

CHAPTER 1

ASIAN GROWTH AND GLOBAL STABILITY

Introduction

The year 2008 will be long remembered for the precipitous slide into world-wide recession that has now affected all Asian economies and their engines of growth, including especially trade and direct investment. The speed and synchronization of the downturn have surprised policy makers and academic economists alike, offering stark evidence of how interdependent the world economy had become. They laid to rest once and for all the idea that Asia—or any other region—could ride out storms that affect its significant centers of global activity.

But 2008 also focused attention on a long-standing trend—a gradual but decisive shift in the importance of different countries and regions in world production and consumption. The crisis originated in the world's financial center, not in developing or emerging markets. Even in the downturn, emerging market economies maintained better economic performance than the mature economies. And when time came to convene the world's economic leadership to develop a concerted policy response, it was the G20, and not the G7, that emerged as the logical choice. To be sure, the advanced exporting economies of Asia were seriously affected, but despite sharp deceleration, the growth rates of China, India and several ASEAN economies help up better than those of developed economies. Twelve years after suffering its own devastating financial crisis, Asia has much healthier fundamentals. The region exhibited remarkable resilience to the global shocks in the past decade. On the back of strong growth and rapidly integrating regional trade and production linkages, Asia now exerts significant influence in global markets and is emerging as a powerful center of global economic growth.

This book seeks to analyze the long-term implications of these changes. Its task is complicated by the uncertainty created by the current crisis. But the changes ahead, even if difficult to discern in the turmoil, are far-reaching. As long-term patterns of economic growth shift, new international relationships are being built. Countries in the growth centers of Asia are increasingly important to each other in trade, finance and investment, and in policy. Their “emerging regionalism” is market based, but also involves expanding government cooperation. It is likely to be reinforced by the crisis. Will Asia's regionalism fragment and undermine the global economy, which has generated so much progress in recent decades, or provide a new tool for restoring its dynamism and stability?

The articles that follow examine the dimensions of Asia's economic integration, the challenges they bring, and the regional cooperative mechanisms that could provide solutions to them. The major issues are divided into three broad areas: growth and productivity, financial stability and interdependence, and economic cooperation. The articles evaluate recent and likely future trends. But they don't stop there—they consider

also whether the region's progress is sustainable, and what policies are needed to keep them so. How will Asia weather the global economic storm? How will its economy change, and what will be its global role during the crisis and afterwards? Can Asia contribute to better governance and greater prosperity not just in its region but also world wide? These issues are addressed from several perspectives, using an approach that seeks to connect theory and evidence, and to derive policy strategies.

The chapters were prepared as background papers for the Asian Development Bank's 2008 flagship study, *Emerging Asian Regionalism: A Partnership for Shared Prosperity*. That study reviewed Asian economic integration especially since the financial crisis of 1997/98 and examined strategies for addressing the region's deepening interdependence and expanded role in global governance. Completed in early 2008, the study did not predict the current global crisis. Nevertheless, it discussed at some length the imbalances that contributed to the crisis, and recommended mechanisms of cooperation that will be essential for dealing with its consequences. The study concluded that regional cooperation was urgently needed to:

- Strengthen financial systems and build deeper regional financial connections
- Create mechanisms of cooperation on the region's macroeconomic and exchange rate policies
- Reduce global imbalances and shift demand from the United States (and Europe) to regional sources
- Maintain and expand trade and investment through global agreements when possible, but also through regional initiatives if necessary.

The proposals in *Emerging Asian Regionalism* have become especially timely in light of the crisis and are now under consideration in the region's major policy forums. This volume presents the analytical foundations of the study and, more fundamentally, explores in detail the forces that are shaping Asia's global role and policy. The authors have been also able to observe the unfolding global financial and economic crisis and to incorporate its implications into their analysis.

What went right (and wrong) with Asian policies?

