

Rebalancing Growth in Asia

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Outline

- 1. Introduction**
- 2. The Global Imbalance and Crisis**
- 3. Economic Analysis of Growth Rebalancing**
- 4. Policies to Rebalance Growth**
- 5. Conclusions**

1. Introduction

- What is the rebalancing of growth? Is it needed?
- Has the pattern of Asian growth been out of balance?
- Was the pre-crisis global imbalance an important cause of the global financial crisis?
- What does growth rebalancing achieve?
- Are policies effective in inducing growth rebalancing?

Why rebalancing is important

- The global imbalance may have been a factor behind the development of the global financial crisis
- US and European demand for Asian export products is likely to remain subdued
- Asia needs to rely more on domestic and regional demand for growth

2. The Global Imbalance and Crisis

(1) The global payments imbalance

(2) The imbalance and the crisis: A causal link?

(3) The US and European economies in crisis

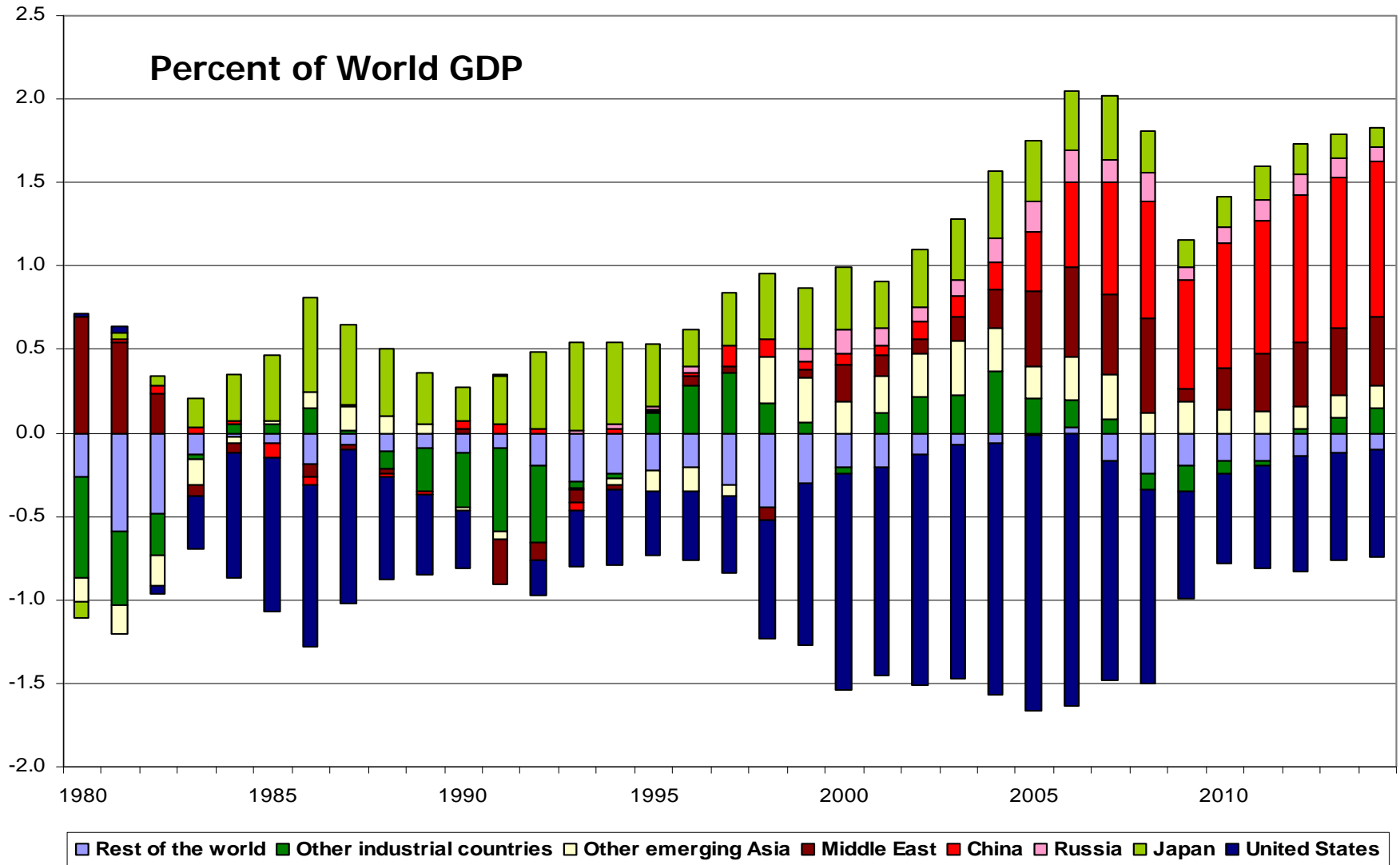
(4) Impact of the crisis on Asian economies

(1) The global payments imbalance

What is the global payments imbalance?

- Large current account deficits in the U.S. financed by capital inflows
- Large current account surpluses in East Asia (Japan, China, NIEs and ASEAN)
- Large surpluses by oil producing countries
- Europe as a whole has a relatively balanced current account (though there are intra-regional imbalances)
- Many emerging East Asian economies are rapidly accumulating foreign exchange reserves

Global current account imbalance



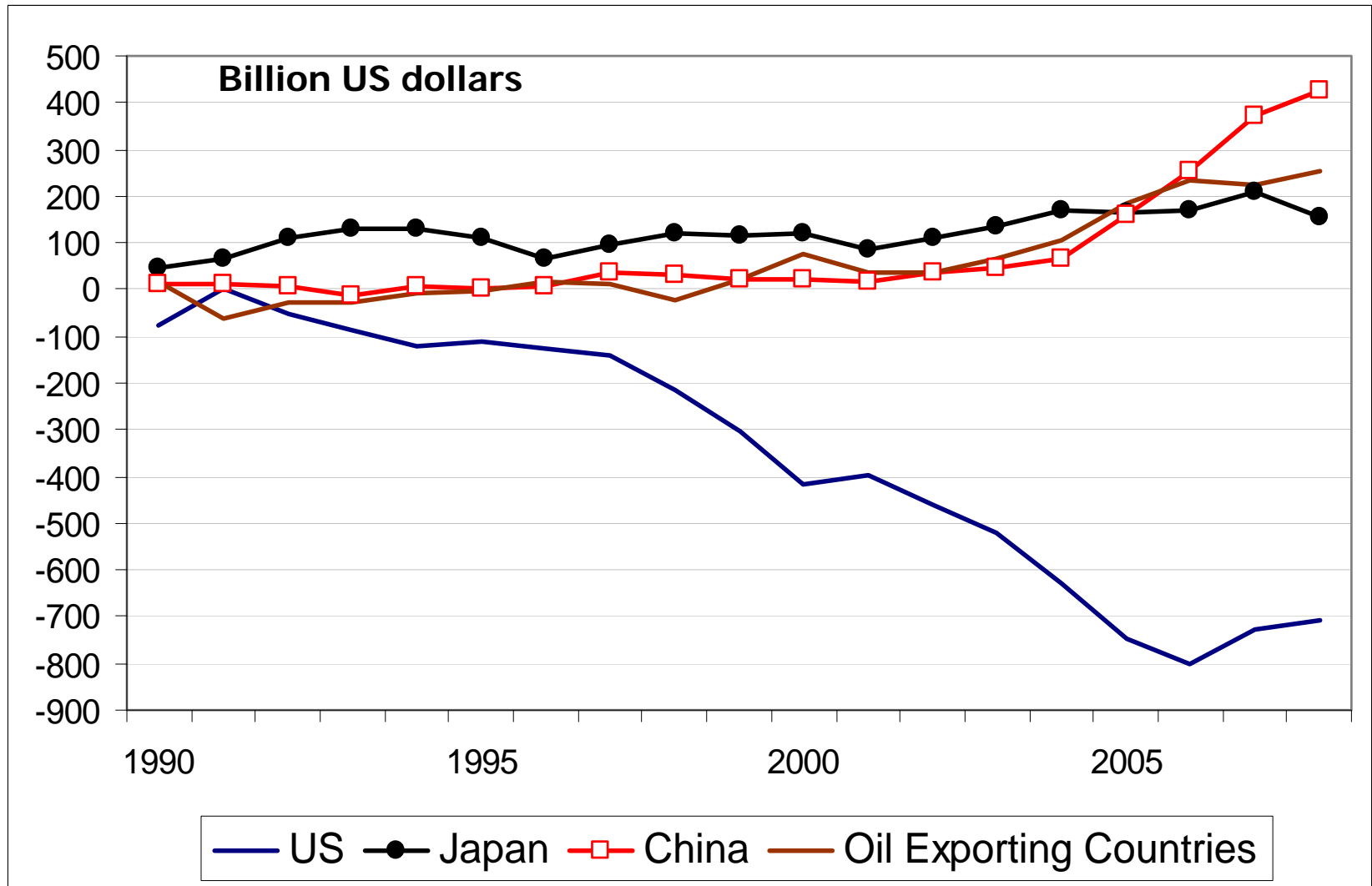
Note: (1) Data for 2009 and beyond are IMF projections

(2) Unlike the original IMF data, other emerging Asia includes Asian NIEs

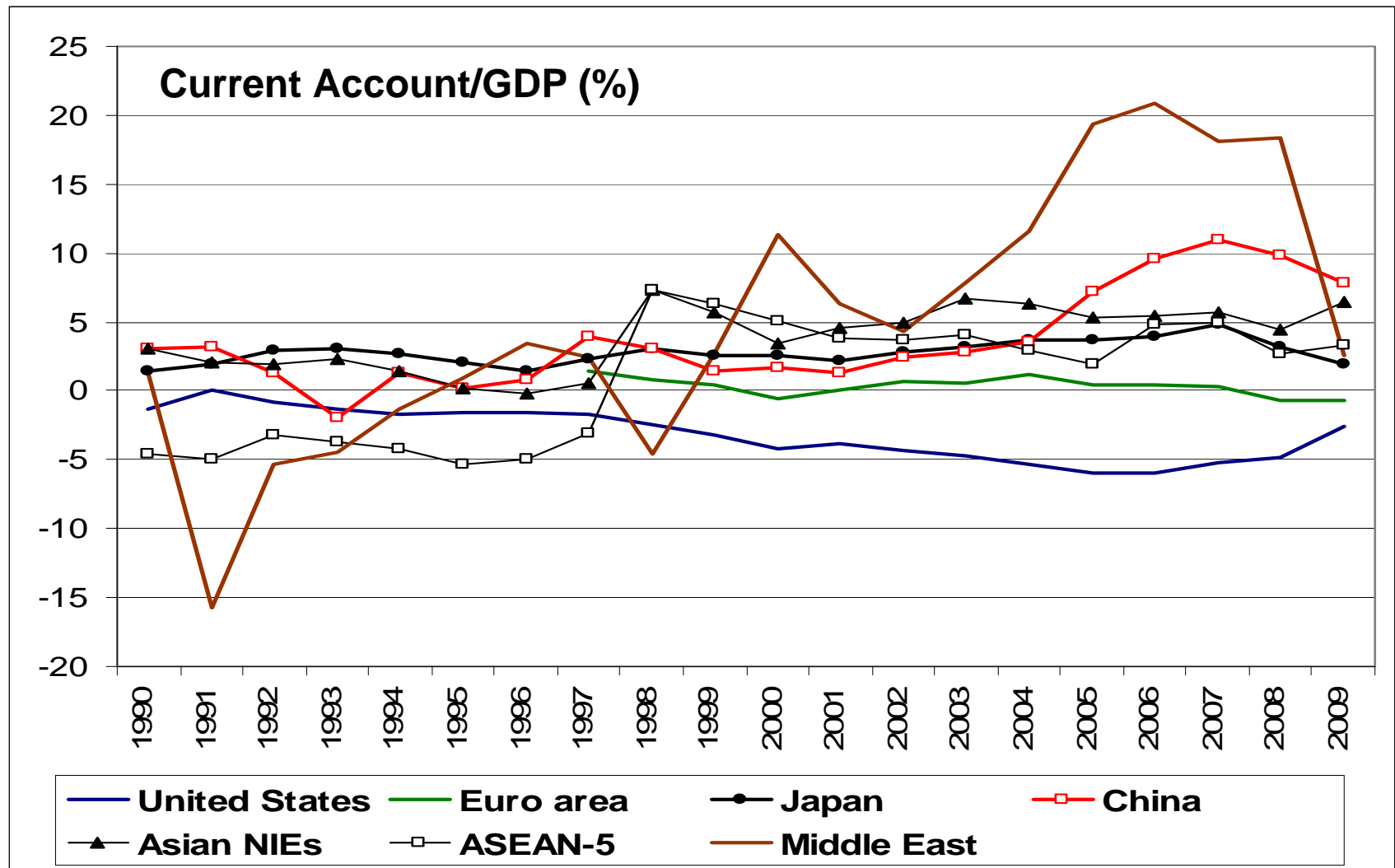
Source: IMF, WEO October 2009

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Current accounts of the US, Japan, China and oil exporting countries



