# 14 Asia's role in global rebalancing

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*A positive outcome of the global economic crisis has been the narrowing of global imbalances. This chapter suggests that, post-crisis, Asia's key challenge is to rebalance their economies, shifting from excessive dependence on external sources toward domestic and regional sources in order to achieve a balanced and sustainable growth structure. Such rebalancing will also be good for the world economy, by offering a new source of global growth amid a stagnant recovery in industrialised countries.*

Emerging Asia is now driving the global recovery. With the recovery gaining speed, many policymakers have initiated an 'exit' from accommodative policies adopted during the 2008–09 global economic crisis. Indeed, monetary authorities across the region have started to tighten monetary policies ahead of much of the rest of the world. But relatively higher yields and expectations of stronger currencies are encouraging currency carry trades. In fact, emerging Asia began to attract large capital inflows in the second half of 2009, before the 'exit' had even started.

While renewed investor confidence in emerging Asia is welcome, the hazards of large and volatile capital flows cannot be ignored. Vast inflows of foreign capital could trigger a surge in consumer and asset prices, whereas sudden outflows could spur a financial crisis in countries with inadequate foreign exchange reserves or weak financial systems. The region's experience during the 1997–98 financial crisis underscores the devastating economic effects of a sudden reversal in foreign capital.

A positive outcome of the global economic crisis has been the narrowing of global imbalances. The current account deficit of the US declined significantly in 2009 over the previous year. The flipside of this is the substantial reduction in the surpluses of the major oil exporting economies in the Middle East, North Africa, and Russia.

But this trend will not be sustainable if it is not accompanied by structural reforms. The latest IMF estimates suggest that by 2012 the current account surpluses of developing Asia, particularly in China, will surpass the previous peaks of 2008, and that world current account imbalances are likely to remain substantial through 2015.

Such potentially large imbalances pose the risk of sparking another financial crisis. Prior to the current global economic turmoil there was widespread concern that a "disorderly unwinding" of growing global imbalances would lead to crisis.

In the end, they did not directly cause the economic crisis that began in 2008. Instead, inadequate financial market regulation and lax monetary policy in industrialised countries, particularly in the US, were the primary causes. Current account excesses nevertheless underpinned the global turmoil of 2008–09, and Asia played a large role.

Together, the two crises, 1997–98 and 2008–09, exposed weaknesses in developing Asia's financial and real sectors. Now, Asia's key challenge is to distil the correct lessons and help avert another crisis. In the interest of its own growth and welfare, Asian countries should rebalance their economies, both collectively and individually, shifting from excessive dependence on external sources toward domestic and regional sources to achieve a balanced and sustainable growth structure. Such rebalancing will also be good for the world economy, by contributing to the orderly unwinding of global imbalances and offering a new source of global growth amid a stagnant recovery in industrialised countries.

## Policies for Asia's rebalancing

Effective rebalancing will require a combination of policy measures that boost domestic and regional demand, and that bolster domestic and regional capacity to meet such demand. This means that consistent adjustments on both the demand and supply sides of the economy must be implemented.

Demand side adjustments are necessary to reduce developing Asia's heavy reliance on extra-regional demand for its exports. This involves expansion of domestic demand and broadening regional trade opportunities in final demand for goods and services. Authorities can target policies at either encouraging greater consumption or stimulating investment. Fiscal policy addressing social concerns can also strengthen domestic demand in both the short and long run.

## Some spefic policies for stimulating domestic demand in the region

First, strengthening domestic consumption requires policies that transfer more corporate savings to households. Emerging Asia has a huge pool of savings coming largely from the private sector and driven mostly by high corporate profitability. However, in countries such as China, these corporate profits are often used to finance investment rather than to pay dividends. Policies that encourage firms to pay out higher wages and dividends will strengthen the link among corporate profits, household income, and consumption.

Second, more government spending on health, education, and housing will reduce households' precautionary motive for savings, which have risen since the 1997–98 crisis. Policies that mitigate risk and reduce the uncertainties that households face will encourage them to save less and spend more. Greater public provision of social services and more extensive social safety nets will enhance consumer confidence and boost consumption.