In the years leading up to the current crisis—in the decade since the 1997-98 Asian financial crisis dealt an even greater setback to the region's prospects—Asia had made a remarkable recovery. By 2007, aggregate GDP growth in developing Asia reached 9.5%, well in the forefront of global growth rates. Astonishingly more than 500 million Asians had escaped from poverty since 1990.¹ The story of remarkable booms in China, India and Vietnam is well known, but progress, though sometimes less dramatic, was widely shared even by countries like Indonesia, where the 1997-98 crisis had led to wrenching social and political change.

¹ Using the current poverty line of \$1.25 per day in 2005 prices, it is estimated that 1.4 billion people were living in poverty in Asia in 1990 vs. 0.9 billion in 2005. This reduction took place despite an increase in the population of developing Asia.

The engine of these achievements was Asia's regional production system, which effectively turned the region into the center of global manufacturing. True, Asian manufacturing production was driven by demand in developed country markets, including especially in the United States. But this demand could have been met from anywhere, and indeed might have more likely been met from Latin America, which was nearer and more closely tied to North America through NAFTA and other bilateral FTAs. The fact that Asia became the world's "factory" reflects many factors, including deep human and technological resources, economic flexibility and adaptability, and policies that encouraged outward orientation and regional integration. This setting was especially conducive to exploiting the benefits of production fragmentation—the splitting of the production process into smaller steps, with each performed in the most advantageous location—which had become possible through business strategies of multinational corporations and advances in information and communications technology. These developments are described in some detail in *Emerging Asian Regionalism*; the key finding is that markets, resources and policies played complementary roles in taking advantage of this technological opportunity.

The macroeconomic context was favorable. In the wake of the 1997-98 crisis, Asia turned to highly disciplined macroeconomic policies. The region effectively controlled inflation—at least until the outbreak of the global inflationary process in 2006. Most countries achieved strong fiscal positions and now face the downturn with unprecedented fiscal space. Some accumulated very substantial foreign exchange reserves, which now totals around \$4 trillion for Asia as whole. This mix of policies reflected a cautious, if largely independent, approach to managing the risks that the 1997-98 crisis had demonstrated. Less auspiciously, it also contributed—in conjunction with monetary and fiscal policies pursued in the United States—to large international capital flows and imbalances that have since become a central element in the global adjustments.

Asia also pursued conservative financial policies since 1997-98. Discipline was partly forced on the region by the weakness of its financial institutions as they emerged from earlier challenges. As a result, as the chapter by Lee shows, the intermediation of the region's huge savings and investment flows took place to a large extent in the more innovative financial centers of London and New York, rather than in the region's own centers in Hong Kong, Shanghai, Singapore and Tokyo. As a result, Asia probably faced higher capital costs than it would have had its regional financial system developed more rapidly; in turn, this may have delayed and dampened the investment rebound in former crisis-affected countries. But financial conservatism and relatively unsophisticated financial system also meant that Asian financial institutions were at least partly sheltered from the collapse of confidence in global financial markets. While the global recession has taken its toll in Asia, it has not been compounded, so far at least, by the kind of financial meltdown that other regions have faced.

On balance, these strategies appear to put Asia in a stronger position to withstand the crisis and to emerge from it than is the case for other regions. But the results are not entirely positive. As the chapter by Huang argues, the conservative, independent reactions of Asian economies to the 1997-98 crisis have led to a large, overall imbalances

with respect to other regions of the world. (These imbalances were obscured for a while by the rapid rise in oil prices starting in 2006.) As the world's factory, Asia became dependent on western markets to drive its economic growth. Although many policy makers understood that these imbalances were not sustainable in the long run—and indeed this became an urgent theme in *Emerging Asian Regionalism*—they were reluctant or unable to discourage the massive investment flows into production structures based on satisfying export demand. The long-term costs and benefits of these decisions remain to be evaluated, but for now these policies have imposed a heavy burden of economic restructuring as capacity has to be shifted to other economic activities. Asia needs to rebalance source of growth from external demand to domestic and regional demand by encouraging more household consumption as well as infrastructure investment, especially in social public goods.