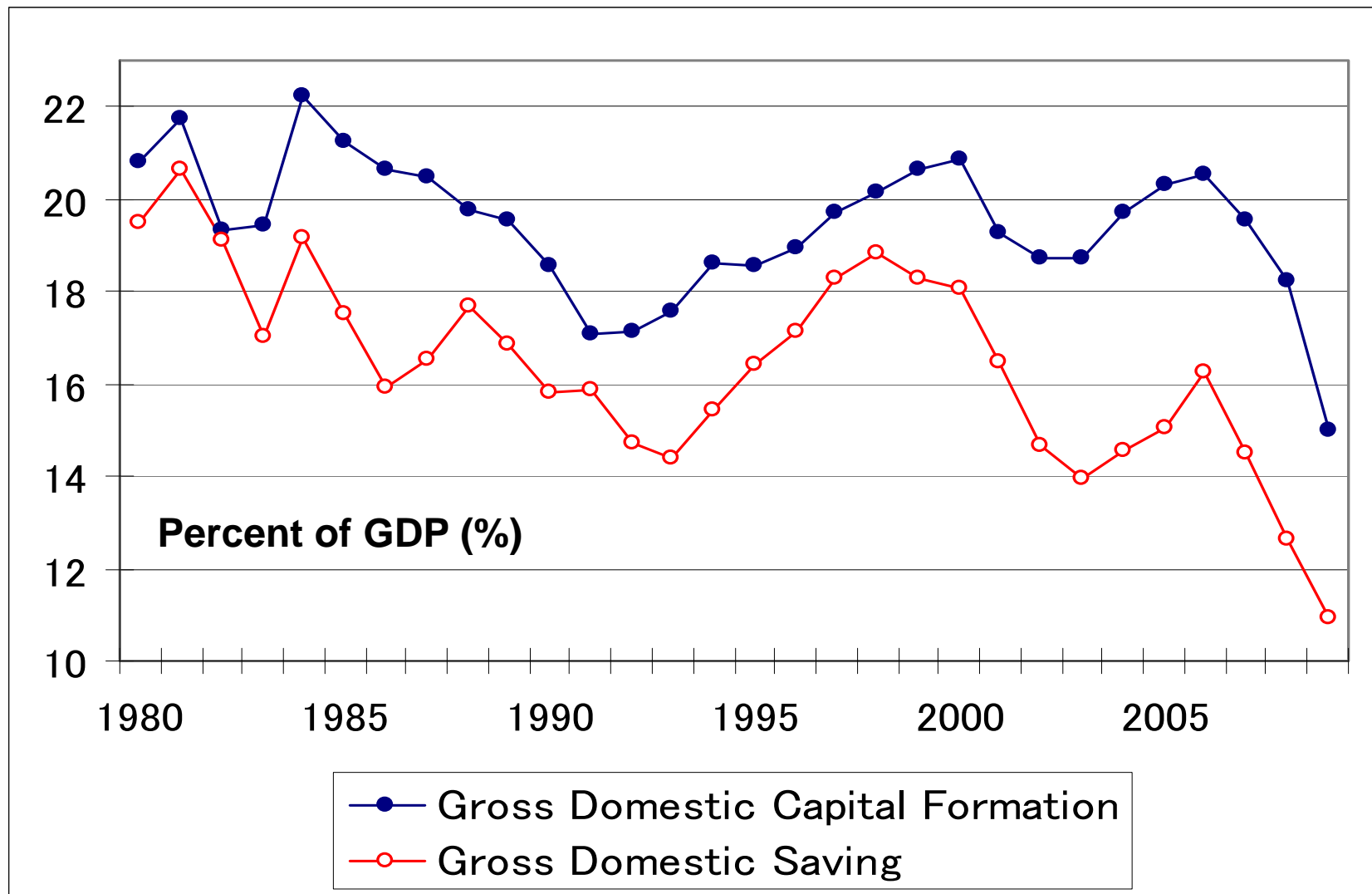
Current accounts of the US, Japan, China, Asian NIEs, ASEAN, Euro area



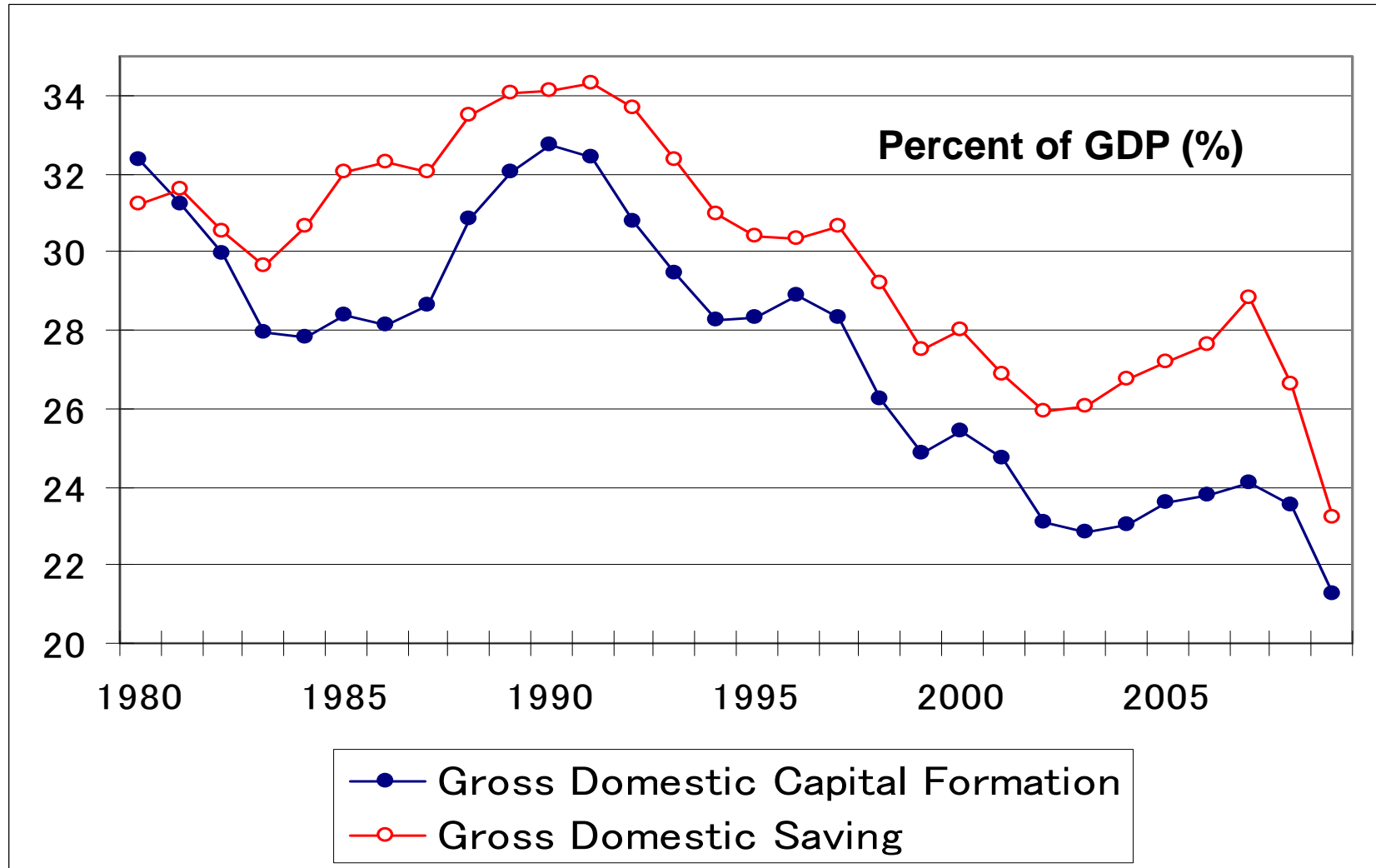
Savings-investment imbalances, or income-expenditure gaps

- US spends more than it earns—low household savings and large fiscal deficits
- Japan spends less than it earns—high corporate sector savings (despite large fiscal deficits and declining household savings)
- China's surge of savings (and investment, but to a lesser extent) by both corporate and household sectors
- ASEAN's sharp drop in investment in the post 1997-98 crisis
- Oil producing countries' sharp rise of savings (oil revenues) due to oil price hikes

