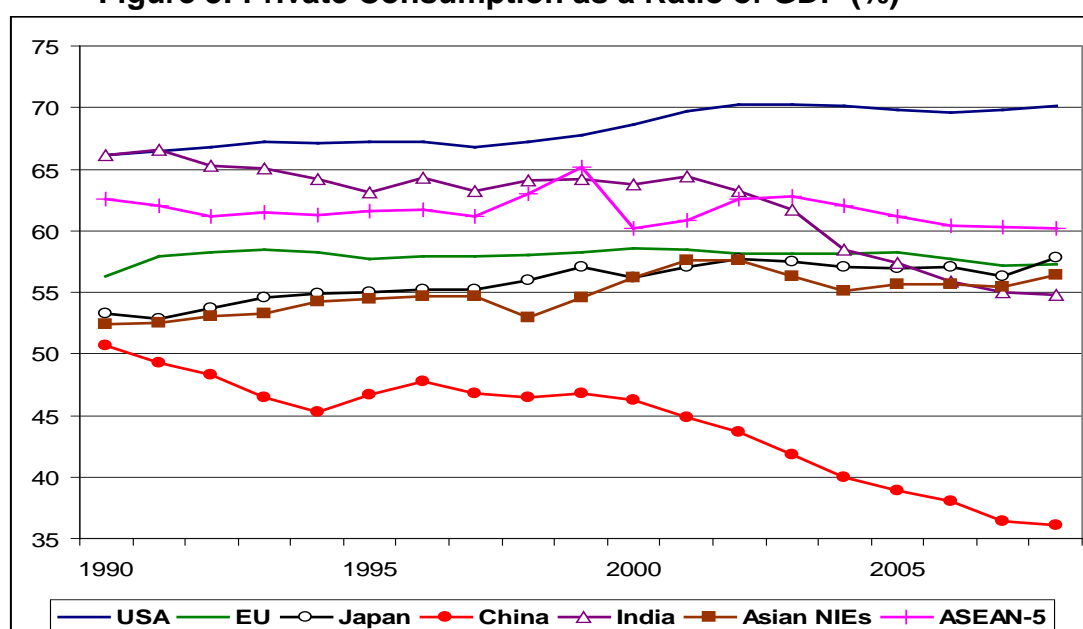
Regional economic surveillance and regional reserve pooling—under the Chiang Mai Initiative (CMI)—is a potentially powerful mechanism to complement the global role of the IMF. The recent agreement by ASEAN+3 finance ministers to multilateralize the CMI with US\$120 billion and set up a surveillance unit is a positive step for regional currency and financial stability. Once the CMI is fully multilateralized, an effective regional surveillance mechanism is fully in place, and the surveillance unit exhibits its ability to formulate independent conditionality associated with crisis lending, the multilateral CMI can be delinked from IMF programs, paving the way toward the creation of an Asian Monetary Fund (AMF). Further increasing the resources of the multilateral CMI is desirable as well.

An AMF is essential to support Asia’s rebalancing process, as economies in the region would accept smaller current account surpluses—and less accumulation of foreign exchange reserves—if an AMF would mitigate financial turbulence and act as a regional lender of last resort. In addition, countries such as Japan could also arrange additional, bilateral yen-based currency swaps with other Asian economies that cannot easily obtain currency swaps with the US Federal Reserve.

Promotion of domestic demand

Asian nations need to give a high priority to expanding domestic demand, including consumption and investment. High national savings rates, relative to national investment rates, are the sources of current account surpluses in the region and, thus, have contributed to the global imbalance. A reduction of current account surpluses would require increases in consumption and investment. Household consumption can rise with a rise in household income and/or the propensity to consume so effective measures are those raising household income and stimulating the propensity to consume.

Figure 3: Private Consumption as a Ratio of GDP (%)