If there was a clear weakness in Asia's strategies since the 1997-98 crisis, it was that its governments acted largely independently of each other and stressed national policy solutions and risk management approaches. Rather than building on the region's dynamic economy to create new markets and sources of demand, each of the economies focused on becoming more competitive in developed country markets, and on building independent reserves to manage global risks. Rather than creating a strong mechanism of emergency cooperation—say, through the multilateralization of the swap arrangements under the Chiang Mai Initiative, which came to fruition in the wake of the 2008 crisis—they built independent national reserves. Greater cooperation could have also led to the development of more balanced production structures and stronger international mechanisms to backstop Asian economies.

A central theme of *Emerging Asian Regionalism* is that the growing integration of the Asian economy and its global rise argue for deeper and more extensive cooperation than has been undertaken so far. There are signs that this has begun—especially in ASEAN, where a substantial effort is now underway to create a regional economic community. The extensive connections among the region's economies in trade, finance, technology, labor flows and above all macroeconomic linkages argue for a much more extensive network of connections and institutions. Especially urgent are those institutions that could provide a framework for macroeconomic cooperation and for managing emergencies and containing contagion. The rationales for such policies and institutional framework are analyzed in this volume.

Will Asia's dynamism continue?

Despite the current threats to Asia's economic prospects, the foundations of the region's dynamism remain in place. They include high rates of savings and investment; effective policies and mechanisms to absorb technology and investment; capacities to develop new ideas; strong human resources; and economic strategies that emphasize open, outward- and market-oriented strategies for development. There is little reason to expect that the crisis of 2008 will force Asia to abandon its outward-oriented growth model, despite the clamor of long-standing critics of the model. Export levels will need to reflect reduced net export surpluses, but in the context of reasonable global growth, this will require

relatively small adjustments. The benefits of economic specialization and integration remain substantial, and especially so for Asia's small, resource-poor economies.

The key role of technological upgrading in Asia's economic performance, initially in Japan, then in the NIEs and Southeast Asia, and now in China is well documented in *Emerging Asian Regionalism*. In their chapter, Guangzhou Hu and Gary Jefferson provide substantial new evidence of the accelerating pace of Asia's technological development, and in particular of important changes underway in China, the region's largest emerging economy. Their indicators confirm that investment in technology is accelerating in China and elsewhere. They also show that economic integration through trade and investment is important in explaining the diffusion of technology from more advanced Asian economies to those at earlier stages of development. Public policy and investments in technological capability are critical to this process because they enhance the abilities of developing economies to absorb international technology.

Asia's labor resources are examined in detail in the chapter by Andrew Mason, Sang-Hyop Lee and Ronald Lee. Their work asks whether Asia's rapid growth is threatened by the ageing of Asia's populations. They examine in detail the implications of declines in fertility rates in some countries, and show that the eventual ageing of populations will substantially reduce "support ratios" in several countries. But they also find that these developments are not an immediate, nor a region-wide threat. Indeed, several Asian economies are just entering the most positive phase of their demographic transition, with large cohorts of workers entering their working career. Still other countries continue to have relatively high birth rates. The demographic challenges are nevertheless insignificant. And given what we know about the political economics of ageing societies, it is imperative that Asian countries prepare for the eventual transition early, when political decisions about building an equitable and viable retirement and health care systems are still manageable.

The chapter by Philippa Dee focuses on the Asian policy reform. She notes the success of policies to remove "border barriers" such as tariffs and quotas in Asia's past. But there are now diminishing returns to further liberalization of border measures; unilateral and multilateral liberalization have reduced these to relatively low levels. The greatest remaining obstacle to integration lies within countries, in so-called "behind the border" policies such as market and investment regulations, inadequate or inconsistent standards, and other impediments to investing and doing business. Dee argues that new "policy review" institutions, both within countries and international setting, could be valuable in sharpening the focus of policy-making on within-border reforms.