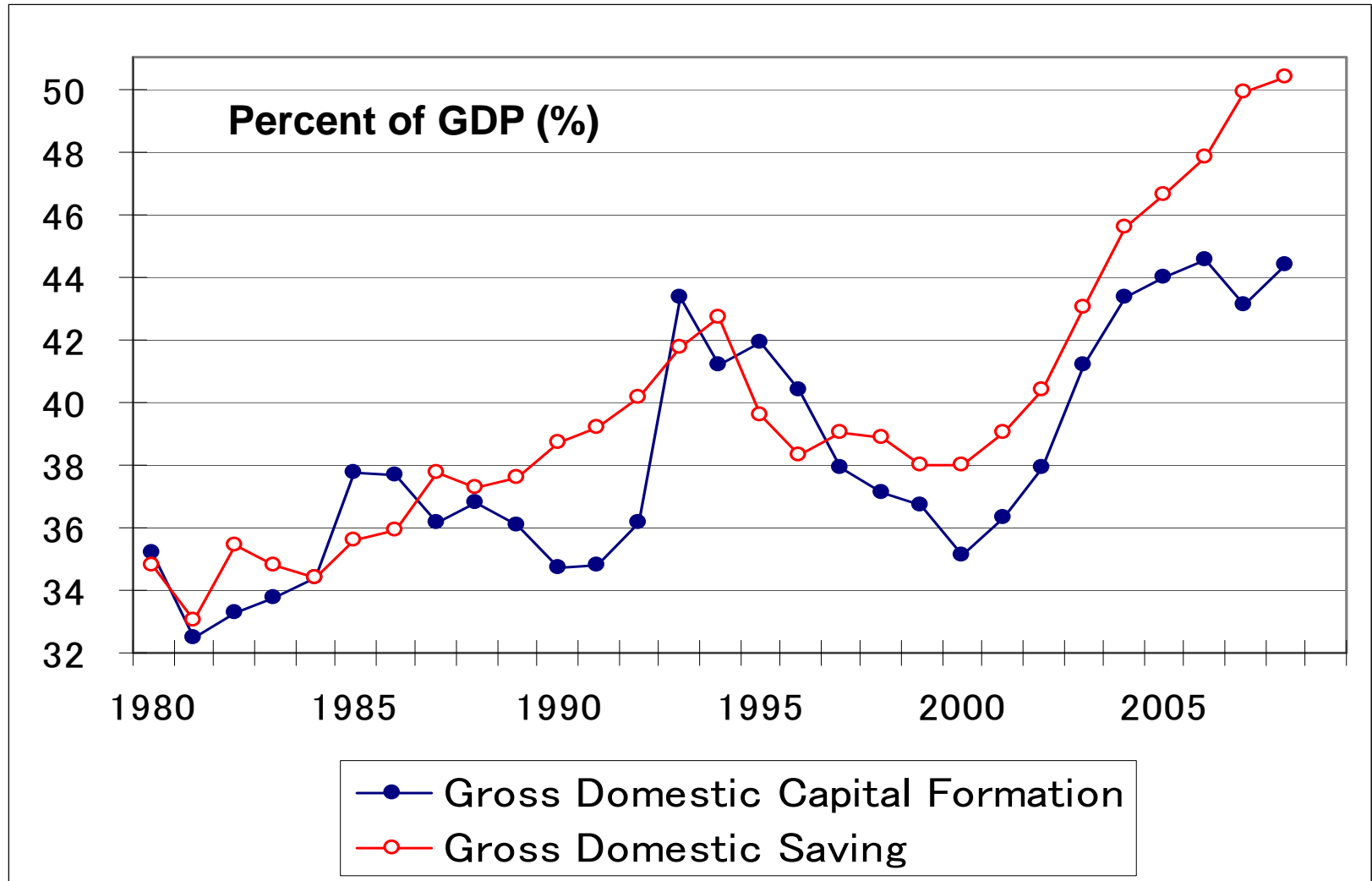
Savings and investment in the US



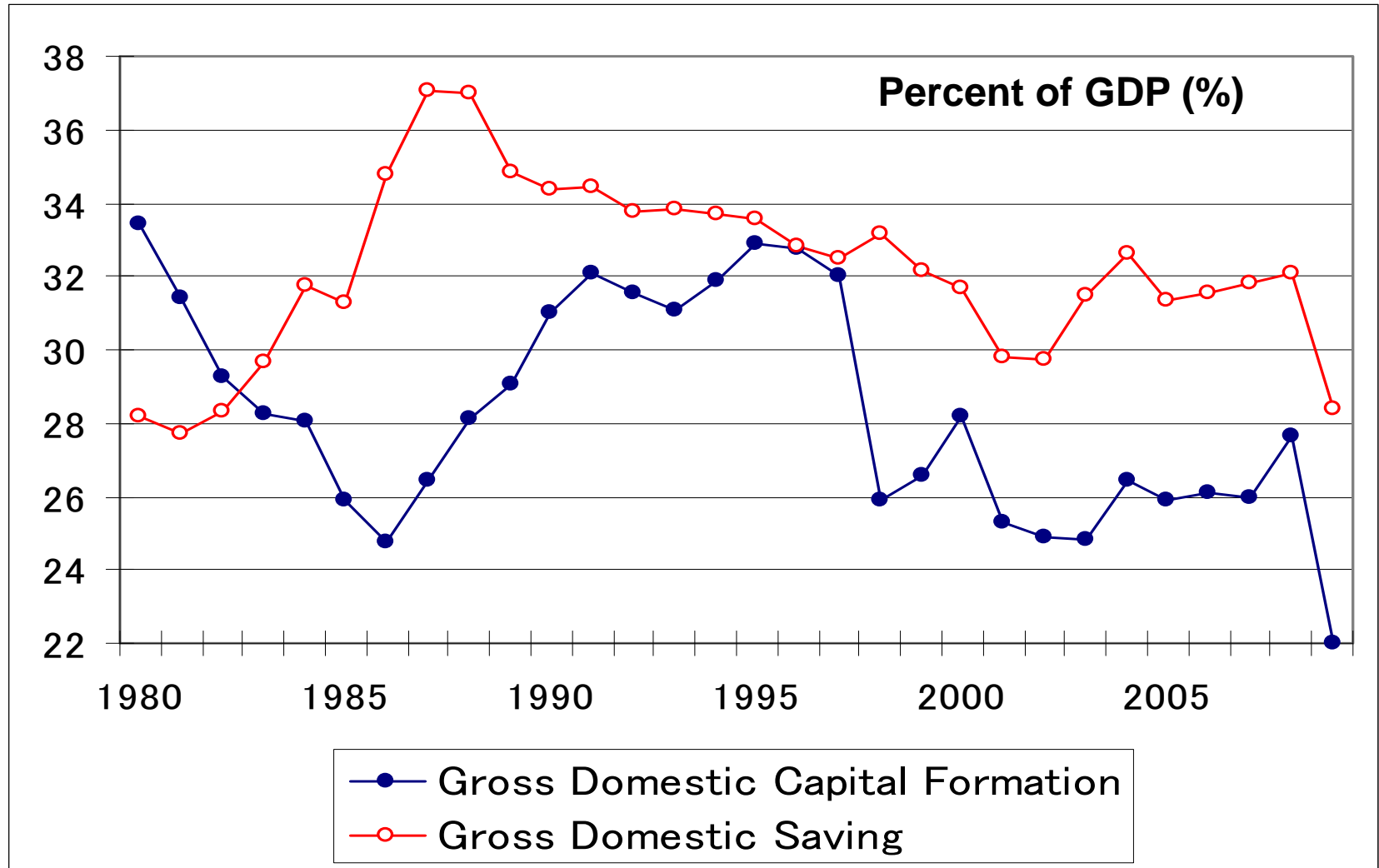
Savings and investment in Japan



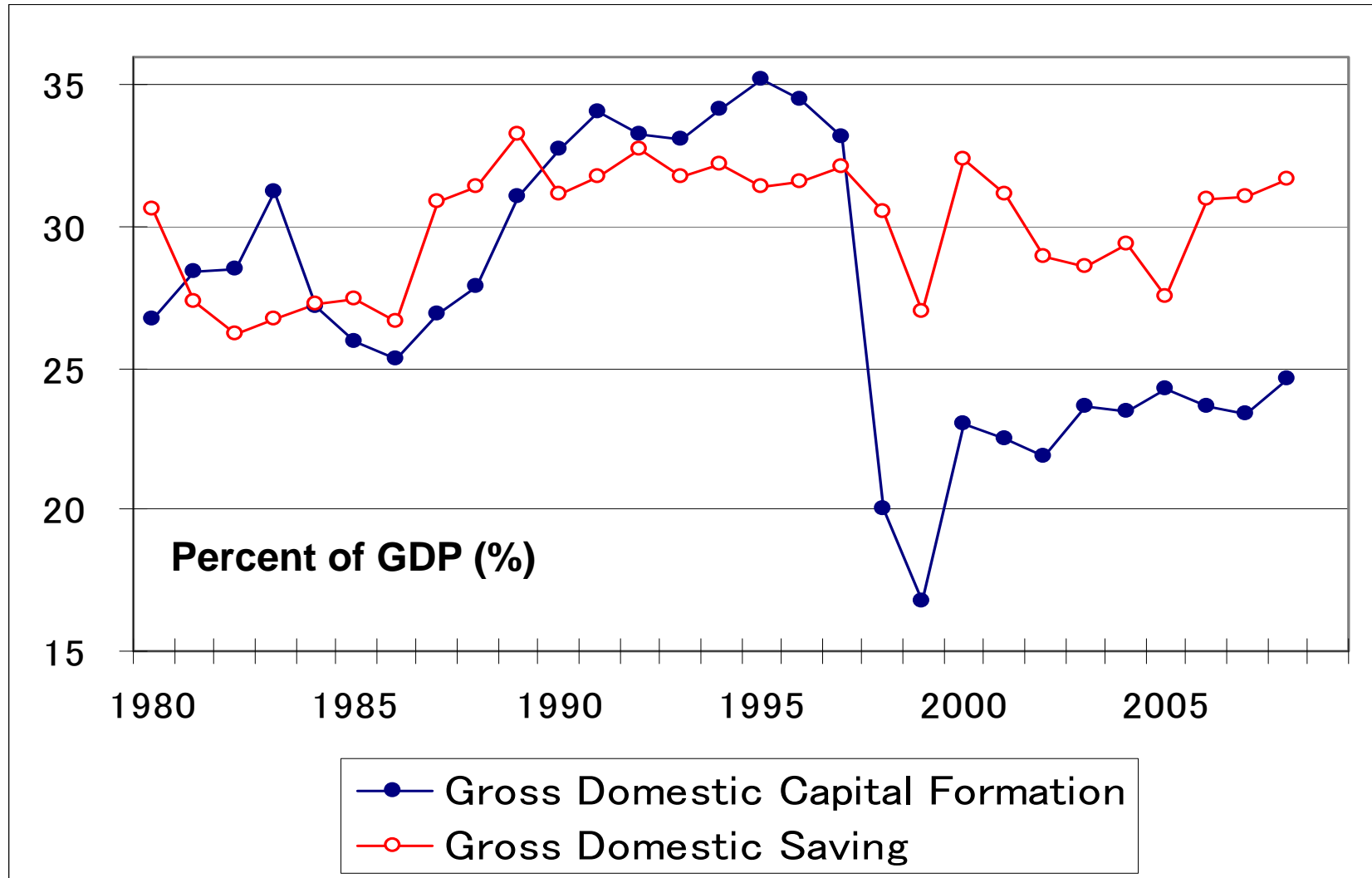
Savings and investment in China



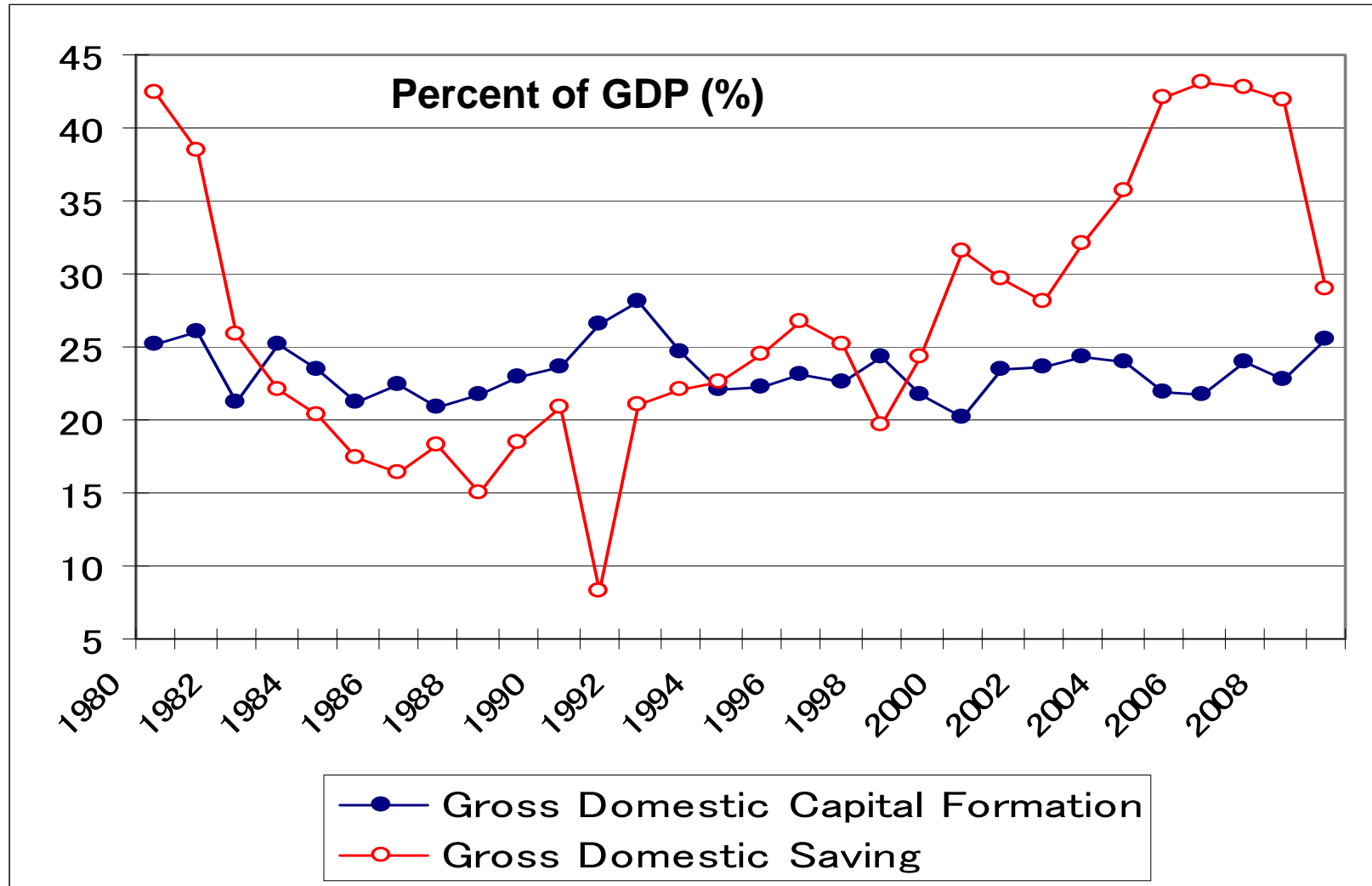
Savings and investment in Asian NIEs



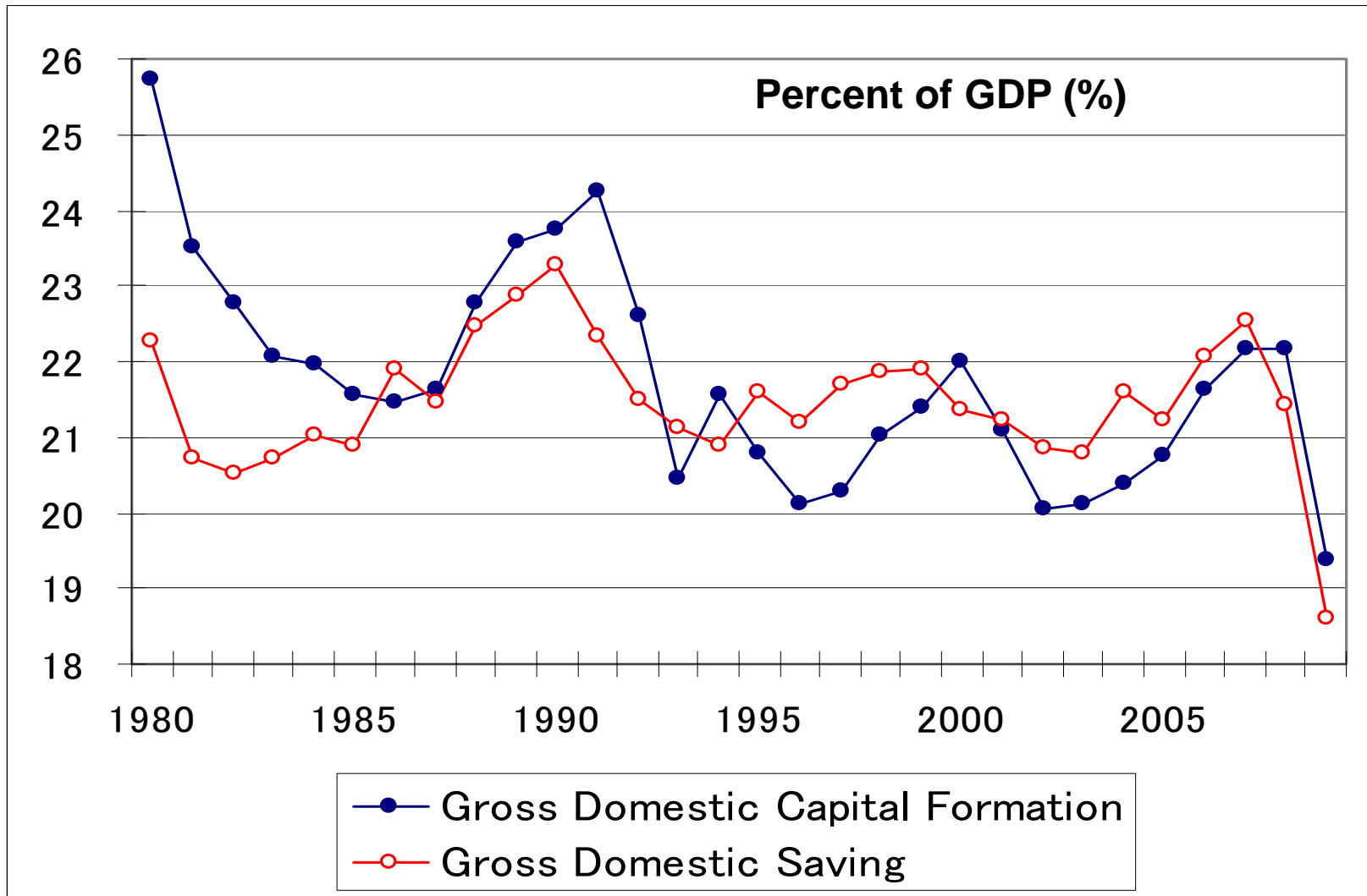
Savings and investment in ASEAN-4



Savings and investment in Asian NIEs



Savings and investment in EU



Why was the imbalance considered undesirable?

- The large, persistent imbalance was deemed to be unsustainable due to the risk of:
 - (1) rising protectionism in the US and
 - (2) eventual loss of confidence on the US ability to repay external debt, leading to a collapse of the value of the US dollar
- The second risk above is still small because of the near-zero balance of interest income payments, but will be serious over time
- If left unaddressed, there could be a disorderly unwinding of the imbalance, with a sharp decline in the US dollar, negatively affecting East Asian economies

(2) The imbalance and the crisis: A causal link?

Two views of the causes of the crisis:

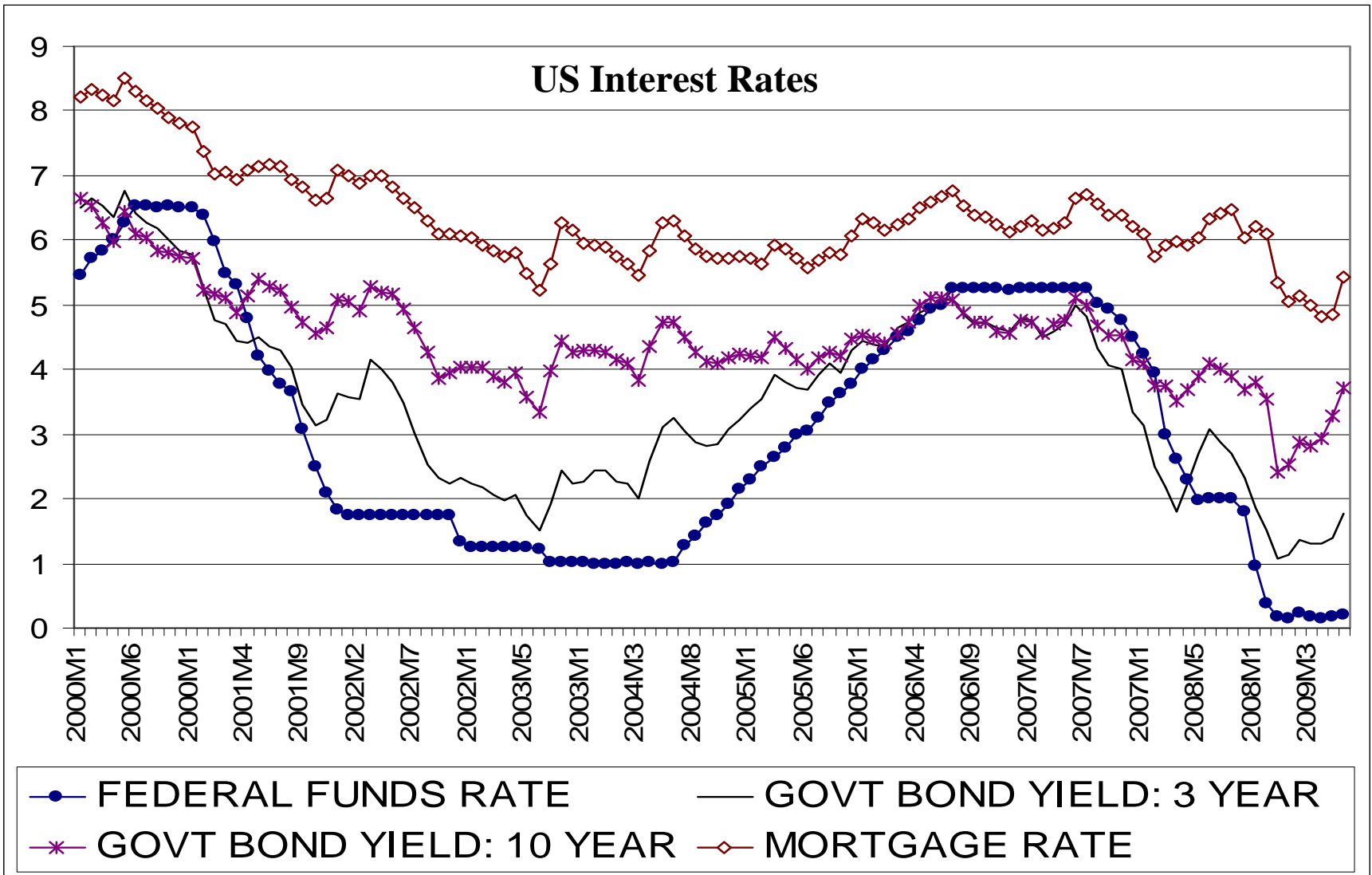
Policy mistakes in crisis countries (US, Europe)

- Failure of macroeconomic policy, particularly monetary policy, to contain a buildup of domestic financial vulnerabilities and systemic risk
 - Flaws in financial regulation and supervision
 - Weak global financial architecture
- * IMF, “Initial Lessons of the Crisis for the Global Architecture and the IMF” (February 2009).