Third, governments should give priority to enhancing the investment climate rather than quantitatively expanding investment. The surge of current account surpluses also reflects a paucity of domestic investment, especially long-term infrastructure investment, in many Asian economies. The business environment across the region lags behind the world's competitive economies because of serious shortcomings in regional institutions and skill shortages. Remedying these weaknesses will help translate domestic savings effectively into domestic investment.

Likewise, supply-side adjustments are needed to achieve more balanced growth. This will likely involve a shift in resources away from tradables to non-tradables. Export-led growth served Asia well. But it also raised the cost of economic vulnerability and introduced substantial economic distortions—its prospective benefits now look much diminished. Simply put, Asia has grown too big to maintain its pre-crisis shares of world exports and, as such, the global financial crisis presents authorities with a chance to implement structural reforms that can ensure a more balanced and sustainable growth pattern.

Policies to encourage these supply-side adjustments include eliminating subsidies and factor-price distortions that favour exporters and tend to suppress labour's share of income. Authorities should also deregulate and encourage investment in growth areas of the services sector, including health, education, information, and telecommunications. Removing regulatory distortions in services will raise productivity not only in the services sector, but also in other sectors for which services such as transportation or telecommunications are important production inputs.

Public policy has a key role to play in helping small- and medium-sized enterprises— where most Asian workers are employed—grow and become more productive. Governments should work with commercial forces to correct existing market failures, particularly in the provision of finance. Authorities should provide information services on technology and markets, vocational training, and technical support services, and foster links between small and medium and large enterprises.

In addition, policies pertaining to financial development can better balance domestic supply and demand. On the demand side, financial development can help channel domestic savings effectively into productive investment rather than into low-yielding foreign government bonds. At the same time, it lessens the need for precautionary household savings and thus encourages greater consumption. On the supply side, improvements in the financial sector can encourage business startups, which are essential to a dynamic domestic economy.

Asian countries must also review and strengthen their own financial regulatory systems to avoid future crises. Reforms must aim to reduce the disruptive potential of volatile capital flows and to develop domestic financial markets to enhance resilience to outside shocks.

It is also clear that emerging Asian economies cannot go on keeping exchange rates stable against the dollar and amassing international reserves. This path led to unsustainable global imbalances in the first place. Achieving global rebalancing and gaining greater domestic macroeconomic stability requires that authorities allow their currencies to adjust in line with an economy's fundamentals. Greater exchange rate flexibility creates an automatic mechanism to absorb shocks and allocate resources efficiently between tradables and non-tradables.

## Regional and global cooperation

Along with these policy prescriptions, there is need for greater policy cooperation and coordination and further integration of regional markets. Key elements include strengthening the Chiang Mai Initiative Multilateralisation Agreement, including the setting up of an Independent Surveillance Unit; establishing an Asian Financial Stability Dialogue to foster economic and financial coordination; promoting measures to support increased regional infrastructure investment; and establishing a region-wide economic partnership agreement to encourage intra-regional trade in goods and services and investment so Asia can benefit from the economies of scale and dynamic efficiency of a larger market.

Regional integration can also play a bigger role in bringing firms and consumers in the region together, an important step given Asia's burgeoning middle classes. An East Asia-wide free trade and investment agreement that covers goods and services could help regional firms reorient production more broadly toward the needs of Asian consumers. Cross-border infrastructure investment can also help boost productivity and connect demand and supply within the region.

As emerging Asia assumes a larger role in the global economy, it must actively participate in major global forums and policy dialogue, and ensure that its global voice as well as responsibility is commensurate with its growing economic and financial importance, and rising political influence. Ultimately, through a stronger, balanced, and more resilient Asian economy, the region can benefit and help lead the global economy.

*The views expressed in this article are those of the author and do not necessarily reflect the views and policies of the Asian Development Bank or its Board of Governors or the governments they represent.*

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