Trade has been the key engine of the region's production system and is likely to remain so in its future. *Emerging Asian Regionalism* argued that Asian economic integration, principally market-led in the past, has now reached the point where it also requires, and stimulates, policy cooperation. Masahiro Kawai and Ganeshan Wignaraja's chapter reviews the rapid transformation of the international policy landscape of trade and investment. They note that disappointments in the Doha Round have already led to a proliferation of bilateral and plurilateral agreements in Asia, and more recently to

proposals for broader, region-wide agreements—for example, built around ASEAN and its major trading partners. They present modeling results for such agreements and find that their likely benefits are substantial, especially if they have comprehensive country and product coverage. The consolidation of the region's trade framework into such region-wide agreements provides foundations for deeper integration and is urgently needed as global support for integration falters.

Financing recovery and development

As already noted, Asia's financial development has been relatively slow; the region lags the advanced economies in the scale and sophistication of its financial markets and institutions. From the vantage point of 2008, this has proved advantageous. Asia avoided the worst financial errors and will benefit from the lessons of the crisis in building stronger financial systems in its wake. Yet investment in the region may have been dampened by these lags, especially in large scale projects such as infrastructure, which provide capacity to serve domestic markets and consumers and to connect poorer sub-regions with the region's centers of economic activity. In retrospect, Asia's financial gaps might have contributed to the weight of investment targeted on developed country markets.

Yiping Huang's chapter highlights the evolution of the current global imbalances. They arose partly because of monetary and fiscal policy decisions in the United States, which generated low interest rates and large government budget deficits. Fueled by tax cuts and asset price inflation, US consumption also rose and savings declined to virtually zero. But the imbalances also reflected Asia's continuing high rates of savings and policy decisions to accumulate unprecedented international reserves. These twin drivers—on the demand and supply side—led to an unsustainable flow of funds into US assets, and many had warned that they could end in a "hard landing" involving a loss of confidence in the US dollar. The current recession reflects elements of the predicted hard landing, but its trigger turned out to be very different and unexpected—a downturn in US housing prices followed by a collapse of complex financial instruments based on them.

Macroeconomic interdependence raises the stakes in macroeconomic cooperation. But Ryuzo Miyao's chapter finds that there has been little progress so far. East Asian countries adopted new monetary policy frameworks after the Asian financial crisis of 1997/98. He finds that the effects of monetary policy shocks are plausible and similar across countries, especially the four inflation targeting countries including Korea, Indonesia, Thailand and the Philippines, and that even for these inflation targeting central banks, exchange rate stability has been an important factor of consideration in monetary policy making. As many economic shocks including exchange rate shocks can be viewed as largely common and the policy actions to these common shocks appear to be similar across countries, he argues that there must be a need for a regional cooperative mechanism in the area of exchange rate management.

Jong-Wha Lee's chapter examines Asia's financial linkages against the benchmark of a gravity specification of bilateral international asset holdings. Using this quantity measure of integration, he finds that Asian asset markets are less well integrated with each other

than with other financial markets. Lee attributes this outcome to the slow development of Asian financial markets, including inadequate institutional infrastructure, restricted capital accounts and high rates of exchange rate volatility. With relatively weak national financial systems, Asia has turned to western financial centers to intermediate its savings.

Douglas Arner, Paul Lejot and Wei Wang examine Asia's financial cooperation and governance. They find that regional institutional and legal structures are scarce and frequently insubstantive because of a lack of effective collaboration among states in the region. They argue that new policies and innovations will be needed to strengthen Asia's financial systems and to absorb the lessons of Western experience.

The architecture of regional cooperation

In a chapter that reports on a new ADB survey undertaken for the *Emerging Asian Regionalism* study, Giovanni Capannelli finds that Asian attitudes are quite favorable toward forging greater connections among the region's economy. In assessing the state of current integration, respondents believe that integration is more advanced in trade and production than in finance. They also believe that integration has positive effects, and that additional international cooperation may now be justified in enhancing and managing the region's growing interdependence. They say that cooperation is most important in areas such as trade and financial regulation, but do not feel that a common currency is desirable or likely until integration reaches more advanced levels. Capannelli also reports some intriguing evidence on the emergence of an "Asian identity"; a reasonably high number of Asian's report feeling "Asian," although of course their identification with their own countries remains much stronger.