Global payments imbalance

- The arguments by Greenspan (“conundrum”) and Bernanke (“savings glut”) suggest that East Asia supplied ample liquidity to the US and kept the US long-term interest rate too low

US policy rates rose but not the housing mortgage rates in 2004-2006



The validity of the 2nd view is weaker:

- The deficit was concentrated in the US while there were many surplus countries
- Concentration of the crisis in the US and Europe
- Not all countries had housing bubbles (eg, Australia and Canada managed well)

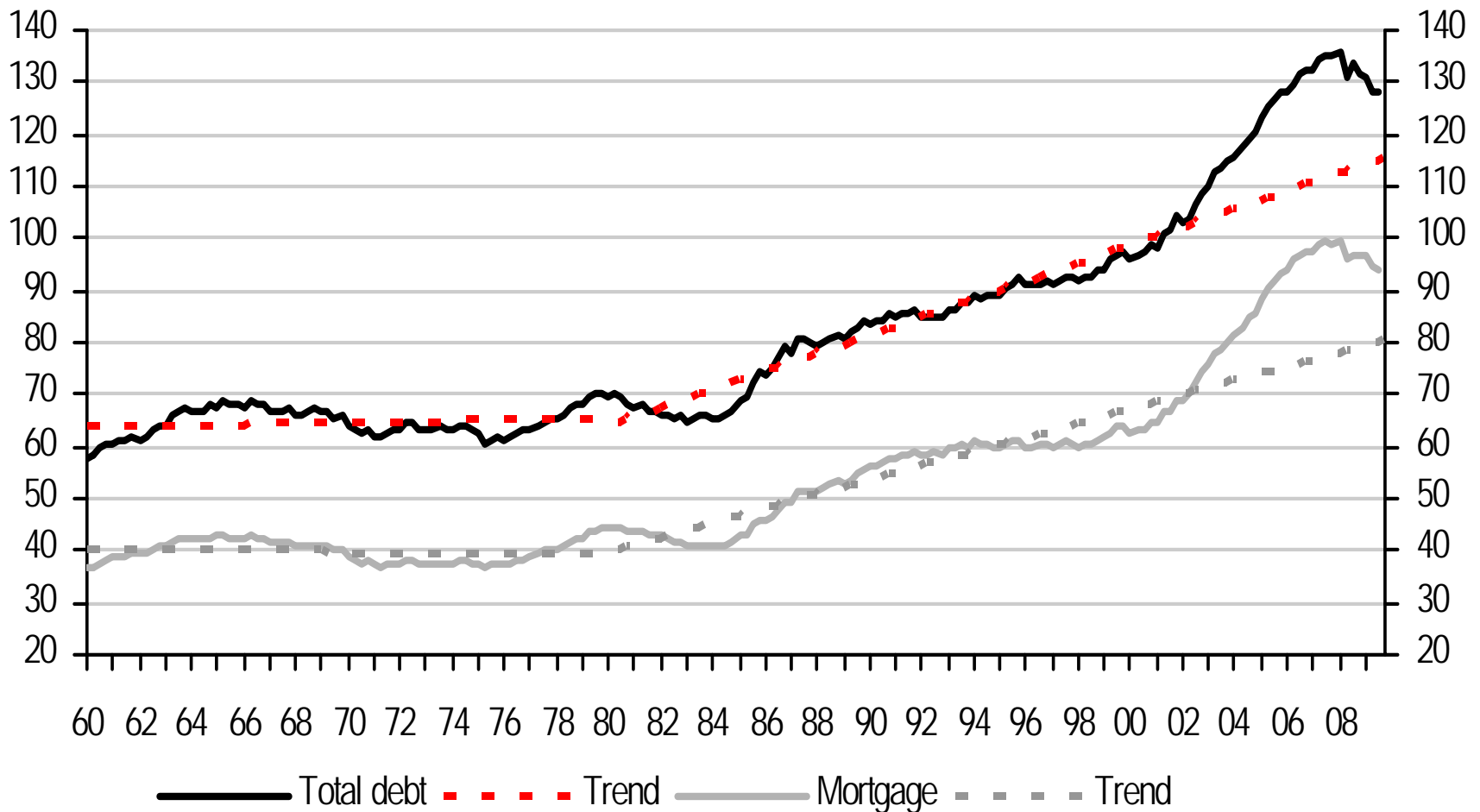
(3) The US and European economies in crisis

Severe economic recession

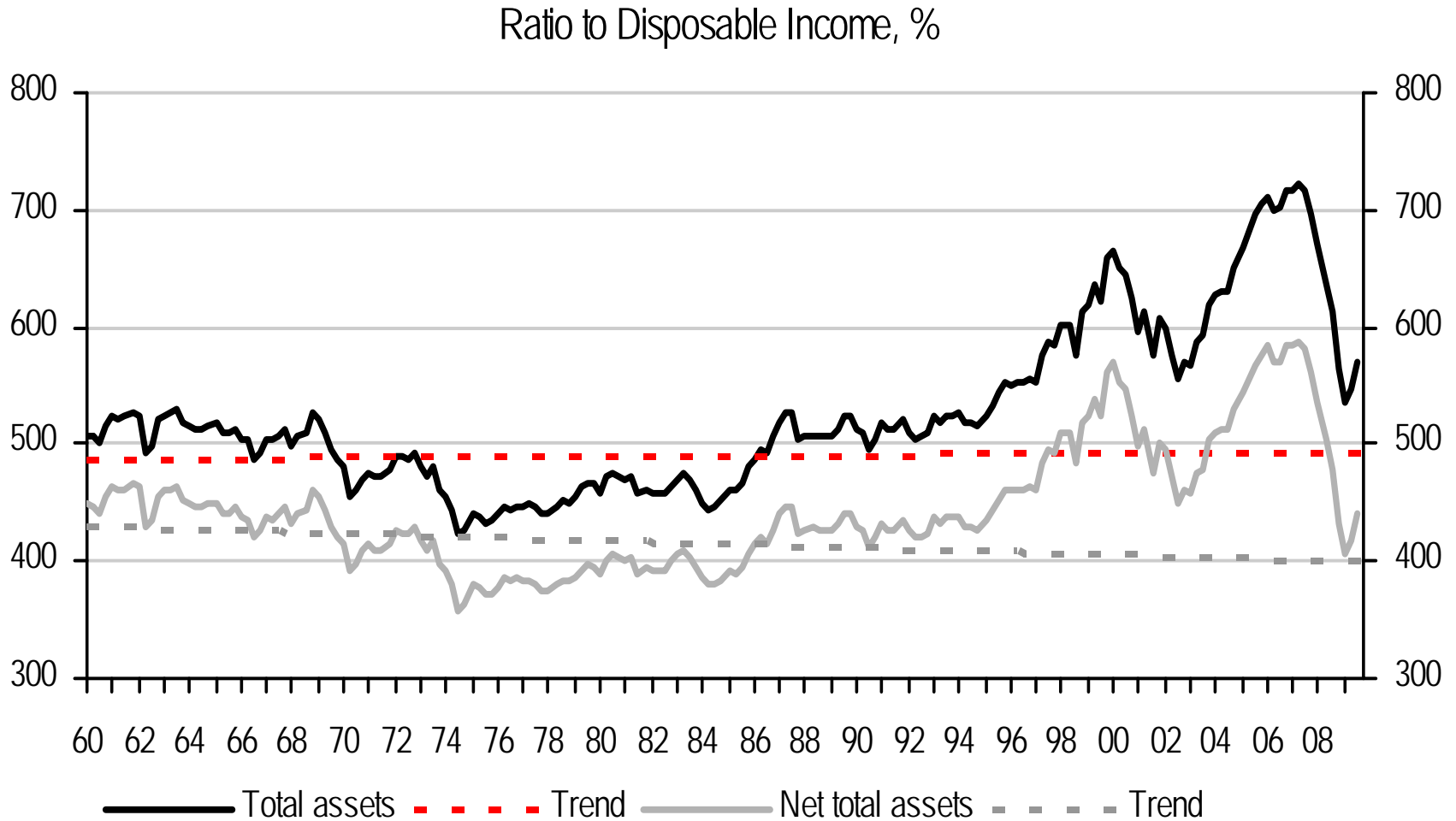
- Bursting of the housing bubble and excess household debt
- Loss of household assets
- Rising unemployment
- Consumption and imports of the US likely to return to long-term trend
- This suggests sluggish recovery and lower potential growth in the post-crisis period

US household debt (total, mortgage)

Ratio to Disposable Income, %



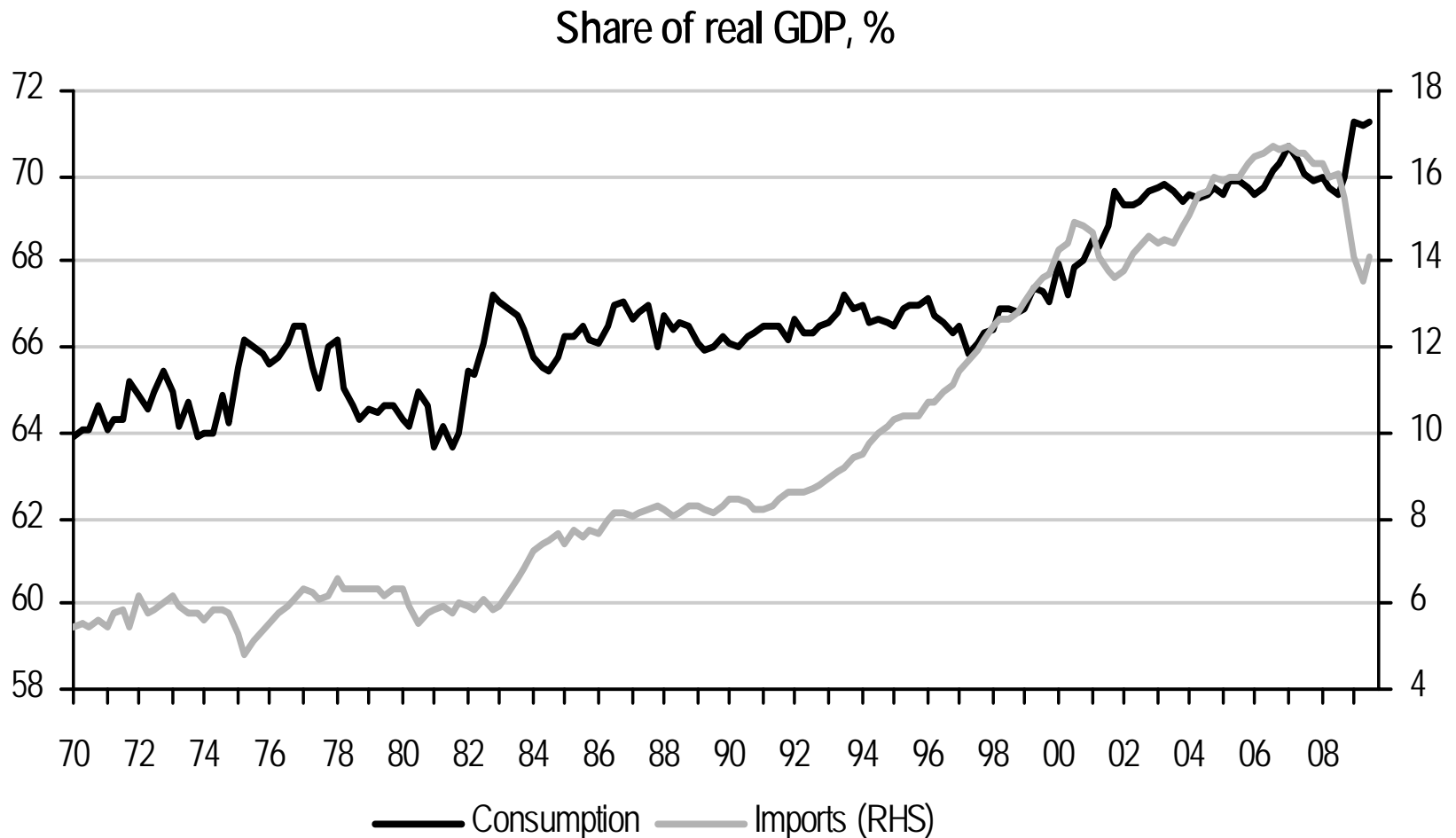
US households suffered a massive loss of wealth, and need to rebuild balance sheets