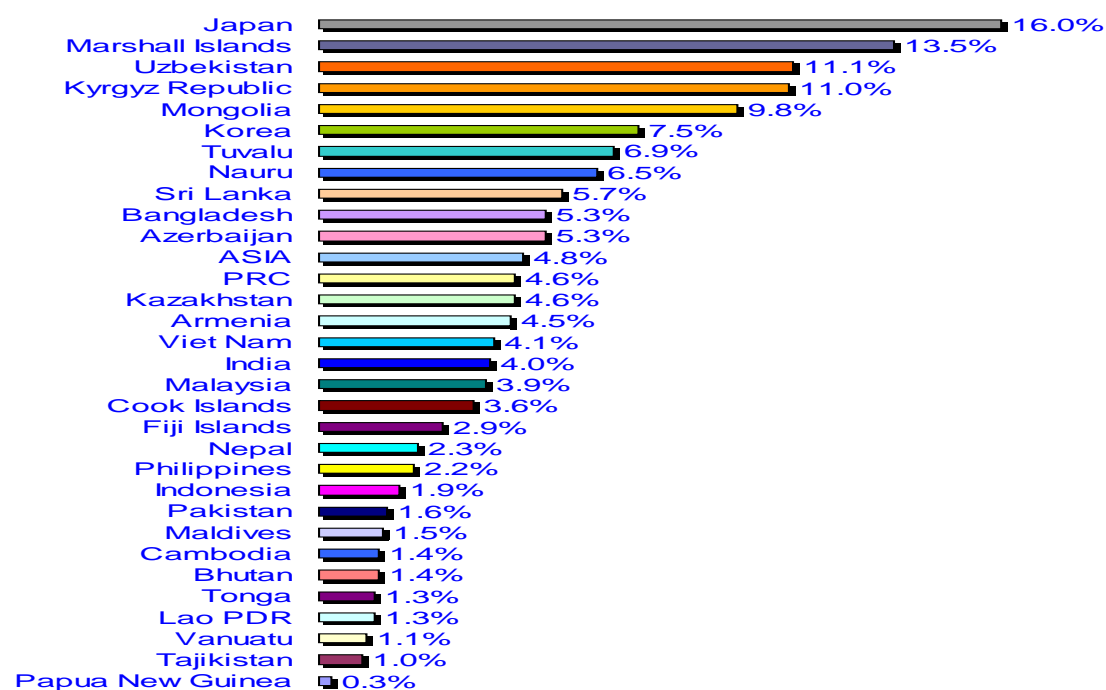


Source: IMF, *International Financial Statistics*, online; and ADB, *Key Indicators*, online.

In many countries, such as China, the share of household income in GDP is low (see Figure 3), and both corporate and household savings are large. Substantial scope exists for these economies to reduce corporate savings and increase household consumption. For example, government policies to raise dividend revenues from state-owned enterprises (SOEs) and transfer such revenues to households have the role of augmenting household income and thus stimulating household consumption. These policies at the same time reduce corporate savings and discourage excessive and often inefficient investment by SOEs.

Studies of China, the Philippines, and Taipei,China show that precautionary demand for savings—created as a result of low levels of government spending on social safety nets—has been an important determinant of overall saving behavior of households. Structural measures to reduce precautionary savings—and thus stimulate the household propensity to consume—should be given high priority, particularly through the strengthening of social protection systems, including larger public spending for basic health, education, and housing as well as system building for health and unemployment insurance and retirement pensions. In addition, income redistribution from the rich to the poor would also stimulate national household consumption as the poor typically have a higher propensity to consume than do the rich.

Figure 4: Asian Countries' Social Protection Expenditure (% of GDP)



Source: ADB.

In contrast, scope exists to encourage investment in a number of countries, especially those where infrastructure investment needs are high such as India, and where the ratio of investment to GDP dropped sharply after the Asian

financial crisis of 1997-98, including Indonesia, Malaysia, the Philippines, and Thailand. This can be encouraged both through targeted public investment, especially in infrastructure and improvement of the investment climate and other supply-side environments, which I will discuss next.

Strengthening the supply side

Asian policymakers need to strengthen the supply side of the economy in order to promote areas of future potential for long-term growth through investment, innovation, and deregulation. These areas include human resources (education, health and training), knowledge activity (research and development [R&D], and information and communication technologies [ICT]), physical infrastructure, services sectors, and green growth. Investment in human resources and knowledge is the key driver of competitiveness and economic growth in the current era of globalization.

Infrastructure development, particularly in transport, energy, and ICT, is essential to forge cross-border connectivity and expand trade and investment businesses. Strong regional cooperation among Asian countries is crucial for establishing Asia-wide physical connectivity towards a seamless Asia. Regional infrastructure will need to be geared increasingly towards supporting Asian production networks and regional supply chains to target Asian markets and promote intra-Asian trade. Asian policymakers should focus on the “soft” component—policies, regulations, rules and procedures—in order to make the “hard” component of infrastructure work. In many cases, public-private partnerships are essential to attract private sector funding and management know-how while mitigating risks involved.

Today, the services sector is the single largest sector in Asia and provides the bulk of employment for the skilled and unskilled workforce. An efficient services sector is critical to a country’s competitiveness and economic growth. But a large part of Asia’s services sector, particularly non-tradable services (such as healthcare, education, distribution, transport, and public utilities), remain unproductive, and improving the productivity of these non-tradable services through deregulation should be a top priority. At the same time, promoting business-supporting services (such as legal, accounting, back-office support, finance, logistics, etc.), which are potentially tradable, is equally important as it is likely to exert an economy-wide influence in providing strong inputs to other economic activities. The role of the services sector is closely connected to that of small- and medium-sized enterprises (SMEs), which provide the bulk of employment in Asian economies. Effective policies are needed to promote SMEs and service industries to better align domestic production with domestic demand and trade within the region.

The new development paradigm should also focus on low-carbon green growth through addressing the problems of energy conservation, climate change and other environmental degradation, and fostering strong regional cooperation. Given the growing scarcity of energy and natural resources, energy efficiency will become increasingly important for Asia’s sustainable economic growth. Future competition for Asia at the international level will be

not just about novelty, price, quality and design; but will also be about eco-efficiency. For this purpose, Asia needs to focus on innovation and technological capacity to integrate the guiding principles of energy efficiency and environmental protection into all economic activity. Supporting R&D towards eco-innovation and green services as well as investment in skill development and local capacity to supply green products and services should clearly be an Asian priority.