Does Europe, where integration has reached a more advanced stage, offers useful models for Asian strategies? Barry Eichengreen's chapter examines the lessons of European experience for Asia, but does not find that it offers a compelling template. In Eichengreen's words, "Asia is not Europe, and 2008 is not 1960." Europe's leading economic powers had great political commitment to integration and provided the leverage needed to overcome obstacles in national legislatures and bureaucracies. In Asia there is no similar consensus, perhaps because the diversity of the region's economies is greater. Moreover, in the current global economic environment, some of the options open to Europe are no longer available; for example, Europe's ability to sequence trade and production integration well ahead of financial integration is difficult to envision in the context of today's deep financial linkages.

The chapter by Ramesh Chandra and Rajiv Kumar emphasizes that the progress of regional cooperation varies within Asia, with much less progress so far in South Asia. But they find encouraging signs in India's reaching out to East and Southeast Asia through national liberalization patterned on East Asian models and through regional trade agreements; these initiatives will not only reinforce India's commitment to move rapidly in opening its economy, but may also provide competitive pressure on other South Asian countries to open their markets to each other and other partners.

The chapter by Masahiro Kawai, Peter Petri and Elif Sisli-Ciamarra turns to Asia's role in the governance of international institutions, including especially the International Monetary Fund and the World Bank. They view these and other organizations as "clubs"—organizations that provide public goods that are not available through markets to a restricted membership. The club approach provides insights into the value of these institutions and helps to explain why they are relatively slow to adapt. (The world's major international institutions today have their origins in the 1944 Bretton Woods agreements, and most retain their original governance structures.) At the same time, there has been significant change in the programs and services they offer. The chapter argues for substantial reforms in governance, and for an "institutional family" approach to creating new flexibility that would permit new programs to be developed and, if necessary, new institutions to be formed in close relationship with existing ones. These developments would mean that Asia would have greater say in the operations of global institutions and could derive greater benefits from them.

Finally, Peter Drysdale's chapter envisions the evolution of the architecture of Asia's regional cooperation. It sees Asian institutions emerging on a relatively broad scale, providing participants not just with an opportunity to collaborate on their regional policies, but also to coordinate their positions in the global context. To make these efforts effective, Drysdale sees the regional architecture nested in broader global architectures such as APEC, that include other regional powers and permit more coherent policy making with North America.

Asia in the global economy

Overall, this volume presents compelling and wide-ranging evidence on Asia's deepening interdependence and on its implications for policy making. The chapters show that many complex problems require increasing regional cooperation. And they explain why this cooperation is difficult, in light of the region's varied economies and interests.

The growing recognition of the need for cooperation in Asia, as represented in the several perspectives of this volume, comes at a time when Western economic institutions are in crisis. This makes Asia's agendas especially challenging, since it means that there is no well-accepted model for fashioning new institutions of economic governance and cooperation, and yet the urgency of cooperation is rising. But it also opens the debate and makes it more likely that Asian interests and insights will shape the reform of the global economic system. Through its economic weight as well as policy contributions, Asia is poised to play a major role in helping the world emerge from the current crisis.

In the meantime, much attention is now focused on policies that will speed the recovery from the global crisis. It appears (as of mid-2009) that several major Asian economies will emerge relatively early from the downturn. But regional interactions could provide additional support for the region's recovery. There is growing recognition that cooperation could help to make the region's responses effective—by working together, countries can reinforce the effects of independent policies and better calculate the implications of policy spillovers on each other. Although the region's institutions are still underdeveloped, the crisis has already brought unprecedented consultation and

interchange among Asian governments, drawing them closer together than at any time in history. They recognize that they face common challenges—for example in replacing US demand with regional demand—and have a common stake in achieving early results.

If this scenario is correct, Asia will play a central role in the global economy that emerges from the crisis not just because it is large to other regions, and not just because it is better positioned to emerge relatively quickly from the crisis, but also because its institutions of cooperation will be strengthened. Contributing significant global demand and providing leadership for the international cooperation would offer important ways for Asia to help stabilize the world economy. Asia's rise comes at a propitious time. Managed effectively, it offers hope for progress at a time when the world economy faces its most severe test in a century.