US and EU unemployment rates rising

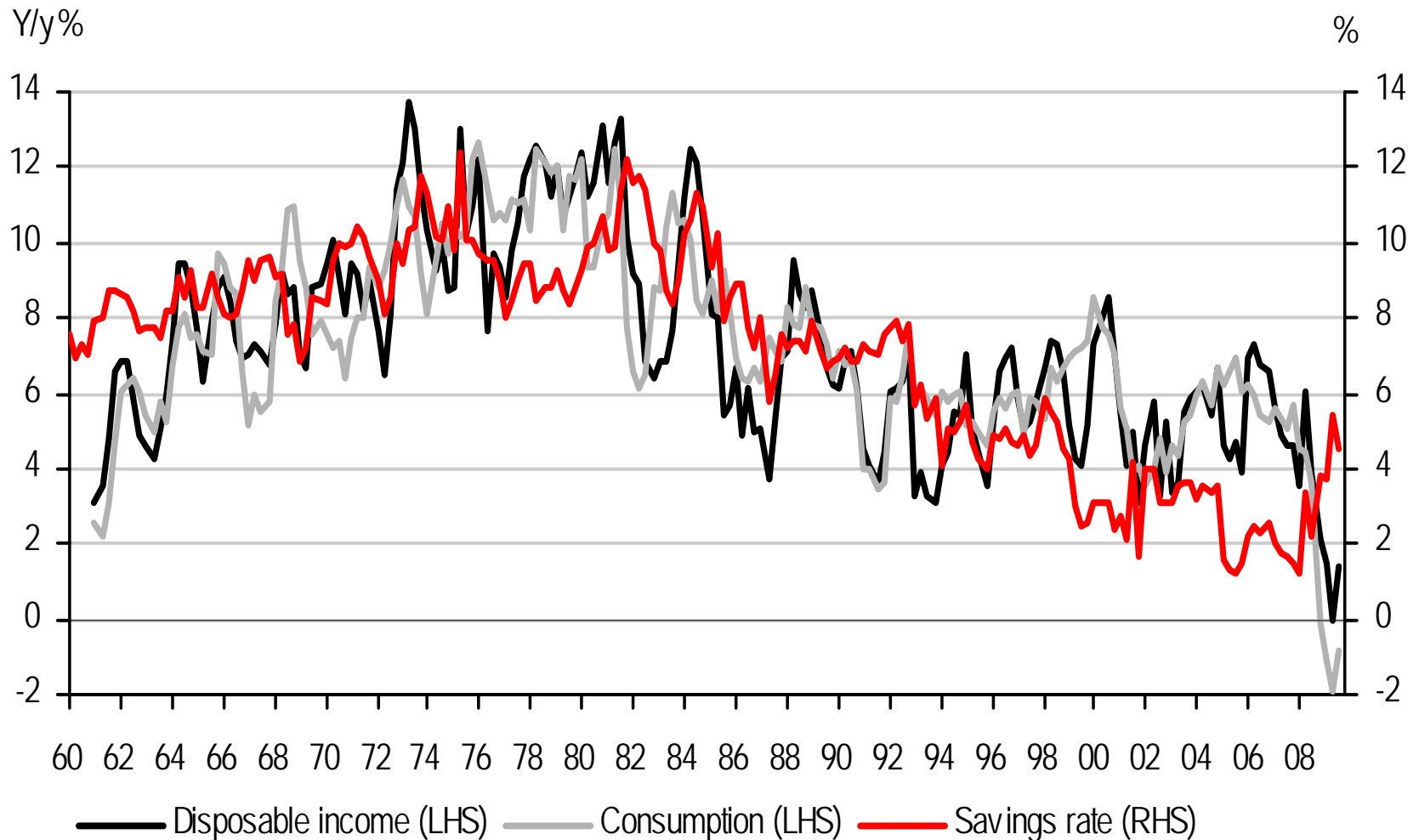


Share of consumption & imports in US GDP likely to return to LT trend



Source: CEIC

Consequently, US households' savings rate needs to rise, and spending slow



(4) Impact on Asia

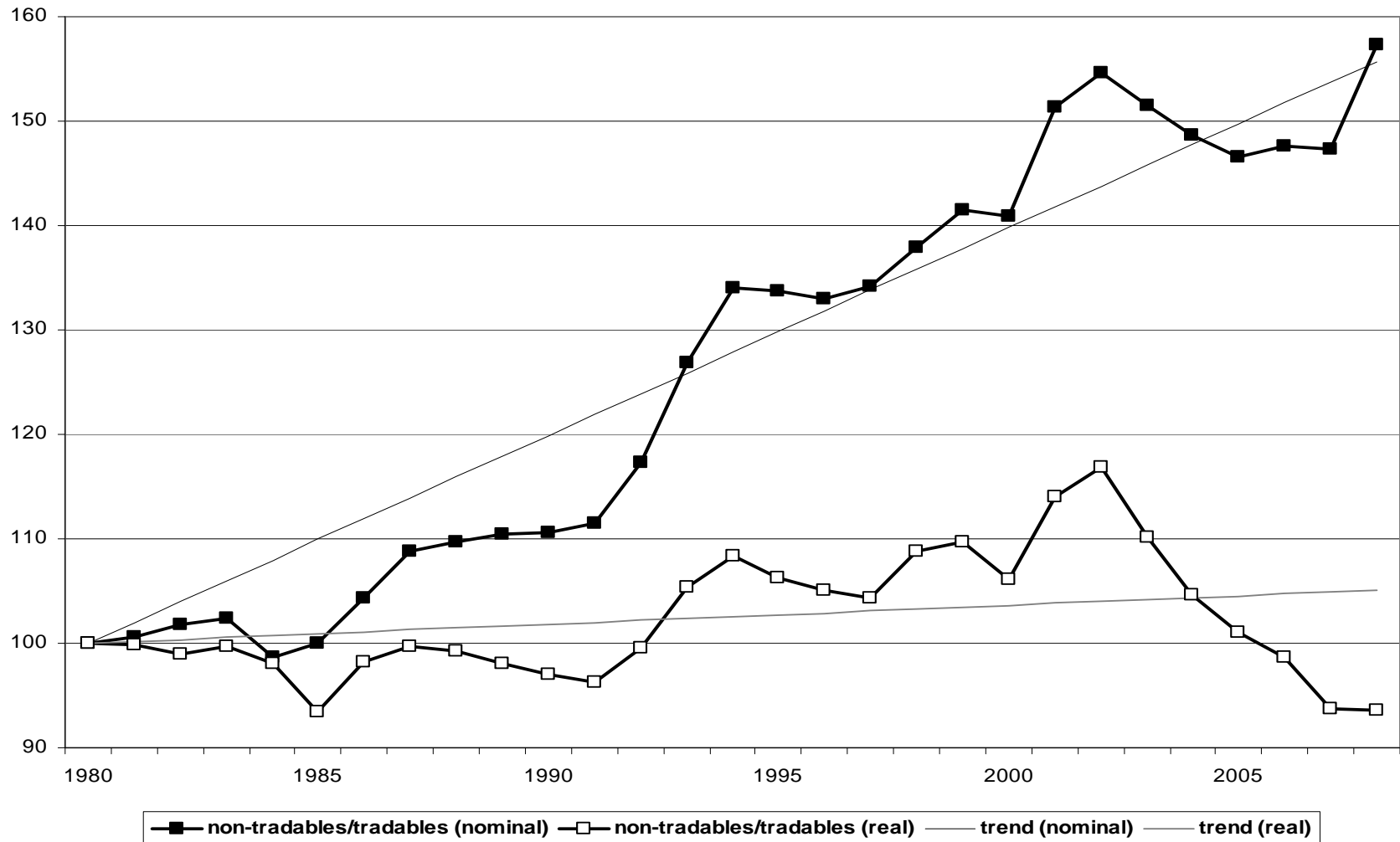
- Export collapse due to excessive dependence on the US and European markets for exports, particularly Japan, Asian NIEs, and export dependent middle-income ASEAN countries (like Malaysia and Thailand)
- Some limited financial contagion, particularly in Korea which almost had a currency crisis
- Loss of business and consumer confidence
- GDP contraction or slowdown
- But quick reaction with countercyclical fiscal and monetary policy

Final demand for Asian exports still comes from the advanced economies

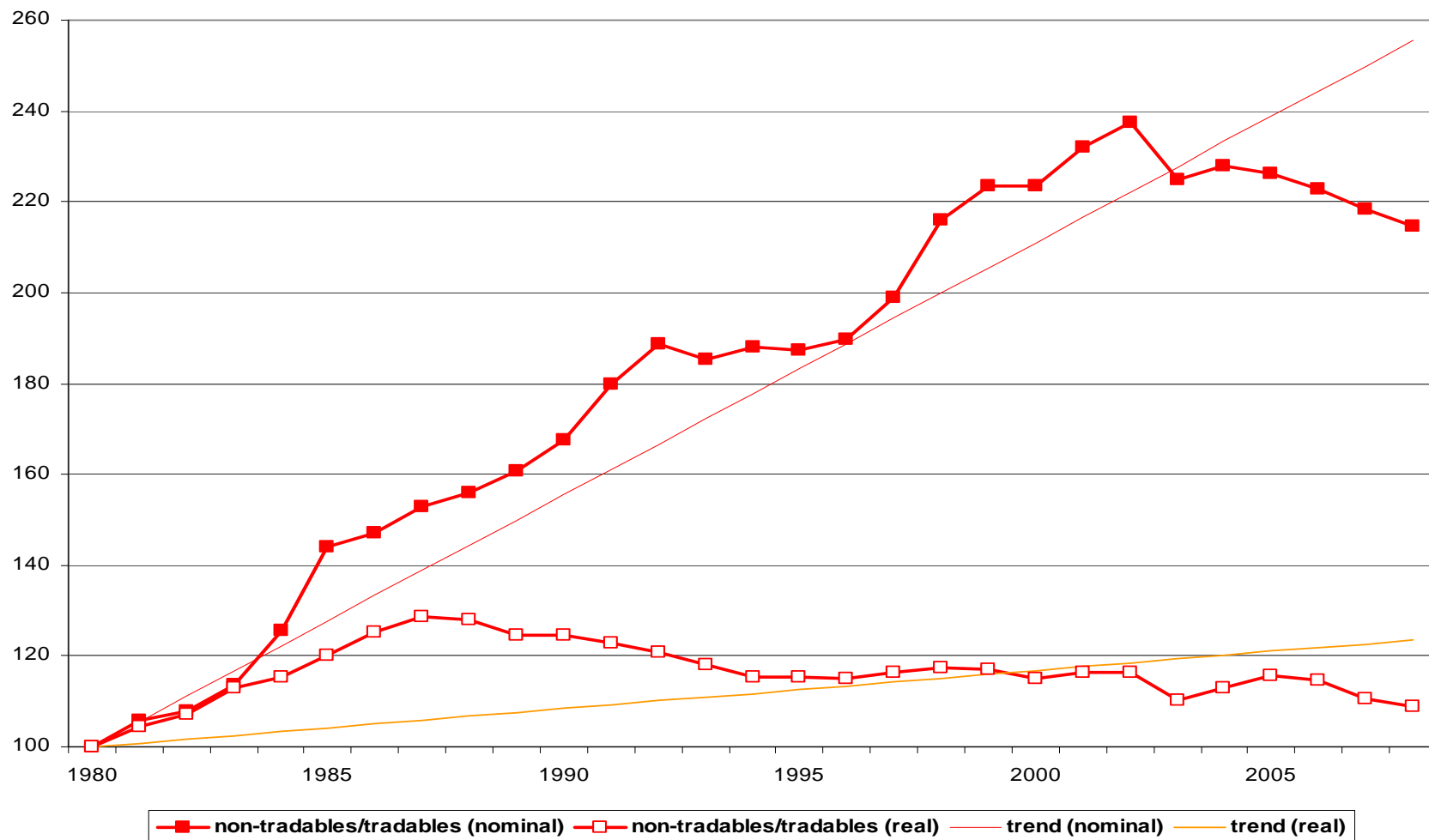
Final demand composition of Asia's export in 2006

Total Asia's exports = 100.0%					
Inside Asia = 51.8%			Outside Asia = 48.2%		
<i>of which to</i>			<i>of which to</i>		
final demand 16.5%	production 35.3%		final demand 23.2%	production 25.0%	
+	<i>of which to</i>		+	<i>of which to</i>	
	final demand inside Asia 15.1%	final demand outside Asia 20.2%		final demand inside Asia 0.9%	final demand outside Asia 24.1%
16.0%	← →		44.3%	←	
=			=		
Total final demand inside Asia 32.5%			Total final demand outside Asia 67.5%		

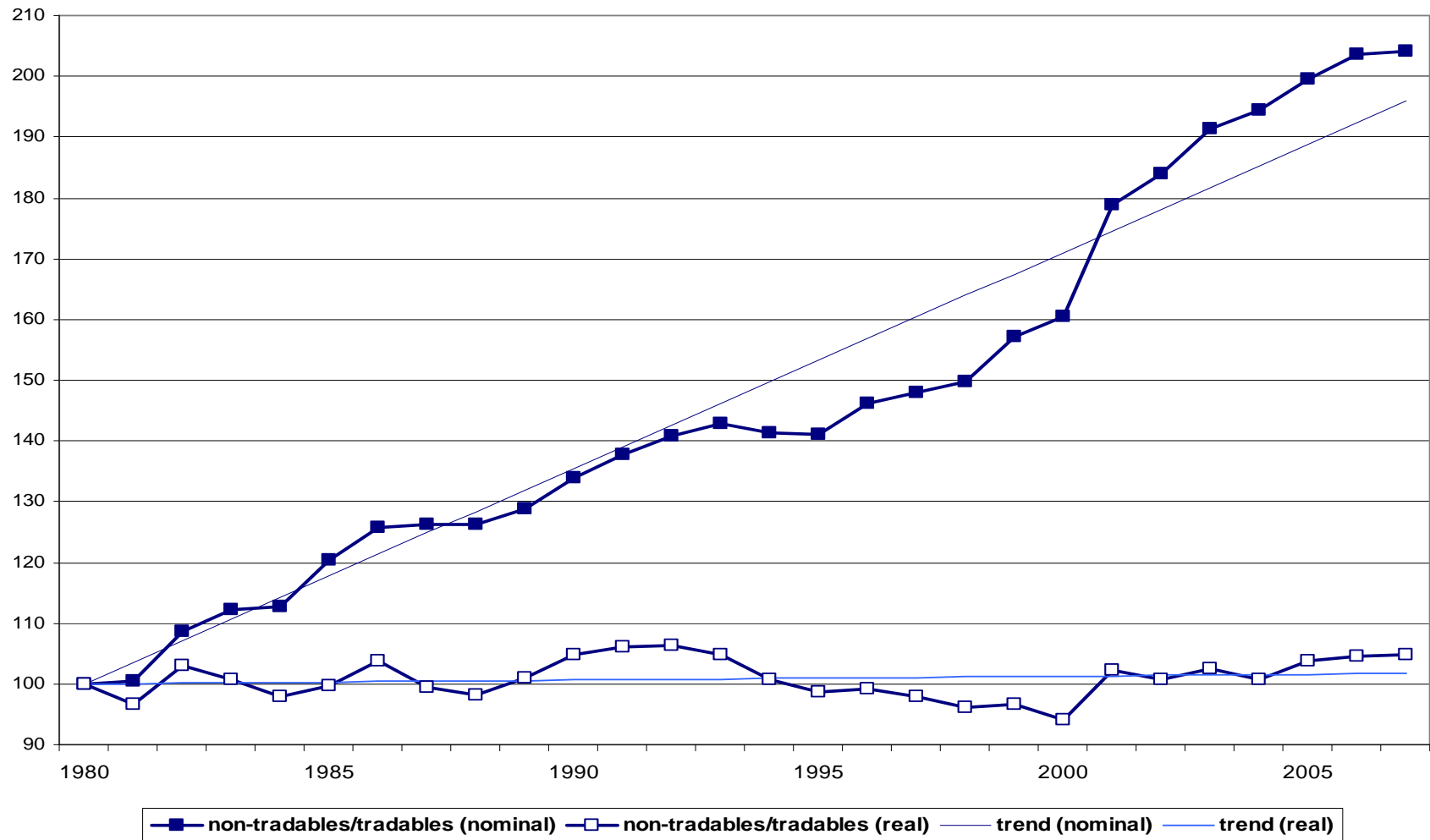
Japan's industrial structure recently shifted to the tradables sector