Regional integration in trade, investment, and finance

Given the importance of trade and investment for economic development in Asia, it is critical that Asian nations affirm their support for free trade and reject any drift toward protectionism.

Beyond this, the creation of an Asia-wide Economic Partnership Agreement (EPA)—to create a free trade and investment area with more harmonized rules, procedures and standards—would contribute to the goal of rebalancing growth. In addition to the liberalization of trade in goods and services, liberalization and harmonization of cross-border investment is also critical to further expanding regional markets: Asian producers can target the expanding high-income and middle class in emerging Asia—totaling 50 million and 880 million people, respectively, in 2008 in China, India, ASEAN and others. In this way, both firms and consumers in Asia would benefit from economies of scale, dynamic efficiency, and greater trade and investment opportunities within the region. Consolidating the existing Asian “noodle bowl”—an array of overlapping bilateral and plurilateral free trade agreements in the region—into a single agreement is thus a high priority.

Further deepening and integration of financial markets can also help support the region’s long-term growth by helping to recycle Asia’s high savings for investment in worthy projects in the region, particularly when capital flows from other regions are volatile. Further development of Asian bond markets (through the Asian Bond Markets Initiative and the Asian Bond Funds) could provide important support to countries seeking to increase investment for growth, whether for infrastructure or other types of private investment. ASEAN+3 countries should accelerate the process of establishing a credit guarantee and investment mechanism to provide credit guarantees for bond issuance in regional currency. Other measures such as encouraging regional credit rating agencies, harmonizing tax rules and regulations on inward investment, and developing an infrastructure for currency hedging and swaps can make regional bond markets more attractive to issuers and investors.

A financial sector that can finance SME businesses and consumer purchases of durables goods and residential housing is quite important to strengthen both the supply and demand sides of the economy. Establishment of national and regional corporate credit databases and credit guarantee systems can support this, together with capacity building for design and establishment of credit information bureau and guarantee systems.

Improving surveillance and strengthening regional financial sectors against future financial shocks can make an important contribution of supporting domestic demand growth. The experience of the current crisis shows the importance of implementing a framework for macroprudential financial supervision and regulation, including effective prudential tools and a powerful Systemic Risk Council, for monitoring and managing systemic risk. Steps to reduce the procyclicality of financial regulation are also important.

Reform of the global financial architecture

Finally, reform of the international financial architecture can play a key role in stabilizing financial systems and promoting growth. Asian policymakers should actively participate in forums such as the G20 and the expanded Financial Stability Board to put their imprint on reforms of the global financial system, and support regional cooperation and integration initiatives. Asian economies need to contribute to the reform of global supervision, regulation and resolution of cross-border financial activities of both systemically important and less important institutions.

They should also aggressively support reforms of both the function and the governance structure of the Bretton Woods institutions, including the IMF and the World Bank. The governance structure of these institutions needs to reflect the increased economic importance and voice of Asia, as well as its successful experience in weathering the current crisis. The effectiveness of these institutions needs to be enhanced to help support growth in emerging economies.

4. Conclusions

The fact that Asian economies began recovering strongly in the second quarter of this year—a quarter before even a mild recovery was seen in the US and Europe—shows that Asia already made a strong contribution to global growth. This resulted both from aggressive moves to ease monetary and fiscal policy and the underlying fundamental strength of their economies.

However, the biggest challenge lies ahead. Given that it is unlikely that the US and Europe will be engines of global growth, Asian economies should contribute to global economic adjustment by creating their own growth engines. This is the only way for Asia to be able to sustain long-term economic growth in the postcrisis era, and will also contribute to growth of the global economy. In order to achieve this, Asia needs to transform itself into a large consumer area while maintaining its competitiveness as the world's factory, by rebalancing sources of growth away from excessive dependence on extraregional—particularly the US and EU—demand toward domestic and regional demand. Asian firms can target the rising high-income and middle class in emerging Asia—China, India, and ASEAN—who will become a big source of final consumption demand.

This growth rebalancing effort requires closer policy coordination in Asia to pursue structural adjustment, integration of regional markets, and pursuit of

socially inclusive and environmentally sustainable growth. Such cooperation will go a long way in creating foundations for an East Asian Community. Key elements of this include measures to: deepen social protection to support social resilience; increase infrastructure investment to create a “seamless Asia”; enhance productivity in the services sector; establish a region-wide EPA to encourage intra-regional trade in goods and services and investment through economies of scale and dynamic efficiency of a larger market; promote a shift to a low-carbon society and support green growth; and deepen and integrate the financial sector to facilitate the recycling of Asia’s high savings for investment within the region. A stronger, balanced, and more resilient Asian economy, with multiple sources of growth, can provide benefits to the global economy, and be a source of global leadership.