China's industrial structure has also shifted to the tradables sector



while the US industrial structure has shifted to the nontradables sector



Asian policy responses to the crisis

- Aggressive easing of monetary and fiscal policy, made possible because of ample policy room due to earlier prudent management
- Supported by strong fundamentals
 - Improved monetary policy frameworks
 - Strengthened balance sheets and reduced currency risk
 - High foreign exchange reserve levels

3. Economics of Growth Rebalancing

**(1) Current account
adjustment**

**(2) A CGE simulation
analysis**

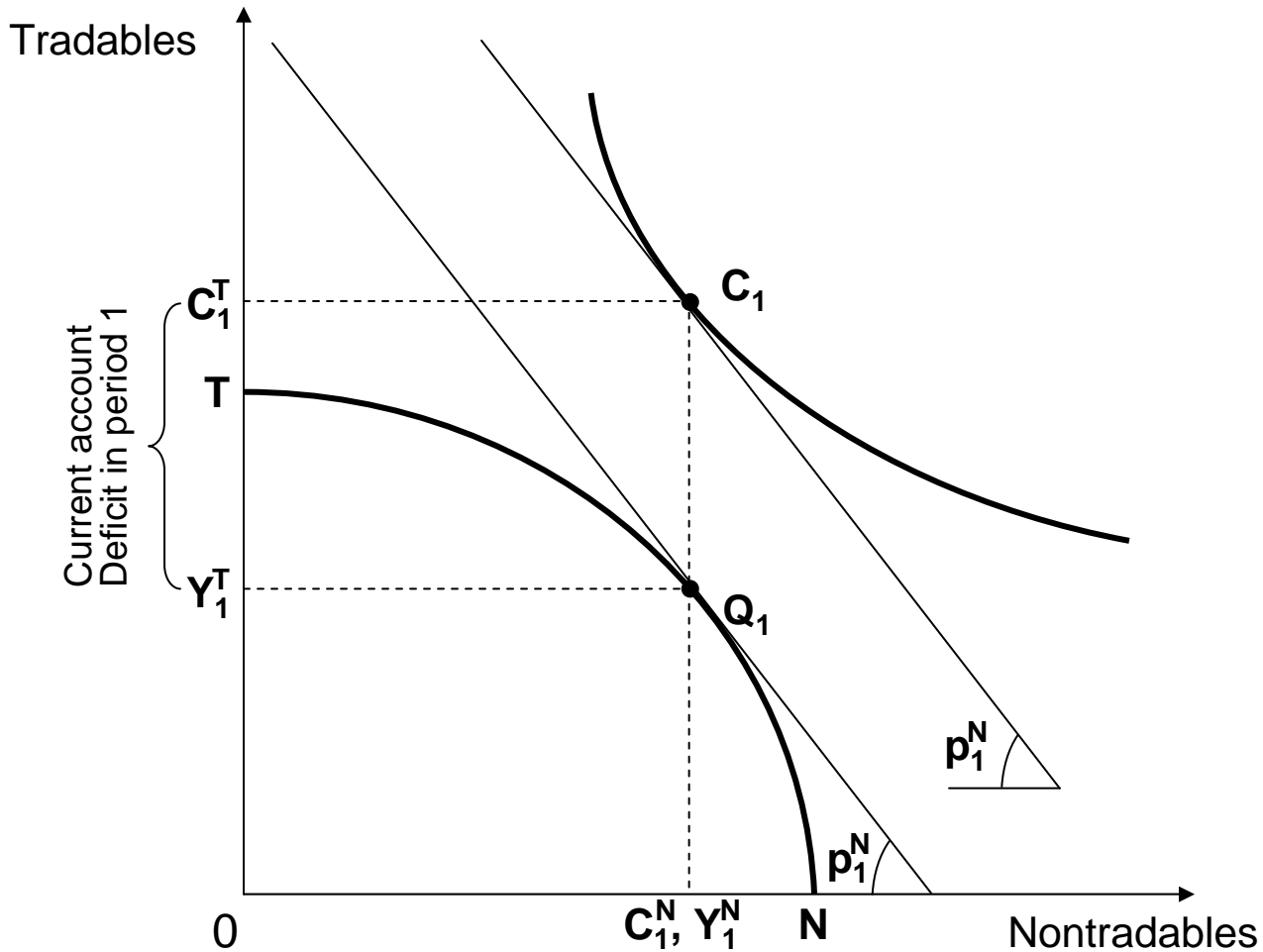
**(3) Demand side factors, and
inclusiveness and
sustainability of growth**

(1) Current account adjustment

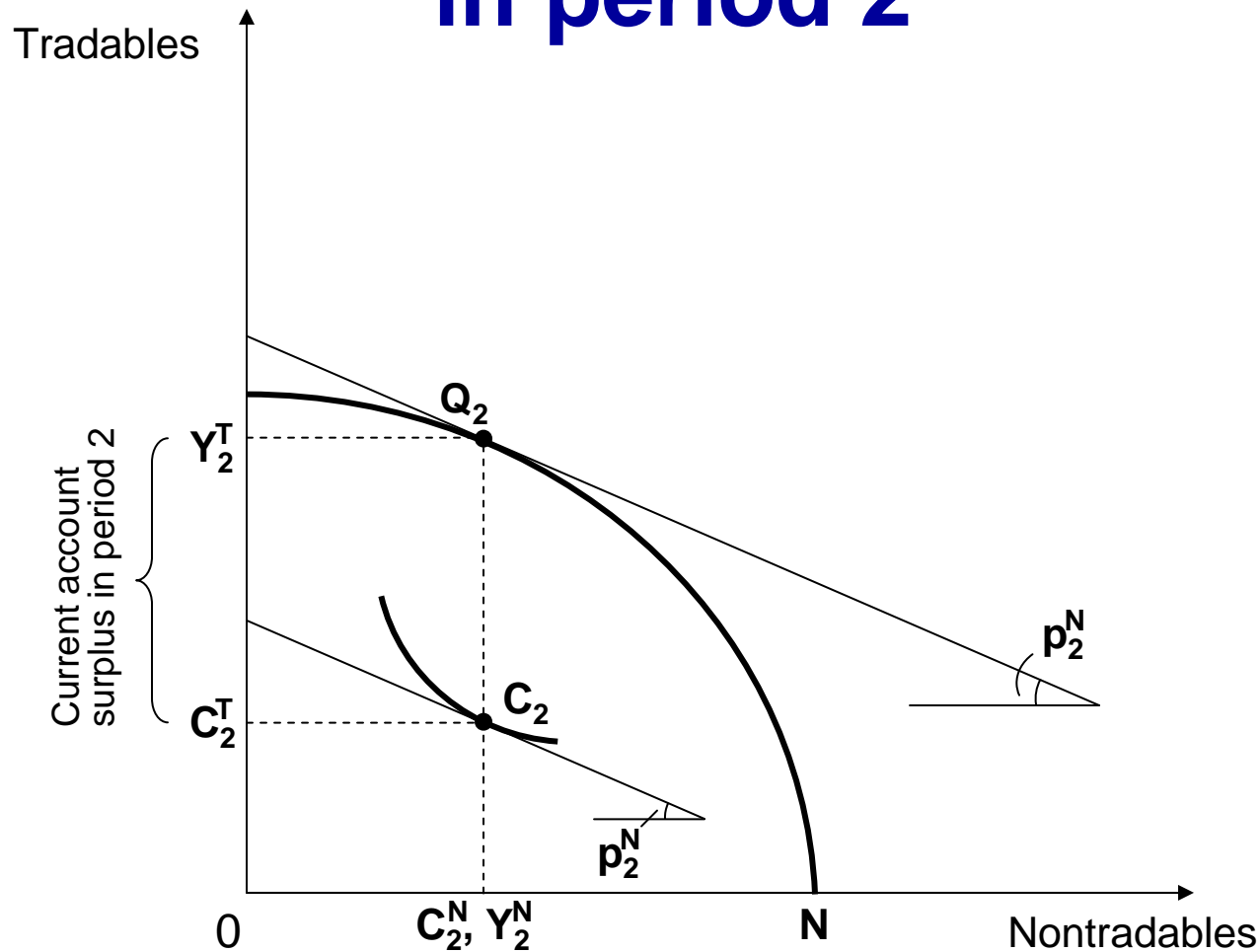
The tradables and nontradables model

- An intertemporal optimizing model of consumers (Figures 1-4)
- Firm behavior of investment can be easily incorporated, but not essential in this analysis
- There are no distortions that impede resource shifts between tradable and nontradable production
- Important role of the relative price of nontradable to tradable goods

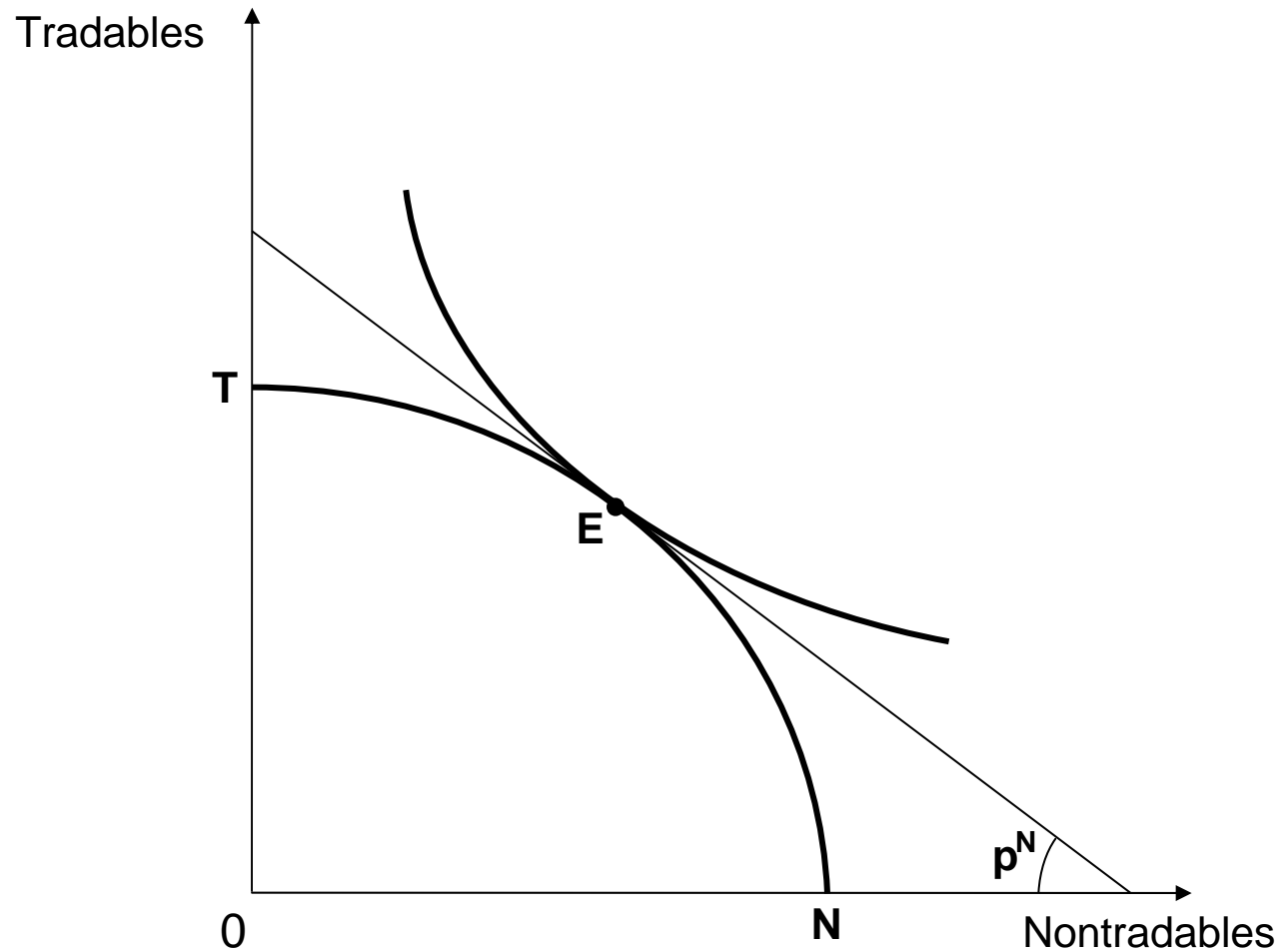
US CA deficit in period 1



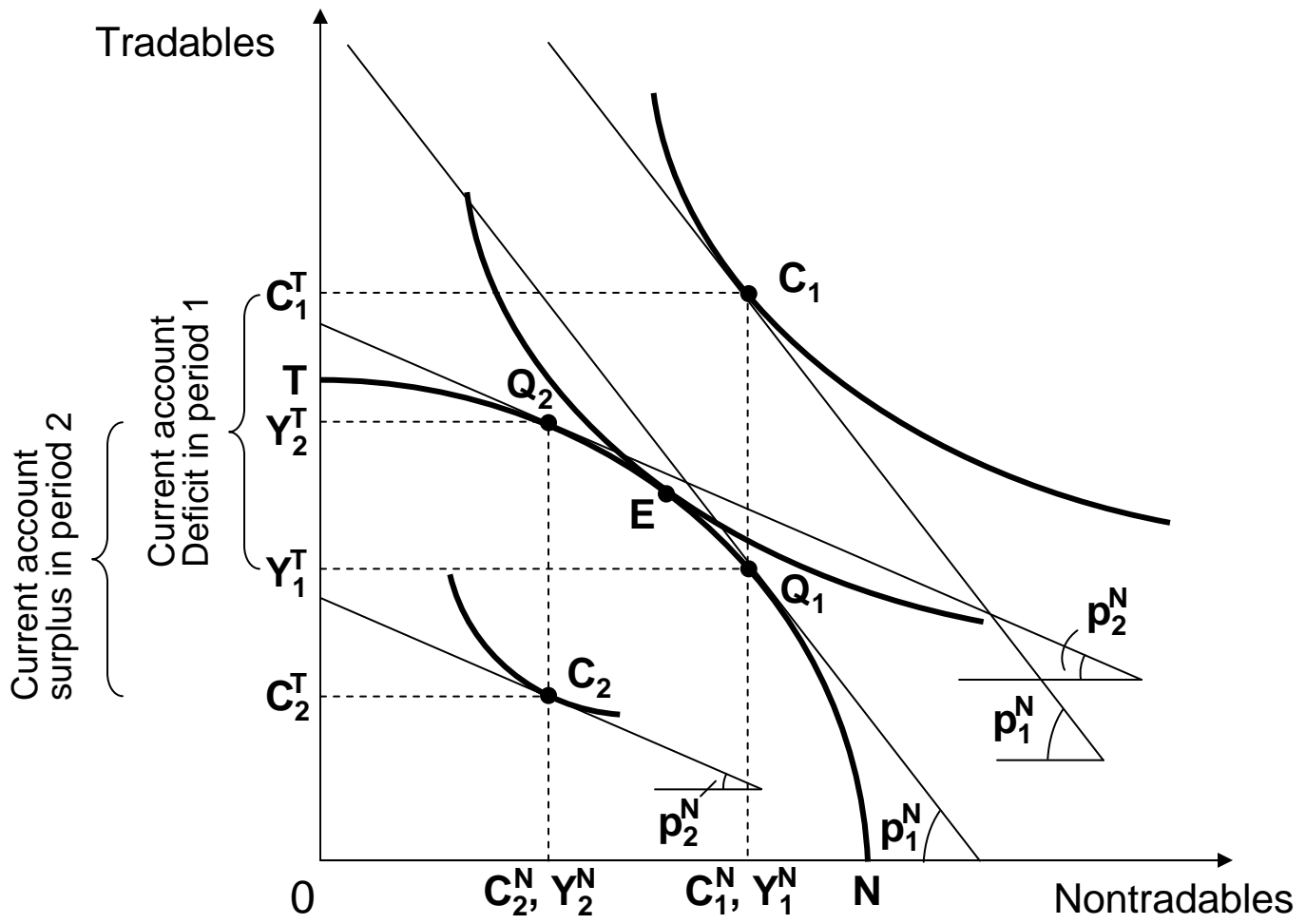
To be matched by a US CA surplus in period 2



CA in balance



CA adjustment in periods 1 & 2



(2) A CGE simulation study

Model assumptions

- Reduction of US consumption by 5% of GDP, which will induce US current account adjustment through real depreciation of the US dollar against the rest of the world
- US GDP potential growth declines by 1% point
- Exchange rate adjustment by non-US economies with constant bilateral real exchange rates among them, or exchange rate adjustment by East Asian economies only
- Current accounts endogenously adjusted
- Long-run full employment

Kawai and Zhai (2009)

Evaporation of US consumption (together with US growth slowdown) induces trans-Pacific adjustment

	CA (change as % of GDP)	Terms of trade (% change)	Real private absorption (change as % of GDP)
China	-2.7 [-8.8]	1.2 [4.0]	3.6 [10.9]
Japan	-1.1 [-3.6]	1.8 [5.7]	1.7 [5.3]
Korea	-2.0 [-5.8]	1.1 [3.1]	2.5 [7.2]
Taipei,China	-2.6 [-7.9]	1.0 [2.7]	3.8 [10.8]
Indonesia	-1.8 [-7.5]	0.9 [3.8]	2.3 [9.3]
MYS&SGP	-2.1 [-12.2]	0.4 [1.6]	4.7 [22.1]
Philippines	-2.6 [-7.6]	0.7 [2.5]	3.5 [9.9]
Thailand	-2.5 [-8.0]	0.5 [2.0]	3.2 [10.4]
Vietnam	-5.4 [-15.5]	0.8 [2.8]	4.9 [15.5]
USA	4.0 [4.0]	-6.4 [-6.4]	-6.9 [-6.9]

Note: Numbers in [] are the case of Asia-only adjustment.

Source: Kawai and Zhai (2009)

Asia's output adjustment differs across countries and sectors

Percentage change in output

	East Asia	China	Japan	Korea	Taipei, China	ASEAN6
Agriculture	1.2 [3.7]	1.0 [3.0]	1.9 [6.2]	1.1 [2.9]	3.1 [8.4]	0.6 [2.2]
Manufacturing	-1.8 [-4.9]	-2.2 [-6.0]	-1.8 [-5.2]	-1.4 [-4.2]	-1.7 [-4.5]	-1.0 [-2.0]
Textile	-2.7 [-9.4]	-3.6 [-12.7]	0.1 [-1.6]	-2.2 [-7.7]	-2.0 [-6.6]	-3.0 [-7.9]
Apparel	-3.0 [-7.6]	-3.9 [-11.9]	2.5 [5.7]	-0.1 [1.4]	-2.4 [-3.9]	-6.3 [-11.7]
Vehicles	-2.9 [-7.4]	-0.7 [-1.6]	-4.2 [-10.7]	-2.2 [-6.7]	-0.8 [-1.7]	0.9 [3.3]
Electronics	-1.9 [-5.0]	-2.9 [-6.9]	-1.8 [-5.4]	-1.5 [-5.0]	-1.9 [-5.6]	-1.0 [-1.1]
Machinery	-2.3 [-5.9]	-2.1 [-5.1]	-2.9 [-8.1]	-1.7 [-5.3]	-0.7 [-4.1]	-1.0 [-0.8]
Services	0.2 [0.6]	0.6 [1.5]	0.2 [0.4]	0.2 [0.6]	0.3 [0.6]	0.4 [0.9]

Note: Numbers in [] are the case of Asia-only adjustment.

Source: Kawai and Zhai (2009)

Findings of the CGE model simulation

- There will be a switch away from domestic demand-led growth to export-led growth in the US, and a switch away from export-led growth to domestic demand-led growth in non-US (particularly East Asian) economies
- A decline in US demand leads to structural adjustment in production and trade in East Asia
- East Asia's manufacturing sectors—such as vehicles, electronics and machinery—are major losers in the adjustment process, while its agricultural and services sectors are likely to gain from the expanded domestic demand

(3) Demand side factors, and inclusiveness and sustainability

Demand side factors

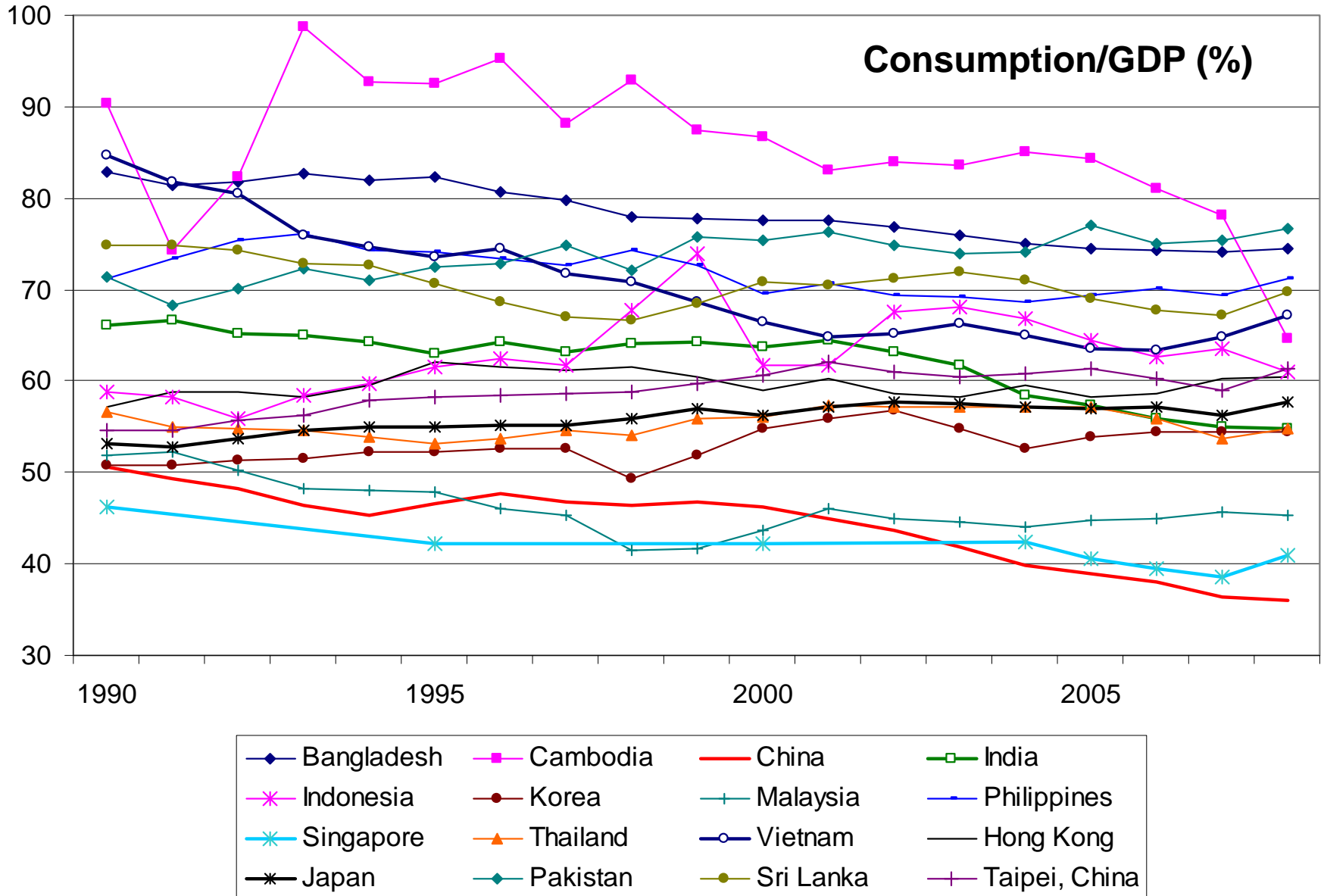
Household consumption

- Level of household income (or discounted sum of life time income)
- Propensity to consume (the rate of time preference)

Corporate investment

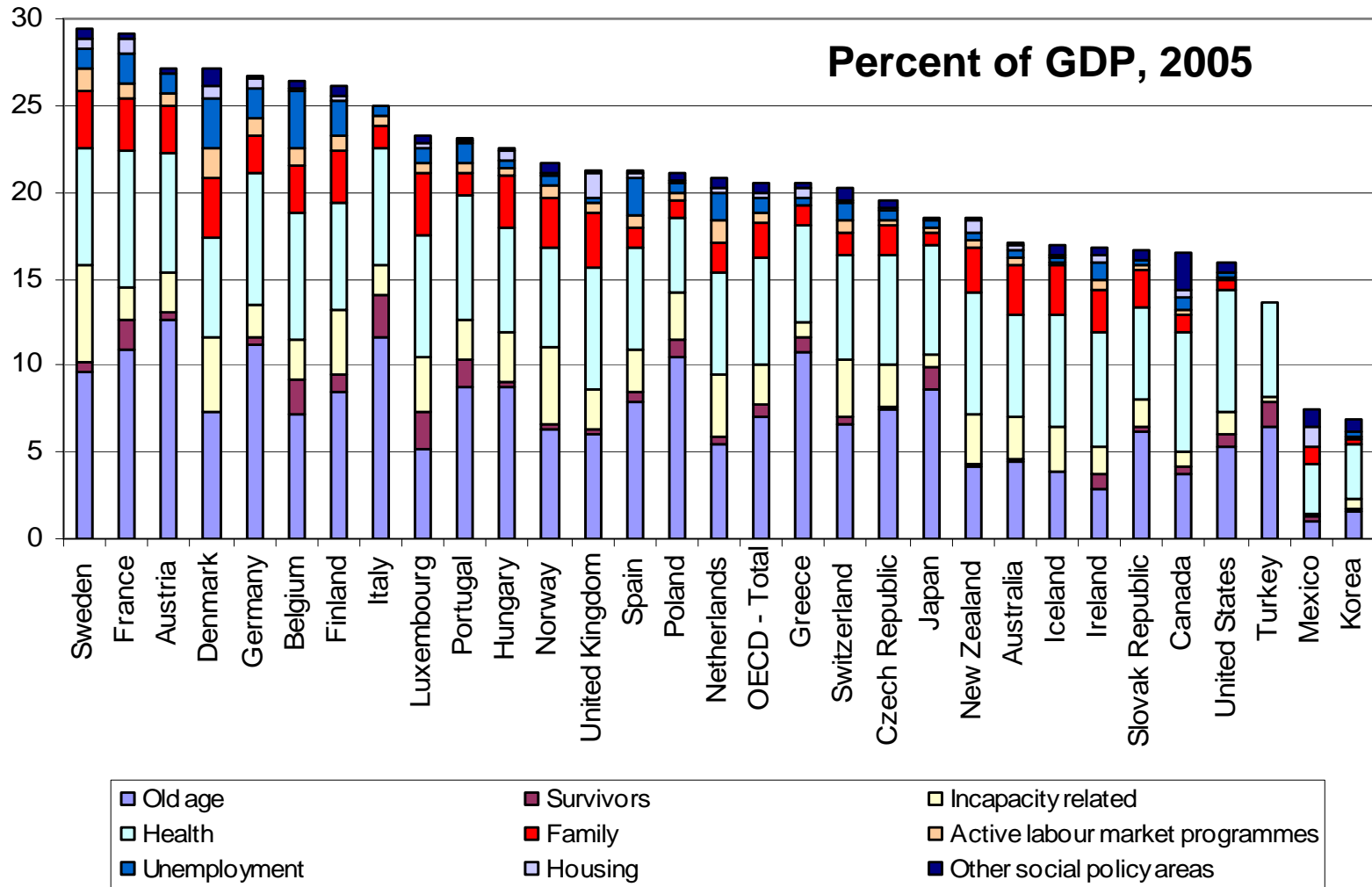
- Retained earnings (or saving) to be used for investment
- Investment climate

Asia's consumption/GDP ratios are low



Source: ADB, Key Indicators, 2009

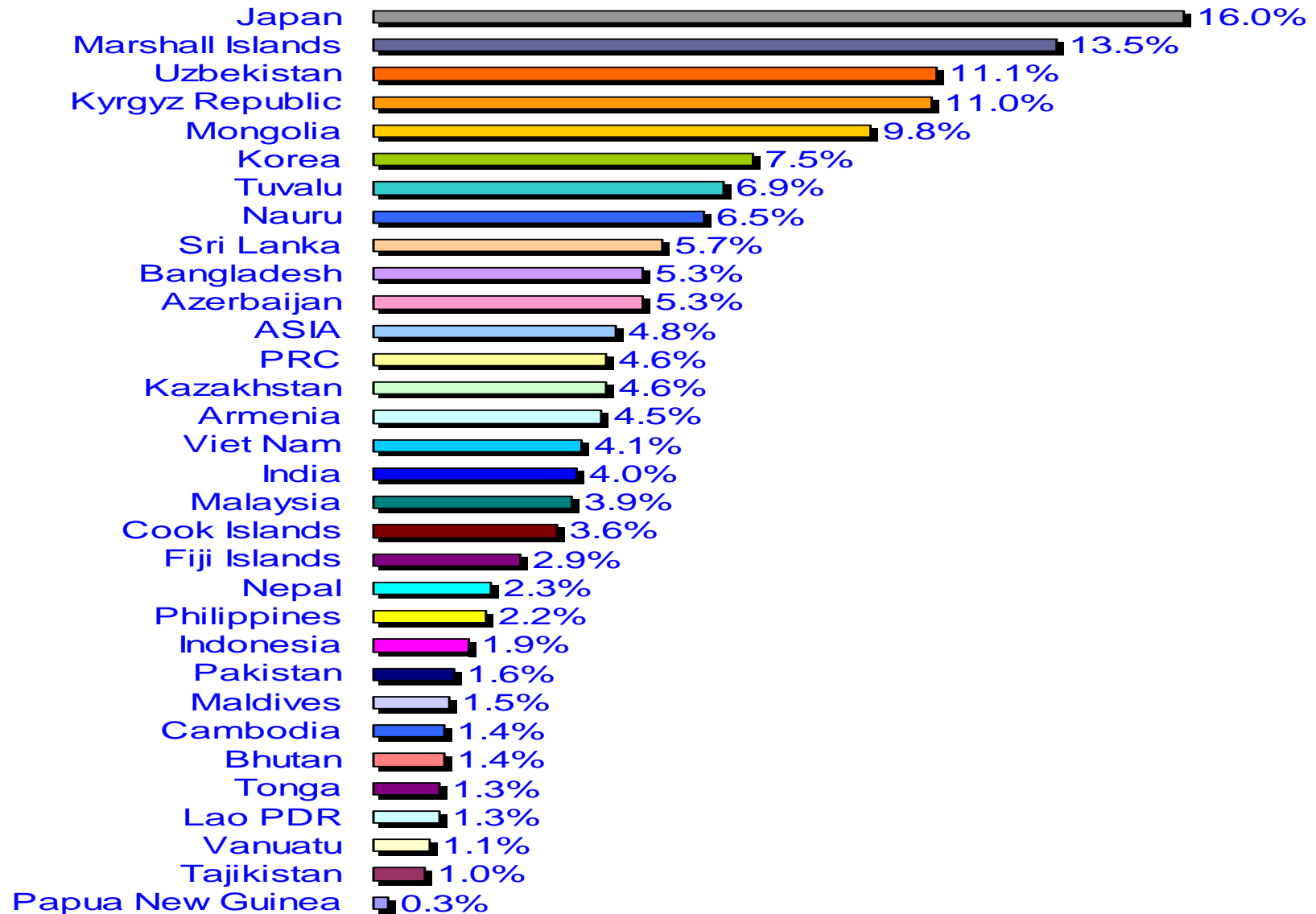
Social spending in Japan and Korea are low among OECD countries



Source: OECD

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Social protection expenditure as % of GDP



Inclusive growth, environmentally sustainable growth

Inclusive growth

- **Inclusive growth** promotes access to opportunities for growth and spreads the benefits of growth more equitably among all people and businesses
- Social sector protection
- Support for SMEs

Environmentally sustainable growth

- Anti-pollution, anti-climate change
- Energy efficiency and conservation

4. Policies to Rebalance Growth

- (1) Supply side policy**
- (2) Demand side policy**
- (3) Regional cooperation and integration**

Rebalancing growth

Stimulate demand for Asia's adjustment

- Large economies (Japan and China) must focus on domestic-demand driven growth
- Japan must develop its growth strategy by addressing the challenge of population aging and public debt, and focusing on green growth and cooperation with emerging Asia
- China needs to focus on social sectors (education, health and pension), rural sectors, the environment and energy efficiency
- India and ASEAN need to focus on investment through better investment climate and infrastructure investments

(1) Supply side policy

- Deregulation of the nontradables sector (health care, education, social services as well as new services with IT) to promote productivity growth
- Reduction of domestic distortions in factor markets (energy, resources, labor, land, credit, etc) particularly in China
- Improvement of financial systems for better financial intermediation
- Promotion of the green industry (energy efficiency, clean energy, environment)
- Investment in human resource development and knowledge

(2) Demand side policy

- Household consumption
 - Redistribution of income towards low-income households whose propensity to consume is high
 - Strengthen social sector protection to provide greater security thereby stimulating propensity to consume
- Investment strategy
 - Infrastructure investment with public sector support (enhancing physical connectivity)
 - Improvement of investment climate
 - Support of SME development & investment

(3) Regional cooperation & integration

A region-wide FTA

- ASEAN+3 or +6 FTA and investment area
- Liberalization and harmonization of investment rules

Financial market integration

- More efficient financial intermediation at the national level
- Regional financial intermediation through financial market integration (Asian Bond Markets Initiatives and Asian Bond Funds, including credit guarantee and investment mechanism)
- Macroprudential supervision and regulation

Financial safeguards

- East Asian economies are reluctant to go to the IMF because of the bad experiences during the 1997-98 crisis
- A credible CMIM needed to convince East Asian economies to accept growth rebalancing
- Flexibility in CMIM use needed—particularly at the time of the type of the crisis observed in Korea in Oct.-Nov. 2008—in line with IMF FCL
- Need to strengthen Chiang Mai Initiative (full multi-lateralization, IMF delinking, surveillance unit, and eventual creation of an Asian Monetary Fund)
- For this purpose, enhance regional surveillance
 - Involve central bank governors in the ASEAN+3 process
 - Establish an independent, professional secretariat
 - Seriously take up the exchange rate issue (ACU)

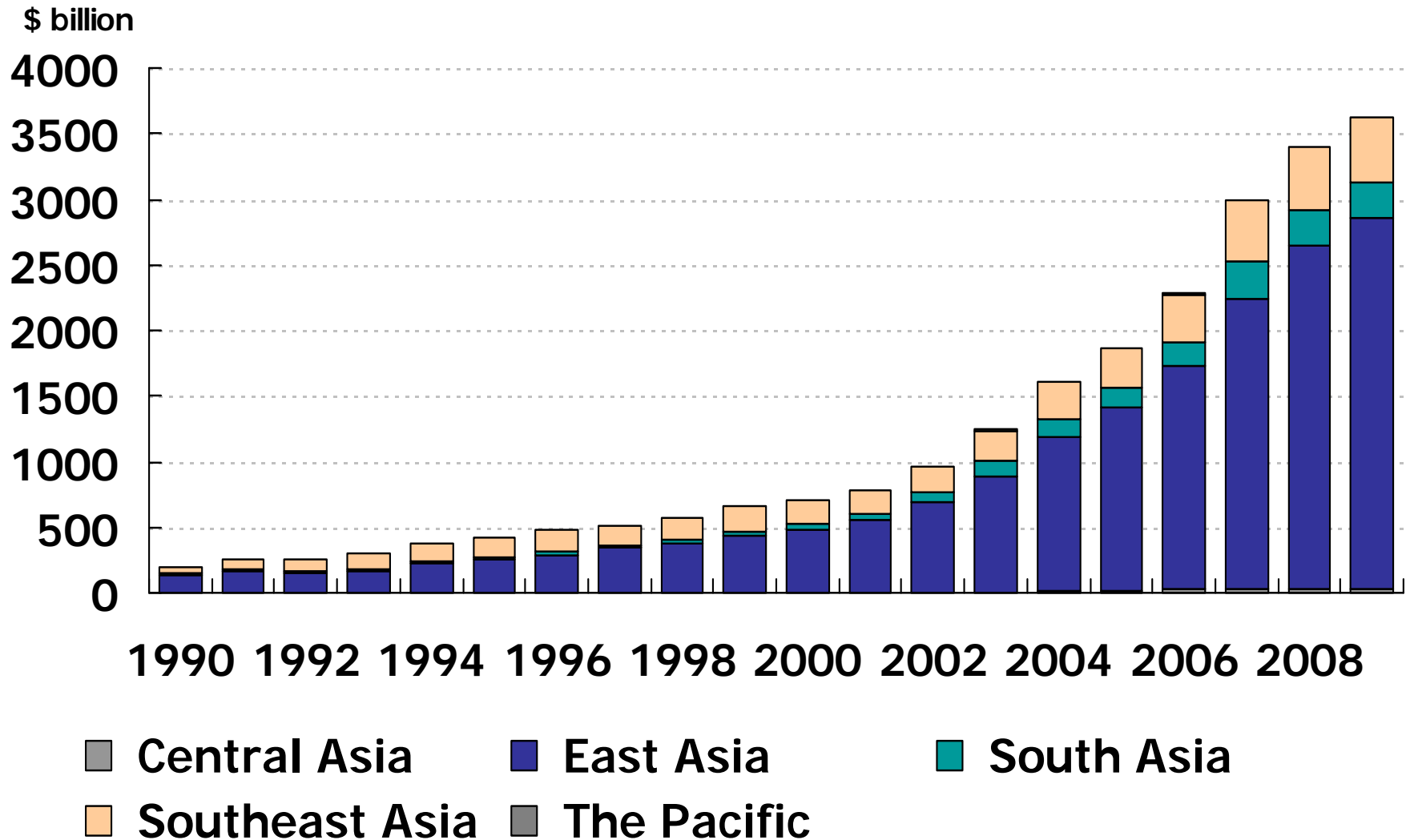
Exchange rate policy coordination

- An important mechanism of growth rebalancing through current account adjustment is a change in the relative price of nontradable goods
- Such a change can be achieved without significant economic costs by nominal exchange rate adjustment
- As many Asian economies will have to see real exchange rate appreciation to facilitate growth rebalancing, exchange rate policy coordination will be increasingly needed because of the heightened economic interdependence in the region
- This is particularly the case given the rising inflows of capital into the region

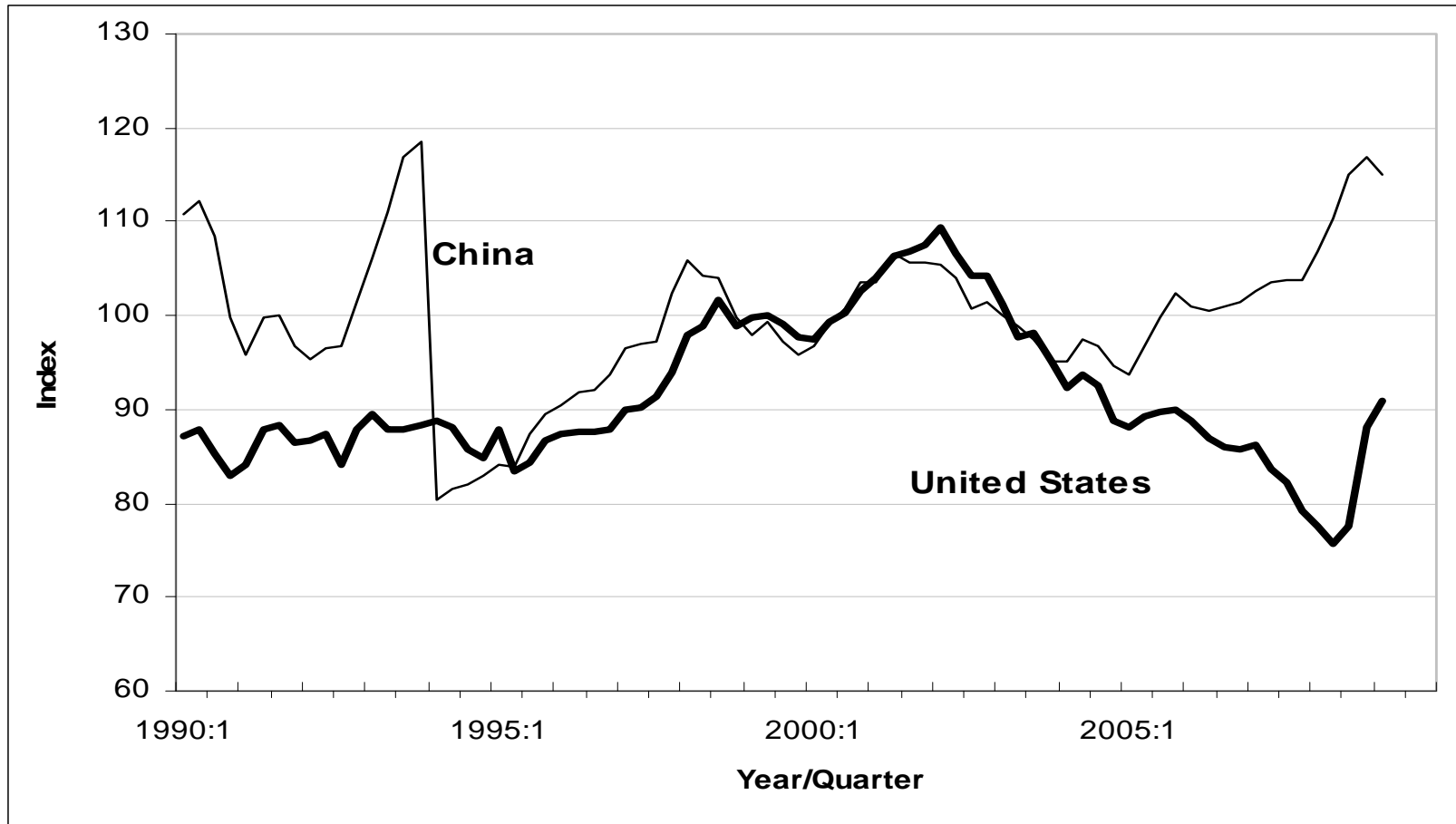
A case for collective currency appreciation

- To maintain domestic macroeconomic and financial sector stability in the face of rapid capital inflows, and to facilitate growth rebalancing, a collective currency appreciation vs. the US dollar is desirable.
- This policy maintains both the relative currency stability within the region and national financial and macroeconomic stability while minimizing the loss of price competitiveness
- This requires exchange rate policy coordination, and it can be facilitated by the use of ACU as a monitoring device

Developing/emerging Asia has built sizable foreign exchange reserves



REER trends: US rate was not exceptionally high until after 2005



5. Conclusion

- In the short run, Asia must shift away from public demand-driven growth to private sector-led growth
- In the longer run, Asia needs to develop a new growth paradigm:
 - (1) to shift away from external (US&EU)-demand driven growth to domestic and regional demand led growth
 - (2) A greater focus on **inclusive growth** (equity, access to opportunities)
 - (3) A greater focus on **environmentally sustainable growth**: a shift from a high- to low-carbon economy

5. Conclusion (cont'd)

- The global imbalance was a factor behind, even though not a dominant cause of, the global financial crisis
- External rebalancing requires closer policy cooperation in Asia: structural adjustment, regional market integration, regional infrastructure investment, stronger social sector protection, green growth, regional financial cooperation, and exchange rate policy coordination
- East Asia can seize this opportunity by focusing on inclusive growth: allow both poor and middle-income people to cope with economic risks, uncertainty and contingencies; empower SMEs
- East Asia's exchange rate management will be key to not only growth rebalancing but also macroeconomic and financial system stability

Thank you

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